THE COMMENTS RECEIVED WITH RESPECT TO THE DISCUSSION DRAFT REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

29 OCTOBER 2012

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
CENTRE FOR TAX POLICY AND ADMINISTRATION
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This document has been revised to include comments which were not compiled in the previous edition. (Added comments are marked *.)

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Dear Joe,

On 2 June 2012, Working Party No. 6 of the Committee on Fiscal Affairs of the OECD released three discussions drafts on (i) *transfer pricing aspects of intangibles*, (ii) *timing issues relating to transfer pricing*, and (iii) *transfer pricing safe harbours*.

*A3F* is pleased to respond to the OECD’s request for comments on these discussion drafts.

**A3F background**

*A3F* (French Women Tax Experts Association - Association Française des Femmes Fiscalistes) was founded in 2005. A3F is a French-based network of professional women from diverse horizons representing most actors of the French and international tax system (experienced tax executives and expert tax advisors from a wide range of French and foreign companies and law firms, MEDEF representatives, University professors, etc). The ever changing and rapidly evolving corporate and individual tax policies in France and around the world are a major concern for businesses. A3F provides its members with opportunities to exchange ideas and best practices, and to contribute to the shaping of tax policy through participation in public debates. A3F currently counts 90 members, all with a recognized work experience.

The president of A3F is Ms Eva Memran, Tax Director for a large French MNC. Ms Memran can be reached at +33 1 45 38 86 79 or eva.memran@accor.com.

**Conclusion**

*A3F* appreciates this opportunity to provide its views on the transfer pricing aspects of intangibles (outlined in the following pages). These comments were prepared by an ad-hoc A3F working group chaired by Ms Laurence Delorme. We will welcome an opportunity to participate in the subsequent public consultations and related discussions.

Respectfully submitted,

For *Association Française des Femmes Fiscalistes*

Laurence Delorme

For clarification of any aspects of this response, please contact:

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1. Discussion draft on the revision of the special considerations for intangibles in Chapter VI of the OECD transfer pricing guidelines and related provisions

<table>
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<th>A.</th>
<th>Identifying Intangibles</th>
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<tbody>
<tr>
<td>A.1.</td>
<td>In general</td>
</tr>
<tr>
<td>5.</td>
<td>&quot;In these Guidelines, the word &quot;intangible&quot; is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities&quot;.</td>
</tr>
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<td></td>
<td>• This first paragraph, which provides for a definition of the word &quot;intangible&quot;, should be very carefully and precisely worded, so as to avoid ambiguities generating uncertainty for taxpayers.</td>
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<td></td>
<td>• We suggest to replace the term &quot;something&quot; with &quot;asset&quot; (the word &quot;something&quot; is too vague and reminds of the previously used &quot;something of value&quot; which was also too vague), and to add the words &quot;legally&quot; and &quot;transferred&quot; in the definition: &quot;...the word &quot;intangible&quot; is intended to address an asset which is not a physical or financial asset, and which is capable of being legally owned, controlled or transferred for use...&quot;</td>
</tr>
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<td></td>
<td>• Question: does the reference to &quot;use in commercial activities&quot; in the definition assume there should be an objective to generate some profit from such commercial activity (profit being an indicator of some intangible value)? How about businesses operating as not-for-profit organizations such as cooperatives or other legal structures with similar tax characteristics?</td>
</tr>
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</table>

| A.2. | Relevance of this Chapter for other tax purposes |
| 1.2. | "The guidance ...is intended to address transfer pricing matters exclusively. It is not intended to have any relevance for other tax purposes". Reference is then made to different definitions of Royalties under DTT and under transfer pricing principles. Also, indication that "this Chapter is not intended to have relevance for customs purposes". |
| | • This paragraph should be made more specific and expand examples illustrating what the Chapter is NOT intending to be relevant for, e.g.: |
| | - Definition of intangible assets for application of registration duties upon transfer; |
| | - Accounting treatment (asset or expense) relating to payments made for the use of an intangible. |

| A.3. | Categorization of intangibles |
| 1.3. | "No attempt is made in these Guidelines to delineate various classes or categories of intangibles (trade vs marketing, soft vs hard, routine vs non-routine, etc). |
| | • We welcome this statement, as it eliminates the recourse to potentially very difficult and subjective distinctions, leading to uncertainty for taxpayer. |
### Goodwill and Ongoing Concern Value

- This whole paragraph should be made more specific as to why it is stated that "it is not necessary to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes" (such statement is a source of uncertainty for taxpayers), and that "In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis".

- The clarifications should introduce the difference between consolidated financial statements, and financial statements on a legal entity basis, only the latter being directly relevant for the purpose of transfer pricing analysis.

- We suggest at a minimum to add the words "directly" and "consolidated" in above sentence: "In most instances, accounting and business valuation measures of consolidated goodwill and ongoing concern value are not directly relevant for purposes of transfer pricing analysis".

### Assembled workforce

"...as a factual matter, [the transfer or secondment of isolated employees] may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm's length dealings".

- We strongly disagree with this statement which opens the door to high uncertainty for taxpayers.

- Even if the transferred employees have been contributing to the development of some valuable IP, their transfer or secondment cannot result in a transfer of such IP from their former employer to their new one. An employee is not an asset (within the above definition of "intangibles" under 5 above), and therefore an employee's transfer or secondment cannot be characterized as a transfer of an intangible.

- We suggest to consider adding a test based on common sense on this question, by reference to observed third-party practices (e.g. other than athletes transferring from one club to another, what are the cases in "real life" where a price is paid by one company for "acquiring" an individual employee working in another one?).

### Identification of Parties Entitled to Intangible Related Returns

**Business is requested to comment as to whether the formulation contained in section B successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks.**

- "In determining which members of an MNE group are entitled to intangible related returns with respect to an intangible, the following factors should be considered: ...(ii) whether the functions performed, the assets used, the risks assumed and the costs incurred by members of the MNE group in developing, enhancing and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns ..."

- Costs are not always a relevant indicator of the value of an intangible (this is particularly true
in emerging markets where assets and costs involved in establishing a market may be limited for some players, yet the value of the associated intangible may still be very significant).

- We suggest including the words "if relevant" in the sentence: "... the risks assumed and, if relevant, the costs incurred..."

### B.1. Registrations and contractual arrangements

30. "Legal registration and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns."

- There may be cases were a valuable intangible has been developed which is neither legally protectable (e.g. groundbreaking ideas allowing breakthrough development on a new market), nor covered under a contractual arrangement established ex-ante between the parties (e.g. it was not anticipated). The wording of this paragraph may suggest that where no protection is possible or has been anticipated through legal registration or other contractual arrangement, no right to the intangible would accrue to the developer.

- We suggest adding the word "existing" at the beginning of the sentence: "Existing legal registration and contractual arrangements..."

### B.2. Functions, risks and costs related to intangibles

(i) Functions

40. "It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities."

- We welcome this reference to practices between independent enterprises when it comes to Outsourcing, and suggest that this statement be emphasized by adding more specific reference to observed outsourcing practices, and how such practices should guide the transfer pricing analysis.

- A first test based on common sense relates to the type of activities that are commonly outsourced between independent parties: those associated to the core business and strategic proprietary value drivers of the company are rarely outsourced to third-parties (or the company might otherwise lose its competitive advantage). Hence in most cases, outsourcing an activity should not be analysed as triggering a transfer of an intangible for transfer pricing purposes, based on this common sense test applied to the specific facts and circumstances.

- A second test should focus on analysing the observed practices in the specific industry sector relevant to the outsourced activity, which may provide useful guidance on terms and conditions between independent parties (scope of outsourced activities, obligations of parties, risk allocation, etc). For example, pharmaceutical enterprises frequently outsource part of their R&D activities to Contract Research Organizations, and part of their manufacturing operations such as Filling & Packing, to third-party enterprises (sometimes their competitors). Even if the existence of such "internal comparables" does not generally allow to quantify an arm’s length compensation merely on the basis of existing third-party agreements, it does provide very useful guidance on terms and conditions, and more generally conduct of the parties in a comparable situation between independent parties, and recourse to this analysis should be encouraged.
40. "It is expected that ...the entity claiming entitlement to intangible related return will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles";

- Despite the attempt to define in the following paragraph the terms "important functions", we suggest to make this definition more specific, as it may otherwise be a source of great uncertainty for taxpayer.

- Also, the terms "physically perform" as a test for attributing entitlement to intangible related return may not be adapted to the organization of international groups managed globally in today’s world of digital communications, with management and control functions exercised by individuals located anywhere in the world, in charge of geographic and/or operational divisions spread across multiple countries, and participating in management committees where key strategic decisions are made, which take place each time in different parts of the world, or do not even take place physically but via videoconference instead.

41. "It is expected that ...the party ...claiming contractual entitlement to intangible related returns will exercise control over the performance of those functions and associated risks, ..."

- We suggest to add the words "in substance", ie "will exercise control in substance over the performance of those functions and associated risks". Indeed, it may not be sufficient for the entity claiming entitlement to intangible related return to exercise such control merely through some delegation of authority to another group entity which is the employer of the people exercising control, and which invoices the costs of these people.

(ii) Risks

43. Particular types of risks that may have importance in considering the entity or entities entitled to intangible related return

- The list of example should be expanded, or alternatively presented as non exhaustive.

44. • Last sentence in paragraph is completely unclear (there seems to be a few words missing).

- Does this also include costs related to failure of a strategy on the intangibles? aside from running costs (costs of performing a function) as well as
<table>
<thead>
<tr>
<th></th>
<th><strong>Arm's length compensation for functions performed by associated enterprises related to the development, enhancement, maintenance and protection of intangibles</strong></th>
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<tbody>
<tr>
<td>51</td>
<td>Marketing functions performed by an associated enterprise acting as a marketer/distributor, and question as to &quot;whether such marketer/distributor should share in any present and future intangible related returns attributable to the trademarks and related intangibles&quot;.</td>
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<td>- We welcome the recognition that a distributor of a branded product may, in some circumstances (illustrated with two examples), operate as an &quot;at risk distributor&quot; and claim entitlement to sharing in the benefits of marketing activities that increase the value of the trademarks and related intangibles.</td>
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<td>- However, we suggest to add a third example (which would be an intermediary between the agency structure described in paragraph 50, and the two &quot;at risk distributors&quot; examples in this paragraph.</td>
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<td>- This additional example should cover the case where a distributor of a branded product would NOT be entitled to trademark return, even after having incurred marketing costs for developing brand awareness on the local market, simply because under the arrangement with the supplier of the branded products, the marketer/distributor is attributed an arm's length return after incurring such marketing expenses (typical case where the TPM is TNMM, or Resale Price operated at Brand Contribution level, i.e. gross margin net of advertising expenses).</td>
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<tr>
<td>52</td>
<td><strong>Outsourcing R&amp;D or manufacturing functions</strong></td>
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<td></td>
<td>- Examples should be tested against evidence in third-party dealings. See comments under 40 above.</td>
</tr>
<tr>
<td>54</td>
<td><strong>Transfer pricing adjustments in cases involving entitlement to intangible related return</strong></td>
</tr>
<tr>
<td></td>
<td>In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance...</td>
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<td>- The words &quot;in substance&quot; should be defined, and illustrated with examples.</td>
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<td>- See comments under 40 and 41 above.</td>
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<tr>
<td>55</td>
<td>&quot;Where relevant functions, risks and costs are in alignment with legal registration and the terms of the relevant contracts, the contractual allocation of entitlement to intangible related returns should generally be respected by tax authorities, and transfer pricing determinations should be made on the basis of that allocation of intangible related returns. Where such risks, functions and costs are not in alignment....., transfer pricing adjustments may be appropriate to assure that each member of the group is properly rewarded for its risks, functions and costs&quot;.</td>
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<td>- This last paragraph, which provides grounds for tax authorities to make adjustments, should make explicit reference to the arm's length principle and to adjustments, if any, being made after comparison with third-party practices, as suggested repeatedly above.</td>
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### C Transactions involving the use or transfer of intangibles

#### C1 Transactions involving the use of intangibles in connection with sales of goods or services

<p>| | |</p>
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| 60 | • This example is worded ambiguously.  
• It should be made clear that, while the patents used in the manufacturing may affect the value of the cars, there is no reason to believe that they should also affect the transfer price to the associated distributors, given that these do no acquire any rights in the manufacturer’s patent.  
• We suggest the inclusion of a new paragraph at the end of section C.1, aimed at preventing tax authorities from attempting to artificially separate a deemed royalty from a “bundled” product price, for the sole purpose of assessing withholding taxes or other taxes on the deemed royalty.  
• For example, in case of a distributor involved in the purchasing of branded products for resale on the local market, the transaction on goods may be priced by the brand-owner/supplier at a price including an implicit license to use the intangible (i.e. brand) for distributing the product on the market. Tax authorities should be encouraged to respect the contractual arrangement, conduct of the parties and selected transfer pricing methodology for the product transactions (in this case, resale price or TNMM) when these do not separate the licence through a separate royalty flow. |

#### C2 Transactions involving the transfer of intangibles

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<tr>
<td>(ii)</td>
<td>Transfers of combinations of intangibles</td>
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</table>
| 70 | "...it is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles which, as a matter of substance, cannot be separated".  
• Reference should be made to third-party dealings in the relevant industry. |

| (iii) | Transfer of intangibles in combination with other business transactions |
| 70 | See also comments at the end of paragraph C1 above. |

| 73 | "Business franchise arrangement" involving the provision of a "combination of services and intangibles to an associated enterprise for a unique fee".  
• It should be stressed that even in case where no reliable comparables can be identified for the entire service/intangible package, segregating the various parts of the package of services and intangibles for separate transfer pricing considerations may not be possible and may therefore be purely artificial if the services and intangibles are too closely connected and inter-related, and if the "Business Franchise arrangement" is so unique that it cannot be compared to third-party practices. |
**D**  
Determining Arm's Length Conditions in Cases Involving Intangibles

**D1**  
Conducting a comparability analysis in a matter involving intangibles

(i) **In general**

81 "A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles".

- This statement should be explained and illustrated with examples. See also comment under 83 below.

83 **Realistically available options**

- It should be emphasized that there may be other counterparts/benefits for the transferor/transferee to be taken into consideration when assessing whether the outcome is less favourable that its realistically available option

(ii) **Intangibles as a comparability factor in transactions involving the use of intangibles**

86 • How in practice is it possible to get into such a level of details when conducting the comparability analysis (i.e. considering "development of customer list and customer relationship, advantageous logistical know-how and software and other tools that it uses in conducting its distribution business")???

87 • Next paragraph 87 acknowledges that "in many cases, parties to comparable uncontrolled transactions will also have the same types of intangibles at their disposal".

• Only tax authorities (but not taxpayers) may have access to such type of detailed information through their tax audit experience of other taxpayers, but in such a case they would be using secret comparables which are to be discouraged.

(iii) **Comparability of intangibles and rights in intangibles**

90 "...it is essential to consider the unique features of the intangibles and the specific terms of the transfer...".

- Because each intangible is unique, and because of the difficulties in conducting a comparability analysis with regard to a transfer of intangibles or rights in intangibles, it should be accepted by tax authorities that such comparability analysis will only provide an arm's length range, not a specific price.

- Transfer pricing is not an exact science, and this is particularly true for intangibles.

(e) **Stage of development**

98 In conducting a comparability analysis involving partially developed intangibles, it is important to evaluate the likelihood that further development will lead to commercially significant future benefits.

- This example should be developed and clarified, notably as to its implications on the transfer pricing analysis
Comparability adjustments with regard to intangibles

103 "If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions."

- Given that identification of reliable and relevant comparable intangibles or comparable transactions in relation to intangibles is often extremely difficult because of the unique features of the intangibles, we suggest to encourage more explicitly the use by taxpayers and acceptance by tax authorities of more than one transfer pricing method for testing and documenting compliance with arm's length pricing in intangibles-related transactions.
- The use of several transfer pricing methodologies may provide a combination of "converging hints" proving useful in reaching a conclusion on arm's length pricing (range), instead of sticking to e.g. a single analysis of unsatisfactory comparables.

Section D.1.(iv) intangibles

105 This paragraph should be clarified, as the practical implications of such "Section D.1.(iv) intangibles" category are unclear.

Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

(i) In general

108 "The functional analysis should identify other factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected and any adjustment incorporated in that method based on the comparability analysis, should appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions".

- Examples would be welcome to illustrate this statement, which is not clear in its practical implications.

(ii) Use of valuation techniques

110 "Valuations of intangibles contained in Purchase Price Allocations performed for accounting purposes are not relevant for transfer pricing purposes."

- This statement should be further developed and illustrated (perhaps again by reference to the difference between consolidated financial statements and legal entity financial statements). PPA is recorded only in consolidated accounts, and as such may indeed not be directly relevant for transfer pricing purposes.
- Conversely, there may be cases where valuation of intangibles for PPA purposes in the consolidated accounts may be entirely relevant for transfer pricing purposes. For example, in case of an acquisition of a business including a brand (which is legally owned by the acquired legal entity). If such brand is fully amortized for PPA purposes in the consolidated accounts of the acquiring MNE, it may be consistent with the fact that no brand royalty is paid to the legal entity owning such brand by the brand users. Conversely, if some value is recognized to the brand in the consolidated accounts, it does not mean that the full brand value should be attributed to the brand legal owner, as there may be other legal entities contributing to the brand value and entitled to brand related return.
"Financial valuation techniques based on the cost of intangible development should usually be avoided".

- This statement is not true in all circumstances.
- For example, marketing development costs (in the form of advertising expenses, as well as sales promotions) incurred over time by brand-owner and/or brand-user may be a relevant indicator, absent any meaningful comparables. At a minimum, they may provide an indication of a minimum level of return which would be expected by the licensor and/or licensee.

Use of transfer pricing methods based on estimated cost of reproducing or replacing the intangible. Case of "development of non-unique intangibles used for internal business operations (e.g. internal software system)"

- We note that internal software system recognized as an intangible, however this seems to be the only place in the report where there is a reference to such type of intangible.
- An example is provided to illustrate the provisions of this paragraph, and the difficulties faced by MNEs in dealing with the arm's length allocation of expenses and intangible related returns associated to internal development of software systems such as ERPs and other costly and complex information systems developments.

Use of more than one method
"The principles set out in paragraphs 2.11, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the use or transfer of intangibles".

- The use of more than one transfer pricing method (providing a combination of "converging hints") should be more strongly encouraged when it comes to matters involving the use or transfer of intangibles, as it is sometimes the only way of approaching arm's length pricing (esp. when no meaningful comparables can be identified because of the uniqueness of the intangible).

Application of rules of thumb
"...application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee, is discouraged".

- Rule of thumb may be a useful practical way of testing reasonableness of the split in intangible related returns arrived at through complex valuation models, which often are highly sensitive to a number of assumptions each individually hard to justify. As such, rule of thumb may be a practical and useful "sanity check".
- Depending on facts and circumstances, rule of thumb may validly be included in the suggested combination of "converging hints" (see above 116) proving useful in reaching a conclusion on arm's pricing, instead of sticking to analysis of unsatisfactory comparables.

Determining and arm's length price for transactions involving the use of intangibles in connection with sales of goods or services

- Situations where reliable comparables exist
(ii) Situations where reliable comparables do not exist
<table>
<thead>
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<th>Determining and arm's length price for transactions involving the transfer of intangibles or rights in intangibles</th>
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<tbody>
<tr>
<td>(i)</td>
<td>Transfer pricing methods where comparable independent transactions can be identified</td>
</tr>
<tr>
<td>135</td>
<td>&quot;Valuation of intangibles on the basis of mark-ups on development costs is unlikely to provide an accurate measure of value and is discouraged&quot;.</td>
</tr>
</tbody>
</table>

- This statement may not be true in some circumstances, e.g. marketing development costs or new product launch costs may in some circumstances provide a good indicator of respective contributions to the development of marketing intangibles (see comments on paragraphs 112 and 113 above)
- This method a valuation by reference to development costs may be a method of "last resort" (used in combination with other methods) in cases where no meaningful comparables can be identified.
**Additional Example #1**

**Example** to illustrate considerations for intangible property regarding an asset (internal software) developed and shared through an Agreement of Costs Distribution (ACD)

1. A MNE group is constituted by 9 subsidiaries (S1 to S9) based in 9 different countries. Company A is in charge of services functions for the Subsidiaries. The teams of IT maintenance are employed by S and are in charge of the group IT maintenance as well as internal consulting for the subsidiaries.

2. **The Group decides to develop an IT community project which development will spread out over 2 years.** The project is developed by S1 with the assistance of A. Since the beginning, S2, S3 and S4 decide to join the project in order to use the software when developed.

3. Under this circumstances, the 4 subsidiaries formalize through an ACD the sharing of the costs, the right granted to each of them, the consequences if the project is not finalized, the conditions to get out of the ACD before the ending contractual period, the rules if a new subsidiary decides to join the ACD in order to use the software in its territory.

4. During the development phases, the gross costs of A are recharged to S1 (i.e. subsidies or R&D tax credit received are not deducted from the total costs). Then the total cost, on a yearly basis are partially recharged to S2, S3 and S4 based on the agreement. Those costs are classified in each company books as current fixed asset.

5. The year the software is being operational, each subsidiary becomes an "economic owner" of the software, having the right to use the software for no further consideration. No transfer of intangible is being identified, as the funders have a free right of users in counter part of their financial contributions in the development of the software. S1 is the legal owner. Therefore S2, S3 and S4 are not holding a license right, instead they obtain a free access to the software.

6. During the normal use of the software, S5 express its intention to use the software in its territory. S5 will pay to the funders an entrance fee which corresponds to its contribution to benefit from a technology which was developed before. S5 does not assume any risk. This entrance fee shall be equal to the value of its part of the economic intangible it acquires.

7. During the normal use of the software, one of the funder decides to stop using the software in its territory. The other members of the ACD will buy back to him a part of the intangible. This member will have to take out of its book the intangible.

**Questions raised by this example and not treated in the Discussion draft:**

- The R&D costs are not relevant to decide of the value of the intangible created. What shall be considered in the circumstances: market value ? accounting value ? How to treat the difference in the company who has the legal ownership?
- Which indicator shall be decided in order to share the costs ? (turnover ?, operational result ?, number of stores ? ...)
- New user, user getting out the ACD : how to qualify the transfer of the intangible ? what is the legal qualification of the entrance fee ?
14 September 2012

**Additional Example #2**

1. X is the trademark owner of a renowned brand for consumer goods.
2. Historically, these consumer goods were distributed in Europe by X.
3. 20 years ago, X was willing to penetrate the Asian market and has used the services of Y acting as a regional distributor for the trademark, thereby purchasing from X the goods and reselling them to local distributors in each of the Asian countries. Y applies OECD transfer pricing methodology with its local distributors: TNMM. This TNMM is not questioned by local Asian countries.
4. X has been over the years behaving as a passive trademark owner, most of the operations except manufacturing and creation, being performed at regional level by Y.
5. The role of Y was to build up a market recognition in Asia for the trademark and to suggest appropriate distribution channels, train local personnel, advertise and enhance the trademark reputation and notoriety.
6. To this end Y has incurred some costs but these costs, due to location savings, proved to be quite reasonable as compared to cost generally incurred by X to market its products in the European territories.

**Questions raised by this example and not treated in the Discussion draft :**

- Based on these facts, did company Y become entitled to intangible related returns by virtue of the functions, risks and costs it has assumed? Is there, aside from the trademarks and know-how, some other intangibles that have been developed by Y?
- Can resources allocation and general knowledge of the region, the markets and the purchasers be recognized as know-how under the OECD definition?
- Is Y the economic owner of some of these intangibles?
- Should it be compensated when Asian clientele developed thanks to its input, is travelling to Europe? In other words, is Y entitled to a share of profits derived by X in its own European market on purchases made by Asian travellers? Should Y be compensated with a commission on such sales?

**Tentative response :**

- Intangibles developed by Y should not be recognized as such, but should be factored in Y remuneration when setting TP on products sold by X to Y.
- However, in respect of profits made by X out of purchases by the mobile Asian clientele travelling in Europe, X should compensate Y for :
  (i) the loss of revenues suffered by Y in respect of travelling Asian customers ;
  (ii) investments made by Y to develop brand awareness with these Asian customers.
- In an ever increasing globalized environment, to the extent IP rights are territorially restricted, profits derived from travelling clients should be reallocated to the company which has developed intangibles in the home country of the client.
PROPOSED REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS.

Comments to the OECD Discussion Draft on the special considerations for INTANGIBLES in Transfer Pricing Guidelines

SEPTEMBER 2012
Introduction

The Spanish Association of Tax Advisers (AEDAF), created in 1967, gathers university graduates who are specialists in taxation and tax consulting, working whether as self-employed or as an employee.

The main purpose of the AEDAF is to provide its members with the best instruments and consulting issues to carry out an excellent professional activity. The members of the AEDAF come from both the professional and the university sector. The AEDAF offers its members a great added value though a constant and quality education and information to be applied in their day to day activity, publications of interest, professional meetings regarding fiscal matters and the regular exchange of information and knowledge among its members.

AEDAF has numerous working groups that discuss issues of particular relevance in certain areas of taxation. The members of the International Taxation group are professionals specialised in advising multinational groups in international taxation, as well as in transfer pricing matters.

We consider the discussion draft provided is a great document, which although not definitive, already provides a good guidance and some certainty in such an ambiguous issue. With our comments we intend to provide some ideas and opinions that based on the experience of our associates could somehow be addressed in this document.

The following members of the AEDAF’s International Taxation and Transfer Pricing Working Groups have participated in the preparation of these comments:

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1. Definition of Intangibles and related items in section A

Section A.1 intends to provide an idea of what should be considered as an intangible in the Transfer Pricing Guidelines. We are aware of how difficult is to delimit certain issues involving intangibles, where being too precise may lead to conflict but on the other hand, being too generic may lead to uncertainty. However, we believe that the fact that accounting, tax and legal definitions shall differ from those provided for Transfer Pricing purposes may lead to confusion within the same taxation jurisdiction, being these even more problematic when dealing with different tax systems, as important differences may lead on what is considered as an intangible.

In this sense, we consider that if it is intended to provide a concrete Transfer Pricing definition for intangibles, this must be very precise. The proposed definition is in our opinion somehow slightly generic and may include some elements of difficult identification and quantification which could lead to conflicts. We believe that some more details in the description of intangibles as well as a more precise delimitation would help its understanding.

For example, identifying and grouping elements that may be involved when dealing with intangibles as “illustrations” may bring to confusion, it may not seem clear enough what shall be considered as a pure intangible (and subject to separate compensation) and what should be considered as a service rendered or a comparability factor. We believe that together with a more precise definition of intangibles in section A.1, a change in the structure of section A.4 where illustrations are provided would help in the understanding and classification of what shall be and shall not be considered as an intangible. A small change in the structure when dealing with the definitions of intangibles, providing a clear separation between a) Intangibles and b) intangible comparability factors should help, in our opinion, to clarify both concepts. This structure could somehow be combined by including paragraphs 23, 24 and 25 (illustrations of Group Synergies, Market Specific Characteristics and Assembled workforce) under section d.1.Ill that describes specific features on intangibles in a comparability analysis.

Additionally, a more precise definition could be given for goodwill and ongoing concern value. The draft addresses possible situations of when these elements could be considered but not specific definitions or features are provided for their identification.

Moreover, we miss in this draft a concrete definition of marketing or marketing-related intangibles. These are addressed in some of the examples illustrated in section D.5. but in our opinion, a specific mention under section A definitions or under section D.1.Ill. would be useful for a better comprehension. We understand that there should be a clear differentiation between two possible situations; i) a marketing intangible that would arise when a
restructuring or transfer of distribution rights occurs, that should be included within the goodwill valuation, and ii) marketing efforts beyond those an independent distributor with similar rights may incur that could be compensated as a lump sum or as a reduction of the sale price in an equivalent amount. In this case, an independent distributor would expect a compensation for the cost of these marketing efforts plus an appropriate margin instead of obtaining a share of the intangible related returns.

In this sense, as we will further explain in point 2, we consider that these elements could be classified as comparability factors or services rendered on behalf of the brand owner. Only in cases where the marketing activities are performed as part of a cost sharing agreement, a share of the related intangible returns would be considered.

2. Example 5 in section D.5 regarding marketing intangibles

Example 5 addresses a situation where a marketer/distributor assumes higher marketing expenses than potential comparable companies. Therefore, it might be assumed that an adjustment in its functional analysis and the remuneration of the transaction shall be considered. In this case, the draft suggests that an independent distributor would obtain a return on the investment on intangibles from the brand owner; this would be compensated as a reduction in the price of the product or as a reduction of royalties according to the wording of paragraph 51 or as a service provided according to paragraph 49. However, example 5 considers also an alternative approach by applying a residual profit split method to determine such compensation.

The fact of considering an excess of performed functions, costs and risks incurred on marketing activities as a potential benefit derived from intangibles may lead into several conflicts given the difficulties that would arise in their identification and valuation. This may not necessary represent the behavior of an independent distributor.

From the example’s wording it may be understood that this excess in functions may lead to the creation of a “marketing intangible” subject to compensation.

As previously discussed in point 1, in our opinion the excess of functions, risks and costs assumed should be treated as services rendered which costs must be invoiced with its reasonable additional margin or compensated with an equivalent amount as a reduction of the purchase price or a reduction in royalty rate. However, we consider that the possibility of sharing returns by applying a profit split method, as stated in paragraph 200, would hardly be agreed between an independent distributor and the brand owner.

3. Issues with regard to Chapter B. Identification of the parties Entitled to intangible related returns.

In our view, this Chapter establishes a principle for allocating income derived from the intangible assets based on a functional, costs and risks alignment associated with the asset, and this criterion could imply a substantial deviation from the traditional and consolidated
rule of allocation of income based on legal ownership or legal rights on the asset; this traditional rule, as it is known, can be set aside applying substance over form rules when an abusive scheme is present according with the facts and circumstances of the case. So it is not crystal clear the foundations and need for a new principle of allocation of income for intangible assets.

In our view, the functional alignment principle so established can be very problematic in practice for its intrinsic uncertainty; the assessment of such functional (costs and risks) alignment would be very dependent on the facts, and generally the tax authorities of the several countries involved would undertake a different or asymmetric approach to such issue. Furthermore, it is far from clear the interrelationship of this functional alignment test with the tax treaty clauses containing the beneficial owner rule.

In sum, the functional alignment principle can generate a good number of high voltage cases of international double taxation. In that sense, the OECD should restrict the application of this functional alignment rule to exceptional cases. A more detailed guidance with regard to the application and implications of this principle should be developed, as well as effective mechanisms for the avoidance of the double taxation that can occur in these cases.

4. Double taxation risk guidance to Tax Administrations considering intangible adjustments

Divergences may arise when dealing with intangibles between several tax authorities at the same time, especially considering that the treatment of these may vary within different tax jurisdictions. Given the potential risk of suffering double or anticipated taxation when a tax authority may consider the existence of transactions involving intangibles, we miss some kind of guidance or recommendations to tax authorities in order to avoid or assess future disputes.

For example, double taxation may arise when one Tax Authority may consider a transaction involving intangibles and this adjustment has an impact in the financials of another company in a different tax jurisdiction. The country of residence of this last company may have some restrictions in the deductibility of intangibles amortization and double taxation may arise. This is the case of goodwill under Spanish Corporate Income Tax Law where there are limitations to the deductibility of goodwill amortization when acquired to a related party.

In this sense, we suggest the inclusion of some kind of recommendations to Tax Authorities in order to allow the deduction of any intangible related costs, including goodwill amortization, when these come from related parties. This should specially be addressed when the intangible cost or expense has been originated by a Transfer Pricing adjustment from a different Tax Jurisdiction.
5. **Assumptions regarding tax rates**

Paragraph 169 of the Discussion Draft states that prices for transfer pricing purposes under a discounted cash flows analysis must typically be determined on a pre-tax basis.

Nevertheless, the existence of R&D incentives both in the form of grants and/or tax credits with a different impact in the pre-tax result should difficult the comparability analysis. While grants represent a lower cost and therefore a better result in a pre-tax level, a tax credit cost reduction will affect at the post-tax result level.

For these cases, a post-tax based analysis shall guarantee a more homogeneous and consistent comparable information since the different effect in the pre-tax result will be neutralized.

* * *
A. Identifying Intangibles

**Uniqueness of know-how**

Discussion Draft – Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (“the draft”) has taken an economically sensible approach by asserting that intangibles are not defined solely by accounting treatment (para 6 (of the draft, as the case may be)) and by legal, contractual or other types of protection (para 7). From a practical point of view, it may be difficult to determine what constitutes the line or test for the absence of intangibles. For example, the description of “non-unique” know-how (para 9) appears to suggest that such know-how is not associated with intangible related returns. If so, the test of the uniqueness should focus more on market tests, i.e., whether a competitor applies the same or similar know-how such that it removes potential excess profit associated with such know-how. Even if such know-how is “non-unique”, as long as no competitor is using such know-how, the company-at-issue may be able to command a premium. Therefore, I believe that the draft should describe that the uniqueness of know-how should be determined by the market rather than on its own.

**Bearing costs and being entitled to return**

Moreover, it is unclear as to how and when “bearing of costs related to intangible development” alone does not constitute the entitlement of the intangible related returns as referenced following para 26. Practically speaking, it may be a rare circumstance...
when a related party does not perform any activities but provides funding for the development of intangibles. It is desirable if the draft clearly states when a party is considered not entitled to intangible related returns despite its funding, and/or what is the level of minimum activities required, other than funding, to be entitled such returns.

B. Identification of Parties Entitled to Intangible Related Return

Inference from the framework of Residual Profit Split Method
The definition of intangible related returns in para 28 appears to be very similar to or essentially the same as the definition of residual profit in the context of residual profit split method (RPSM). If so, in order to avoid confusion, it may be desirable to clearly state the relationship between the intangible related return and residual profit.

Arm’s Length Royalty
Attention should be paid to description of the relationship between “intangible related returns attributable to its licensed rights, subject to its obligation to provide arm’s length compensation for the grant of the license” (para 35) and arm’s length royalty. It may be more important to emphasize how “arm’s length compensation for the grant of the license” should be determined, rather than how the remainder should be. It appears that the “arm’s length compensation” would be interpreted as a fixed royalty rate which is predetermined under typical licensing agreements. On the other hand, some companies apply variable royalty rates to reflect the nature of an underlying business in which joint contribution of intangibles is warranted. Thus, it would be appreciated if the draft extends the discussion of the “arm’s length royalty” where and how both fixed and variable royalty are acceptable depending on the relationship, risk sharing and contribution between the licensee and licensor in related party context.

Form vs. Substance
Although it may be economically reasonable to emphasize the importance of parties’ conduct over legal or contractual relationship (para 37) when evaluating the attribution, it is practically not an easy task to objectively determine parties’ conduct, especially when it is deemed to be inconsistent with a contractual relationship. It may be beneficial if the draft introduces examples with descriptions as to where an observed party’s conduct is considered more important than the relevant contract when evaluating the attribution.
C. Transactions involving the use or transfer of intangibles

The Value of a Patent Depending on Economic Circumstances
It may be important to consider the possibility of changing relative value between a buyer and a seller or a licensor and a licensee according to a normal business cycle. It may be appreciated if the draft extends the discussion about “the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval” (para 68). For example, this statement can be applicable to pharmaceutical licensing arrangement and may include that, other things being equal, the value of product licensing is always higher for buyers or licensees after the product is approved by relevant regulatory authority compared to when the underling drug is still in phase 1 of the clinical research. Giving such concrete statement, it may be helpful in ways to avoid the possibility of misunderstandings.

Guidance for applying best method rule
Although flexible use of transfer pricing method (TPM) is suggested (para 75), it may be beneficial if a more practical guide regarding the selection of the best TPM were introduced. For example, the draft has correctly pointed out possible interdependence of the value of certain intangibles on the other intangibles or other tangibles or businesses (para 67, 69). If such an argument is applicable, it would be logical to apply a profit-based TPM such as TNMM (for one-sided contribution of the relevant intangible) or RPSM (for multi-sided contribution of the relevant intangible) since transactional comparable can be difficult to find if the tested transactions are interdependent. The draft also correctly points out that the value of intangibles may change over time (para 68). Therefore, the draft can point out the use of a fixed benchmark such as specific royalty rate may not be appropriate when applying a CUT method or specific benchmark for royalty rate.

D. Determining Arm’s Length Conditions in Cases Involving Intangibles

Internal comparables
Regarding the discussion between internal comparables and external comparables, although it seems economically sensible to emphasize the generally favorable
comparability for internal comparables (para 84-89), it is worthwhile to extend the
discussion to where and how the internal comparables should be used. In particular, this
should include how such comparability factors as described in para 92-102 should be
analyzed and whether they need to be adjusted rather than rejected outright.

Stage of Development
For the latter example of para 97, it is my experience that pharmaceutical companies
frequently license both early and late stage products to and from related parties as well
as to and from third parties. This is a different practice from some other industries. The
current draft may place too much emphasis on related party transactions. For example,
in this context, internal comparables based upon terms and conditions of transactions
with third parties may be available to indicate the degree to which varied stages of
development affect the value of a relevant intangible.

Reliability of Comparability Adjustments
The statement in para 103 may not be accurate that larger comparability adjustments
indicate less reliability of the adjustment. The reliability of the adjustments should
depend upon the “quality” of the adjustments, not the “quantity” (or mileage). For
example, if robust outside data with reliable calculation method, such as established
conventional statistical adjustments, can improve the comparability and if the impact of
such adjustments is relatively significant, this adjustment should not be rejected due to
the size of the adjustment.

Section D.1 (vi) Comparables
The use and benefit of introducing the concept of “Section D. 1 (vi) comparables” is
somewhat unclear (para 105, 120, 121). While the efforts to introduce a more concrete
discussion applicable to actual cases are recognized, this discussion may not be as
influential as is desired unless clearer descriptions are given.

The Third Factor
While it may be important to be cautious regarding a simplistic and formalistic use of
RPSM type of analysis in para 108, it is suggested that the draft provide a more detailed
discussion of other factors beyond an intangible’s contributing to value creation. In
particular, “location” should be fully explained. the term “location” is assumed to refer to
“location specific advantages” either through preferable market conditions or cost
structures specific to each location, subject to the competition in the marketplace that
would allow companies in the value chain to retain excess profit without passing through them to suppliers or buyers. (the term “locational advantages” are used in para 124)

**Purchase Price Accounting (PPA)**

It would also be helpful if the draft provided a more detailed explanation of why PPA analysis is not relevant to an intangible’s valuation for transfer pricing purposes. Currently, this discussion simply describes accounting analysis as being too conservative (para 110).

**Useful “Rule of Thumb”**

While the need for rigorous analysis is appreciated, totally discrediting the “rule of thumb” (para 116) may not be appropriate. The gap between potentially useful comparables and the rule of thumb may not be as clear as originally thought. For example, the application of “rule of thumb” by experts who have the experience of having negotiated more than 100 pharmaceutical deals may be useful. In contrast, applying “rule of thumb” without analyzing a specific transaction at issue may not be instructive.

**Location Advantages and Market Differences**

It is noteworthy that the draft recognizes potential importance of such factors as “locational advantages” and “market differences” in determining arm’s length price (para 126). However, the draft provides little guidance related to these important concepts. It would be beneficial to add further explanation that could describe areas such as:

- **Locational Advantages**
  - Unique advantage due to the fact that a company has a certain advantage at a certain location either in terms of price or costs
  - Unique low-cost manufacturing location vis a vis competitors would be a location advantage
  - Unique market presence where the lack of competition enables a distributor to charge a premium price, relative to the price charged at other locations
  - These locational advantages are expected to be temporary and are not expected to last for extended periods

- **Market Differences**
The concepts of market differences and locational advantages can be applied interchangeably.

Market differences may refer to external factors such as government policy for investment, tax, environment or other regulations.

**Attribution of Residual Profit**

It may be important to emphasize that residual profit should not be presumed to be solely attributable to a licensor or transferor. Thus the last sentence of para 141 “It should not be assumed that all of the residual profit after functional return would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement” is significant. It is suggested that the draft provide a more concrete explanation or examples as to the important role played by licensees in earning residual profit through marketing activities, product development, improvement activities or other entrepreneurial activities.

Although the concept of “the value of contributions other than intangibles to the ultimate generation of profit” is very important to value transferred intangibles through profit split (para 144), a more detailed explanation would be helpful to provide clarification. For example, does the concept refer strictly to routine profits or all “other” profits attributable, such special factors as “Locational Advantages” and “Market Differences” (para 126). While it may likely be the latter, it would be helpful to have a more detailed explanation in the draft.

**DCF approach**

The discussion of the discounted cash flow (DCF) approach in para 148, calling for “the calculation of the discounted present value of the streams of cash flows attributable to the intangibles from the perspectives of both parties to the transaction” may not be realistic. If it refers to a related party situation, typically both ends of the transaction do not develop different sets of cash flow streams. If it refers to an unrelated party situation, although two different cash flow projections may exist, it is usually the case where a party does not disclose its own cash flow projection to the other side. Therefore, in either event, it is highly unlikely that such cash flow projections from both parties are available for the analysis.

**Sensitivity Analysis**

Although there may be benefits to conducting sensitivity analysis (para 151), it is
important to note that the base case should be clarified relative to different scenarios, and there should also be some indication as to how sensitivity analysis should be interpreted. (i.e, by materiality, complexity, reliability, etc.)

**Measuring Useful Life**
It should be emphasized that it is important to measure the useful life of certain intangibles (para 165). For example, some intangibles may have “spill over” effects, meaning that the benefit and value of the intangible may last for more than one generation of relevant products that incorporate it. It should also be noted that the analysis of useful life is up-to-date, since past information may not always represent an ideal benchmark in a rapidly changing business environment.

**Terminal Value**
The draft (para 167), should provide more guidance as to those requirements in calculating reliable terminal value. For example, when possible, comparable information should be used to derive terminal value. Further, the projection beyond reasonable time period should be conservative and discount rates should be adjusted if it is reasonable to expect increased uncertainty.

**Discount rates**
It is very important to distinguish discount rate between for an investor and for an investment, and determine the appropriate one. The issue is evident when choosing a tax rate (para 168). Particularly if an investor in a developed country with relatively low discount rate is investing in emerging country with a higher rate, it is important to carefully determine the appropriate level of discount rate to apply. It may be a mistake to apply a discount rate of based on the investor since the risk of the investment varies based on the objective of the investment. If the objective is the same, the discount rate should also remain the same regardless of who is investing. This type of basic finance principle should be clarified in order to avoid confusion when using the discount rate for transfer pricing analysis.

**Pre-tax WACC**
For a clearer understanding, a typical WACC formula should be introduced in para 169, so that it is clear as to how a pre-tax discount rate should be calculated.

**Forecast vs. Actual (hindsight)**
From our experience, discussion around para 174-178 on the relationship between forecast and actual raises important points. It is difficult to accurately forecast the flow of profits associated with intangibles, and the longer the time horizon is extended, the less reliable the forecast becomes. While the draft appears to emphasize the efforts made to make reliable forecasts, it may be more important to provide guidance as to how companies should respond to unexpected changes that may produce a discrepancy between forecasted financials and actual results. It would be beneficial if the draft provided examples of how often companies should evaluate actual relative to forecast and how the original price or royalty rate was determined. On the other hand, it is not practical to request companies to make frequent adjustments based on these parameters due to the difference between forecast and actual. Third parties may not move to readily revise the price or rate if they find that a significant difference between forecast and actual exists. It is not uncommon to spend a year or more before an agreement on the new price or rate in difficult third-party situations can be reached. Therefore, the related companies should closely monitor the difference between forecast and actual. However tax authorities should not push to change the price or rate so quickly, and provide ample time for voluntary adjustments for periods of 1-3 years, for example. In another words, it should be clarified that the companies engaging with intercompany transactions of intangibles should monitor the differences and react only when the differences are structural.

This point was further discussed in para 262, in the example of 20. It is not clear whether it is appropriate to make adjustments to royalties in year 3. While it may be true that there is no foundation for tax authorities to make adjustments of year 1 and year 2, it may be the appropriate course of action if the royalty rate is adjusted according to unexpected changes in the business situation in year 3. The important question is whether the company is expected to make immediate adjustments in year 3, or should be given some flexibility that may ensure that changes in its business environment are fundamental and not short-lived; thus the appropriate change is necessary for the royalty rate.

**Variable Royalty**

In regard to forecast vs. actual, it should be emphasized that “variable” royalty, as long as not subjectively changed, should generally be acceptable for tax authorities. Since, except for start-up companies, it is uncommon to have third-party licensing agreements in which the change of royalty rate is contemplated, some practitioners tend to believe
that variable royalty per se is not at arm’s length. It tends to be true in normal business environment that fixed royalty for considerable length of years is a commonly used practice. On the other hand, para 174-178 appears to correctly promote the use of variable royalty. Unless there is a certain flexibility of royalty rates, it is difficult to respond to the issue of divergence between forecast and actual as discussed in para 174-178. Further it may be problematic if material intercompany transactions consist only of royalty. Therefore, a principled use of variable royalty should be encouraged. As a result, incorporating examples of how “principled” variable royalty should be constructed and implemented into the draft would be helpful.

**Relationship Between Intangibles Expenditures and Returns**

Although measuring expenditure to build intangibles can be useful to evaluate intercompany transactions of intangibles, it may be too soon to conclude that a party that incurs these expenditures should have access to excess return for the intangibles (para 200). This aspect of the relationship between intangibles expenditures and returns should be carefully analyzed through risk-sharing perspectives. For example, under the TNMM type of pricing arrangement between the related parties, if a related distributor is guaranteed to earn certain level of operating profit, the fact that the distributor spends more marketing expenses than comparables does not mean that the excess expenditures can be a source of excess return for the distributor. Instead, the distributor is not taking economic risk for the marketing investment, but is merely executing the marketing strategy determined by other related party or parties. It would be helpful if the draft included examples that could further an understanding of this issue.

**Termination Risk**

Para 202-205 appears to provide examples for analyzing termination risk. While termination risk is one of the most difficult but important issues in the evaluation of risks in transfer pricing analysis, the example given in para 202-205, in which related parties determine and change the length of supply relationship may not be realistic. If the supplier’s side of termination risk is significant, independent buyers would insist on receiving a premium to compensate for termination risk.

**Relationship Between Brand Royalty and Supply Price**

Page 208 provides a practically important example. To clarify, the draft may require to further incorporate the description of the relationship in such a way that the companies
are free to apply brand royalty (as long as it is legally acceptable and economically justified). However the benefit for licensees should be clear that arm’s length return for those distributors paying brand royalty can be usually measured at operating profit after paying the royalty under TNMM, therefore the numerical trade-off between brand royalty and supply price should be recognized. Simply unilaterally introducing brand royalty without substance may not be viewed as arm’s length and can be subject to adjustments by tax authorities.

**Intangibles Valuation in PPA**

The draft states that the valuation of intangibles for accounting purposes in purchase price allocation (PPA) is not applicable for transfer pricing purposes (para 236 and 238, for example). Since this point is practically important, it requires further explanation, including the scope of intangibles to be evaluated and how they are valued in either situation.

(end)
Subject: Comments on the Discussion Draft on the revision of the special considerations for intangibles in Chapter VI of the OECD transfer pricing guidelines and related provisions

Dear Mr. Andrus,

Altus Alliance (hereinafter referred to as Altus) is pleased to comment on the Discussion Draft on the revision of the special considerations for intangibles in Chapter VI of the OECD transfer pricing guidelines and related provisions (hereinafter referred to as "the discussion draft").

First of all Altus Alliance is enthusiastic on the interim draft as it provides new guidance on various topic related to intangibles. The practical examples and illustrations are useful and a can be referred to when dealing with concrete issues. We support the OECD’s leadership efforts to promote and maintain a broad international consensus on transfer pricing issues related to intangibles and are convinced the interim draft is a step forward in this matter.

Our comments on the interim draft are as follows:

- **Use of intangibles versus transfer of intangibles** - the new draft provides guidance on both the ongoing use of intangibles as well as the one-off transfer of intangibles. For the one-off transfer of intangibles the discussion draft refers to the existing Transfer Pricing methods. In particular the CUP method and the profit split method are discussed. The application of the profit split method is presented as the method to characterise the application of valuation techniques. This suggests that the application of a valuation technique can be considered as the application of the profit split method. Altus believes this is not accurate and could lead to the perception that the use of a valuation technique can be compared with the application of the profit split method. Altus believes that the main purpose of applying a certain TP method is to allocate profit. Although profit allocation is a key component of a valuation technique, the
purpose of the use of a valuation technique is to arrive at a net present value of the anticipated future profit. They are not the same. Altus would welcome additional guidance on the distinction between transfer pricing methods and valuation techniques.

- **Pre- and post transfer** - As also mentioned in Chapter IX there can be a relation between the pre- and post transfer of intangibles. In particular, “*information on the arrangements that existed prior to the transfer and on the conditions of the transfer itself could be essential to understand the context in which the post-transfer arrangements were put in place and to assess whether such arrangements are at arm’s length. It can also shed light on the options realistically available to for the related parties involved*”

According to Chapter IX part D. “Comparing the pre- and post-restructuring situations”

Although these aspects are also relevant in the context of intangibles, they are not discussed or referred to in the discussion draft.

- **Combination of intangibles** - The draft provides guidance on the transfer of combined intangibles. Unfortunately guidance is only provided in the event of a transfer. No guidance is provided for the use of combined intangibles. In practice many group companies make use of a combination of intangibles of related parties. Altus would welcome additional guidance on aspects surrounding the arm’s length compensation for the use of combined intangibles.

- **Secondment of isolated employees** - Altus welcomes the introduction of secondments of isolated employees in the transfer pricing guidelines. Nevertheless we believe the guidance is short and could potentially raise questions. Currently the discussion draft links secondment with a transfer of valuable know-how or trade secrets. We do not believe this link is appropriate as the transfer of valuable know-how or trade secrets can take many forms (such as through email, regular mail or telephone conversations) and is not in particular related to secondments. Without more elaboration, we believe the current wording may introduce unnecessary discussion and disputes between tax payers and tax authorities.

- **List of intangibles** - Paragraphs 14 until 26 provide a list of intangibles. Although the list is for illustration purposes only and not supposed to be exhaustive, Altus believes some important intangibles should be added. These include contract based intangibles and customer related intangibles. These intangibles can have significant impact on the profitability of group entities. Currently they are however not included in the draft.

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1. See Chapter IX part D. “Comparing the pre- and post-restructuring situations”
2. See C.2.(ii) paragraphs 66 until 70
- **Use of “other methods”** - In paragraphs 106 and 107 reference is made to paragraphs 2.1 through 2.11 of the TP Guidelines for guidance on the selection of the most appropriate method. Paragraph 2.9 of the TP Guidelines introduces “other methods” as an alternative to the 5 TP methods. “Other methods” expands the use of methods to demonstrate that prices charged either do or do not satisfy the arm’s length principle in accordance with these Guidelines. Altus believes that in the context of intangibles, the inclusion of other methods can contribute to a harmonisation practices and avoid further disputes. In practice MNEs sometimes assess profit allocation through the use of complex mathematical tools or methodologies. These do not always fit one of the 5 TP methods. Altus would welcome further guidance on the use of other methods in the context of intangibles.

The members of the Altus Alliance are pleased to provide these comments to contribute to the further development of Chapter VI on intangible assets.

Yours sincerely,

Daniel Rybnik and Roderick Veldhuizen
On behalf of the Altus Alliance
17 September 2012

Ms. Michelle Levac, Chair of OECD Working Party No. 6 on the Taxation of Multinational Enterprises

Mr. Joe Andrus, Secretariat to OECD Working Party No. 6 on the Taxation of Multinational Enterprises

Dear Michelle, Dear Joe,

Baker & McKenzie welcomes the opportunity to comment on the OECD Discussion Draft on the Proposed Revision of Chapter VI of the OECD Transfer Pricing Guidelines (hereafter "TPG") and Related Provisions which was released on 6 June 2012.

Our main comments are summarized below. Additional comments and editorial suggestions are included in the Annex to this letter.

Process

We appreciate that this Discussion Draft is an interim draft, released at an earlier stage than originally planned, when the Working Party is still discussing a number of the concepts in it and has not yet reached consensus on the text. We applaud the Working Party's open-mindedness in sharing such a preliminary draft with the public as we trust that the process of finalising the guidance as well as interested parties’ understanding of it can greatly benefit from and be facilitated by an early dialogue with the private sector.

We note that the interim draft does not address all the issues which are being considered by the Working Party as part of this project. In particular, we note that revisions are contemplated to the guidance on comparability factors in Chapters I-III and to the guidance on Cost Contribution Arrangements in Chapter VIII. We think that it will be important to read the new Chapter VI in connection with the revisions made to Chapters I-III and VIII. We look forward to the opportunity to further comment when a more advanced draft of
Chapter VI as well as the proposed amendments to Chapters I-III and VIII are ready.

**Main points of agreement**

We applaud a number of important clarifications contained in the Discussion Draft, which we hope will be confirmed in the final version:

- We support the inclusion of a reference to the arm's length principle and Article 9 of the Model Tax Convention ("MTC") at the start of the paper as it appropriately sets the legal framework in which Chapter VI of the TPG should be drafted and read (paragraph 1).

- We agree that in order to determine arm's length conditions for the transfer of intangible assets, it is important to consider as part of the comparability (including functional) analysis the identification of specific intangibles (paragraph 4).

- We support the notion that an intangible should be capable of being owned or controlled. We suggest that this notion would be better captured if the phrase "intangible property" which is currently used in Chapter VI was retained. We further submit that an intangible can only be the subject of a transfer requiring compensation if it is transferable (separately or not) (paragraph 5).

- We applaud WP6's proposed clarification of the difference between transfer pricing intangibles and "market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise" (paragraph 8).

- We agree that the availability and extent of legal, contractual or other forms of protection may affect the value of an item and the returns that should be attributed to it. We further note that at arm's length, parties only pay for an intangible if the owner of the intangible (or holder of rights in the intangible, e.g. the licensee) has the capacity to exclude others from using the intangible (paragraph 7). In fact, we believe that the identification of a legal or contractual right is an essential part of the identification of existing intangibles.

- We support the clarification that not all research and development expenditures produce or enhance an intangible and that not all marketing activities result in the creation or enhancement of an intangible (paragraph 10).

- We support the conclusion that synergies are not intangibles per se. Synergies are consequences which may (or may not) be derived from...
the use of several assets in combination. We regard synergies as valuation factors for otherwise existing intangibles or activities (paragraph 23).

- We agree that in a particular circumstance, intangible related returns with respect to an intangible may be positive, negative, or zero. We urge the OECD to further emphasise that the determination of entitlements to intangible related return should be made in an objective manner, irrespective of whether it leads to the sharing of a residual profit or loss (paragraph 28).

- We agree that the parties performing functions related to the development, enhancement, maintenance or protection of intangibles should be provided with arm's length compensation for the functions they perform taking into account the risks they bear. Such compensation should be determined by following the guidance in Chapters I-III of the TPG (paragraph 48).

- We agree that in many cases, the intangibles used are not unique intangibles, i.e. similar intangibles are used by parties to comparable uncontrolled transactions. We further agree that where that is the case, the level of comparability may be sufficiently high that it is possible to rely on prices paid or margins earned by the potential comparables as an appropriate measure of arm’s length compensation for both the functions performed and the intangibles owned by the tested party (paragraph 87).

**Scope**

We suggest that the discussion draft could be made clearer and more efficient by focusing on situations involving the transfer of valuable intangibles.

First, because most if not all transactions involve the use of some intangible (e.g. routine know-how), we do not believe that it would be a good policy to attempt to apply the guidance in the revised Chapter VI to all transactions, irrespective of whether the intangibles involved are valuable and/or unique.

Furthermore, situations involving the mere use of intangibles are generally adequately dealt with by applying the guidance in Chapters I-III. To the extent needed, the guidance in these Chapters could be complemented. On the other hand, we think that it would not be helpful if competing standards are set forth in Chapters I-III and VI for manufacturing or distribution activities, just because they involve the use of intangibles.

**Intangibles migration and base erosion concerns**
We note the current OECD focus on situations of double non-taxation and the developments of the other OECD projects in the area of harmful tax competition and international cooperation. We think that the direction of the Discussion Draft is largely influenced by concerns expressed by some OECD countries in relation to intangibles migrations and base erosion.

We believe that the arm's length principle can be used and its application strengthened to address some of these concerns to the extent they arise from non-arm's length pricing of controlled transactions. On the other hand, we believe that it is important to recognise that the arm's length principle is not the problem nor the solution to all the concerns expressed by countries in relation to cross-border taxation. We are of the view that the arm's length principle should not be stretched beyond the standard set by Article 9 of the MTC in order to address base erosion or profit shifting concerns in those cases where such concerns are linked to tax competition or abusive schemes, rather than to non-arm’s length pricing between associated enterprises.

**Economic substance within and outside the arm's length principle**

The notion of economic substance is a complex one, and countries do not have a single definition of it. Furthermore, it has differing bearings in the context of the arm's length principle and beyond it.

When applying the arm's length principle, economic substance should be assessed by reference to what independent parties do or would have done in comparable circumstances. The Working Party had extensive discussions of this question as part of the business restructuring project. We suggest that the guidance on *economic substance for transfer pricing purposes* and on situations where contractual terms related to the attribution of rights in intangibles can be disregarded in the revised Chapter VI should be more closely aligned with the guidance in TPG 1.64-1.69 and 9.161-9.194, and that the discussion of "control" should be more closely aligned with the existing guidance in TPG 9.22-9.28, as we believe that these paragraphs in the TPG provide the latest international consensus on how the arm's length principle relates to economic substance and anti-abuse concepts.

Economic substance is also a concept which in many countries is relevant to *anti-abuse or anti-avoidance rules outside the arm's length principle* and Article 9 of the MTC. We suggest that, to the extent the OECD and its member countries want to set some economic substance requirement which is not grounded in an analysis of what independent parties do or would have done in comparable circumstances, they should do so outside the TPG. Otherwise, they risk creating policy and legal issues.

From a policy perspective, the arm's length principle and TPG are used by thousands of MNEs and medium sized enterprises to set the prices of their intragroup transactions on a daily basis. If an essential piece of transfer pricing
guidance is amended to tackle some very specific structures irrespective of whether such structures in effect depart from what independent parties do or would have done in comparable circumstances, the OECD risks jeopardising the operation of the principle for the vast majority of transactions which are not the ones tax administrations are presumably concerned with. Guidance designed to tackle specific situations should be drafted specifically and have an appropriately defined scope.

As an example, we understand that some countries may be concerned with certain structures whereby the investment in the acquisition or development of the intangible is located in a low tax jurisdiction and/or in a structure that lacks economic substance. We respectfully submit that such concerns should be dealt with within the appropriate policy and legal parameters. We think that it would be greatly damaging for the arm's length principle and TPG if such concerns led the OECD to ignore the fact that in the vast majority of cases, independent parties do remunerate the investment in the acquisition or development of the intangible; and that many of the entities investing in the acquisition or development of the intangible are not located in low tax jurisdictions.

From a legal perspective, the TPG are and should remain an interpretative tool of Article 9 of the MTC. Nothing in the wording of Article 9 allows tax administrations to tax profits unless they would have been made by independent parties in comparable circumstances. If the guidance in the TPG is disconnected from an arm's length test, legal concerns would arise as to its application in interpreting bilateral treaties and its relationship with domestic transfer pricing rules in a number of countries. In Chapter IX, the OECD noted that "Domestic anti-abuse rules and CFC legislation are not within the scope of this chapter." If the OECD wishes to have a project to coordinate country approaches to anti-abuse rules and CFC legislation, we suggest that it should do so in the relevant legal and policy setting. For instance, it is likely that such a project would differentiate between transactions with low-tax jurisdictions and others, while such a differentiation is not legally grounded in the arm's length principle.

**Consistency with the arm's length principle and with the 2010 TPG**

We note that in a number of instances, the Discussion Draft tends to prescribe solutions making no or very limited reference to what independent parties do or would have done in comparable circumstances.

Typically, this is the case for the discussion of the notions of "control" and "important functions" and of their consequences on a party's "entitlement to intangible related return".

We also note that the Discussion Draft presents inconsistencies with the guidance in Chapters I-III and IX of the 2010 TPG. For instance, the
discussion of the arm's length remuneration for entities contributing to the development of intangibles or using them is not aligned with the discussion of the selection of the most appropriate transfer pricing method in Chapter II. The discussion of "control" and "risks" is not aligned with the one in Chapter IX, Part I of the TPG.

In our view, these inconsistencies, if retained in the final Chapter VI, would raise questions about the applicability of the new guidance to existing bilateral treaties.

In the Scoping Paper which was released in January 2011, the OECD indicated that "The intention with the new project on the transfer pricing aspects of intangibles is not to re-open issues that were resolved in the 2010 revision of the TPG. Rather, it is to develop guidance on issues specific to intangibles that need to be updated." We therefore assumed in our comments that the inconsistencies between the proposed revision of Chapter VI and the 2010 TPG are not intended, and we are providing detailed suggestions to deal with them.

On the other hand, if the OECD's intention is to re-open and amend the consensus achieved in 2010, we suggest that this should be clearly communicated to the public.

**Goodwill**

We are concerned with the discussion of goodwill in the Discussion Draft. If, as expressed in the Discussion Draft, this term describes "important and monetarily significant" intangibles, it should be precisely defined. Not providing a clear definition for an "important and monetarily significant" transfer pricing intangible can only create "important and monetarily significant" transfer pricing disputes.

We recognize that countries use the word goodwill to refer to different concepts. We suggest that each of the relevant concepts should be separately named, defined and commented on. Specifically, we suggest that the word goodwill should be used in the context of Chapter VI to refer to the portion of the purchase price, paid in the context of an acquisition of an entire business, which is not allocable to any identified asset of said acquired business. This is an accounting notion. Other words or phrases could be used to refer to a clientele or *fonds de commerce*, which is to a large extent a legal notion; profit potential, which is a valuation concept, as recognised in the Glossary to the TPG and in TPG 9.66; or reputational characteristics, which are not intangible assets but are characteristics of otherwise existing tangible or intangible assets.

We respectfully disagree with some of the statements made in the Discussion Draft on the notion of goodwill. Specifically, we think that if goodwill is
defined, as suggested above, as the difference between the purchase price of shares in an acquired entity and the fair value of the underlying tangible and intangible assets, it may arise from a number of factors, including a control premium paid by the acquirer, a premium paid to exclude competitors from the acquisition, a premium paid because of anticipated synergies with the acquirer's other assets or activities, or in some cases an over-optimistic evaluation by an acquirer who has imperfect information on the assets and liabilities of the acquired entity (as is always the case in arm's length acquisitions). Goodwill should therefore not be assumed to correspond to the value of assets of the acquired entity. It also should not be assumed that goodwill value "does not disappear", as this depends on the facts and circumstances of each case.

**One-sided methods or profit split; allocation of residual profits to the development and use of intangibles**

We think that the Discussion Draft can be read as generally encouraging a much broader use of the profit split method than is the case in the 2010 TPG, and providing more intangible related return (whether residual profit or loss) to the countries where intangibles are developed and/or used versus the countries where they are owned. In particular, we note that while it puts a lot of emphasis on the remuneration of the development and use of intangibles, the Discussion Draft does not provide a clear and explicit recognition of the need to compensate investment risk and risk of failure of research and development activities. We also note that the stringent comparability standard set in the Discussion Draft and negative comments on the use of database information may lead to the rejection of comparables in a very large number of cases. We wonder whether this direction is explicitly supported by all the countries participating in the WP6 project.

We often encounter tax audit situations where tax authorities claim an associated party in their jurisdiction should have rights to intangible related return when they perceive it to be a residual profit, but reject the profit split method when it leads to the sharing of a loss. The Discussion Draft already recognises that intangible related return may in certain circumstances be a loss. We suggest that this point should be further emphasised in the revised Chapter VI.

**Contractual terms**

We are of the view that under the arm's length principle, contractual terms ought to be the starting point of the analysis. However, contractual terms ought to be respected only to the extent that they conform to the actual behaviour of the parties and are arm's length.
Despite the statement at paragraph 30 of the Discussion Draft that "Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns", we find that the rest of Section B tends to give little weight to contractual arrangements and fails to clearly articulate the situations where contractual arrangements could be disregarded by a tax administration. Chapter IX provides a detailed discussion of the extent to which contractual terms ought to be respected or can be disregarded. We regret that the proposed revision of Chapter VI does not endorse the same analytical path, and more generally that it seems to give little weight to contractual terms.

**Important functions and control**

We suggest that the discussion in the revised Chapter VI of "important functions" leading to the development of intangibles and of control should be more solidly grounded in the arm's length principle and comparability analysis. See our above comment on economic substance. We note that "important functions" are not clearly defined in the Discussion Draft. We suggest that the discussion of important functions and control in the proposed revision of Chapter VI should be more closely aligned with the discussion of control in Chapter IX, Part I. We urge the OECD to confirm that its intention with the reference to "important functions" is not to import into the TPG in an Article 9 setting the "significant people functions" concept that was developed to attribute profits to a permanent establishment under Article 7 of the MTC.

**How to define and allocate intangible related return**

We urge the OECD to clarify that by using the words "entitlement to intangible related return", it does not suggest that such "entitlement" could itself be regarded as an intangible asset. The mere fact that an entity has earned a return for using an intangible does not mean that it has necessarily acquired a right to retain the same return in future years or be compensated in case of restructuring of the activity.

Furthermore, we submit that the discussion of intangible related return should differentiate between (i) the return attributable to the investment in the acquisition or development of the intangible and associated risk, (ii) the return attributable to the functions leading to the development of the intangible and (iii) the return attributable to the use of the intangible and associated risk. Not differentiating between these components is confusing because it implies that various parties should share in the intangible related return without providing any affirmative guidance on how to share such return in practice.

(i) *Return attributable to the investment in the acquisition or development of the intangible and associated risk*
We suggest that the determination whether the contractual allocation of the return attributable to the investment in the acquisition or development of the intangible is arm's length should follow the same analytical path as was developed at paragraphs 9.17 to 9.32 with respect to risk allocation.

This would imply recognising that contractual terms should be the starting point in the analysis, but that they should only be respected if they conform with the actual behaviour of the parties and are arm's length. In addition, the guidance in TPG 1.64-1.69 and Chapter IX, Part IV would apply in exceptional circumstances.

With respect to the determination whether contractual terms are arm's length, we believe that more weight should be given to a consideration of what independent parties do or would have done in comparable circumstances, and that the reference to "control" should not be a substitute for comparability analysis.

Finally, we suggest that the revised Chapter VI should more clearly differentiate the guidance developed for transactions taking place between associated enterprises (Article 9 of the MTC) and the Authorised OECD Approach for Attributing Profits to Permanent Establishments (Article 7 of the MTC).

We provide more detailed comments on the above and drafting suggestions in the attached.

(ii) Return attributable to the functions leading to the development of the intangible

The functions leading to the development of an intangible should be remunerated at arm's length by reference to the remuneration that independent parties would have arrived at in comparable circumstances.

Depending on the facts and circumstances of the cases, such a remuneration may be set by applying a Comparable Uncontrolled Price method, a Cost Plus method, a Transactional Net Margin method or a Profit Split method. We believe that the guidance in Chapters I-III should apply to select and apply the most appropriate transfer pricing method to the circumstances of the case.

In some specific circumstances, the performance of functions leading to the development of an intangible would be compensated at arm's length by the attribution, to the party performing them, of a share in the ownership rights in the intangible developed. This can be achieved through a profit split in the situation where such a method is the most appropriate to the circumstances of the case, see TPG 2.1-2.11 and 2.109-2.114. This however is not the general rule and should be determined with great caution, on a case-by-case basis.

(iii) Return attributable to the use of the intangible
The use of an intangible, for instance through manufacturing or distribution activities, should be remunerated at arm's length by reference to the remuneration that independent parties would have arrived at in comparable circumstances. Depending on the facts and circumstances of the case, such remuneration may be set by applying a Comparable Uncontrolled Price method, a Cost Plus method, a Resale Price method, a Transactional Net Margin method or a Profit Split method. We believe that the guidance in Chapters I-III should apply to select and apply the most appropriate transfer pricing method to the circumstances of the case.

In some circumstances, the entity using the intangible would itself own valuable intangible assets. This determination should be made on a case-by-case basis, in light of the rights and other assets of the entity. For instance, some distributors hold long term contractual rights in the activity and/or own a valuable clientele which predates and is independent from the distribution of the group products, and consists in a valuable, locally-owned intangible asset. Some other distributors "only" serve the group's clientele in a given territory and do not hold any long term contractual rights. It should not be assumed that the mere performance of a distribution function creates a local marketing intangible for the entity performing it.

Valuation issues

We believe the Discussion Draft either says too little or too much about valuation techniques in its current state. We regret that the Discussion Draft abstains on defining the standard of valuation, which is, perhaps, the single most important driver of how valuation techniques are applied. We believe that the Fair Market Value standard of valuation, if adopted, could help address WP6's concerns in relation to valuation methods. We provide detailed comments on this aspect in the attached.

Conclusion

Baker & McKenzie congratulates Working Party No. 6 for producing within a very short timeframe a dense and ambitious document. We commend the Working Party for its willingness to consult widely at the early stages of the project.

We applaud this work for clarifying a number of important points related to the application of the arm's length principle to situations involving intangibles.

We also believe that the Discussion Draft on several occasions presents departures from the arm's length principle and from the existing guidance in the 2010 TPG. Our view is that the concerns expressed by some countries in
relation to specific structures should be addressed within the appropriate legal and policy parameters and that the TPG should remain an interpretative tool of the arm's length principle as set forth in Article 9 of the MTC. We suggest that the guidance in the revised Chapter VI should be balanced and acknowledge that the facts and circumstances of each case ought to be taken into account in a transfer pricing analysis. Prescriptive requirements should not be set as substitutes for comparability analysis.

We look forward to the opportunity to participate in the November consultation and to further dialogue on the Discussion Draft and on the next version of the document once released.

Our designated contact person, and the principal author of this submission, is Caroline Silberztein in our Paris Office (caroline.silberztein@bakermckenzie.com).

Yours sincerely,

Baker & McKenzie, Global Tax Policy Group

Baker & McKenzie, Global Transfer Pricing Practice

Mary C. Bennett, Principal

Gregg D. Lemein, Principal

Encl.: Detailed comments
Annex: Detailed comments

Introduction

Para. 1: We support the inclusion of a reference to the arm's length principle and Article 9 of the MTC at the start of the paper as it appropriately sets the legal framework in which Chapter VI of the TPG should be drafted and read. We believe that clearer and stronger references to what independent parties do or would have done in comparable circumstances should be made in several parts of the document where the language tends to be over-prescriptive (as identified in our comments below).

Please refer to our comments in the cover letter related to the interaction between the arm's length principle and the notion of "economic substance", abusive structures and base erosion concerns.

Para. 2: The use of the phrase "specially tailored" suggests that there would be a clear threshold making it possible to identify transactions to which Chapter VI would or would not apply. This expectation is however not met by the paper, because (i) it does not propose a clear cut definition of intangibles which would make it possible to apply such a threshold; (ii) it does not propose a clear cut definition of transactions involving "the use or transfer of intangibles" to which the guidance in this Chapter would apply (see for instance paragraph 75); (iii) in its current form, it addresses transactions involving both the use and the transfer of intangibles, while the former are already covered in other Chapters of the TPG (Chapters I-III in particular).

In fact, most if not all business transactions involve the use of some sort of intangible. All distributors have some commercial know-how and customer relationship, otherwise they could not operate. All manufacturers have some manufacturing know-how and processes. All service providers have some know-how which they use in the provision of their services, otherwise no client would hire them. By adopting a very broad definition of intangibles for transfer pricing purposes without differentiating between "routine" and "non-routine" or "valuable, unique" intangibles, the proposed revised Chapter VI as currently drafted would literally apply to all related party transactions, making Chapters I-III largely irrelevant and its own application a real challenge in practice.

We suggest that the clarity and efficiency of the paper would be much improved if it was focusing solely on transactions involving the transfer of intangibles (which we interpret to include the transfer of rights to use intangibles, as in the case of licenses). Issues related to the use of intangibles outside the context of a transfer of intangibles could be further addressed to
the extent needed by completing the guidance in Chapters I-III, in particular the guidance on comparability factors as is already proposed.

For instance, assuming that a manufacturer M uses patents licensed to it by an associated enterprise I to manufacture products sold to an associated distributor D. Chapter VI guidance could usefully be extended to address the determination of an arm's length price for the license between I and M. On the other hand, the determination of an arm's length price for the products manufactured by M and sold to D should follow the existing guidance in Chapters I-III and does not need to be re-discussed in Chapter VI. We believe that such a narrower focus of Chapter VI could make it possible to avoid the current perceived definitional difficulties and the confusion that is sometimes made (and which the paper attempts to clarify to some extent) between intangible assets and other value drivers which are not intangibles.

Furthermore, we suggest that the focus of the paper should be on transactions involving the transfer of valuable, unique intangibles which are insufficiently captured in Chapter I-III type analyses. This would make Chapter VI more relevant and would be consistent with WP6's recognition that the administration of transfer pricing needs to be simplified in relation to transactions which do not carry significant value.

Para. 4: We agree that in order to determine arm's length conditions for the transfer of intangibles, it is important to consider as part of the comparability (including functional) analysis the identification of specific intangibles. What matters is not just the perception (on someone's part) that something is valuable. We are concerned that this important statement is unfortunately lost in some other parts of the paper, for instance when discussing goodwill (see paragraphs 19-22) or "entitlement" to intangible related return. We suggest that the importance of the statement in paragraph 4 should not be lost sight of in the later parts of the paper.

A. Identifying intangibles

Para. 5: We support the notion that an intangible should be capable of being owned or controlled. We suggest that this notion could be adequately captured by retaining throughout Chapter VI the existing reference to "intangible property".

We furthermore submit that an intangible can only be the subject of a transfer requiring compensation if it is transferable (separately or not). While it may be stating the obvious, we believe that such a statement by the OECD would be very helpful.
We think that the sentence in the middle reading "Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet" addresses a valuation question, not a definitional threshold. It should therefore be in Section D.2 (v), not in Section A.

Para 6: WP6’s mandate is to provide guidance on the application of Article 9 of the MTC and accordingly it does not interfere in domestic legislation related to the treatment of transfer pricing intangibles as expenses or amortizable assets for general tax purposes. However, the Committee on Fiscal Affairs has a broader mandate to encourage "the elimination of tax measures which distort international trade and investment flows". Although the Committee now is increasingly focusing on the elimination of "unintended double non-taxation", we understand that the elimination of double taxation and of tax obstacles to cross-border trade remains a priority area.

In this context, we would like to draw your attention to an increasing number of situations our clients are facing in tax audits, whereby one tax administration considers that a payment for "something of value" ought to be made because of a "loss of profit potential" or other similar concept in one country, while the other country involved does not recognize such payment as either a tax deductible expense or an amortizable asset, because it regards it as too vaguely defined. The country from which the payment is required is often not a low tax jurisdiction and the risk of double taxation is real, for sometimes very significant amounts. These situations arise despite the welcome clarification in the Glossary of the TPG and in Chapter IX that profit potential is a valuation concept, not an intangible.

We understand WP6's reluctance to discuss the domestic general tax treatment of transfer pricing intangibles, which echoes the language in paragraph 9.8 of the TPG. However, we believe that the proposed revised Chapter VI as currently drafted considerably broadens the circumstances in which a tax administration may find arguments to consider that an ill-defined "transfer pricing intangible" has been transferred, because "profit potential" has been transferred. This will inevitably lead to an increasing number of disputes and of double taxation cases. Hence,

- We believe that it is essential for this paper to adopt a more solid definition of transferable intangibles and intangible transfers;
- We submit that, as part of its other project on improving the resolution of cross-border tax disputes (if not in the TPG itself), the Committee on Fiscal Affairs should at a minimum urge countries to resolve the
double taxation which may result from differing interpretations of the notion of "transfer pricing intangibles" in the revised Chapter VI.

Para. 7: We agree that the availability and extent of legal, contractual or other forms of protection may affect the value of an item and the returns that should be attributed to it. We further note that at arm's length, parties only pay for an intangible if the owner of the intangible (or holder of rights in the intangible, e.g. the licensee) has the capacity to exclude others from using the intangible. Public goods are not valuable intangibles. We suggest that this notion should be added either to paragraph 5 or to paragraph 7.

Para. 7: We believe that the fourth sentence "Therefore, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes" should be balanced by adding the notion that transferability (separate or not) is obviously necessary for an item to be characterized as an intangible that is the subject of a transfer requiring compensation.

Para. 8: We support WP6's proposed clarification of the difference between transfer pricing intangibles and "market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise." We look forward to reading the amendments which will be proposed by WP6 to the guidance on comparability factors.

Para. 9: We suggest that a new sentence should be added at the end of paragraph 9 to read: "The rest of this paper focuses on situations involving the transfer of valuable, unique intangibles." Adding such a sentence would avoid creating unnecessarily complex compliance burdens for transactions involving only "routine" intangibles, while at the same time being consistent with the view that low value is not a parameter to determine that "something" is or is not an intangible under paragraph 5 of the paper.

Para. 10: We support the conclusions in paragraph 10.

Para. 15: We suggest the following edits: "[...] However, there is no direct relationship between research and development costs and the value of a patent. In some circumstances, however, small research and development expenditures can lead to highly valuable patentable inventions; in other circumstances, costly research and development efforts may not lead to any valuable outcome. The developer of a patent may try to recover its
development costs (and earn a return) through the sale of products or use of a process covered by the patent [...]"

Para. 19: We find the reference to goodwill in the third sentence confusing. The paper acknowledges five differing definitions of goodwill, and it is not clear which meaning is intended in this sentence. In fact, none of the five definitions noted at paragraphs 21-22 seems to be relevant to paragraph 19. We therefore suggest deleting the reference to goodwill in paragraph 19.

We do not think that reputational characteristics are an intangible per se. Reputational characteristics are characteristics of otherwise existing intangibles, e.g. a business, trademark, trade name, or product. See also comment on paragraph 22.

We therefore suggest that the third sentence be revised as follows: "A brand may, in fact, represent a combination of intangibles, including, among others, and depending on the facts and circumstances of each case, trademarks, trade names and logos." The phrase "among others" should suffice to keep the definition broad enough.

Paras. 21-22: The paper recognizes that there is some confusion about the meaning of the word "goodwill". It quotes several possible definitions of goodwill and concludes that "it is not necessary for the purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes", while also stating that "the terms goodwill and ongoing concern value are often used to describe an important and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred."

We respectfully disagree with the view of WP6. If these terms describe "important and monetarily significant" intangibles, they should be precisely defined. Not providing a clear definition for an "important and monetarily significant" transfer pricing intangible can only create "important and monetarily significant" transfer pricing disputes.

We recognize that these words have differing meanings in differing contexts. We urge the Working Party to define these words in the context of Chapter VI, for transfer pricing purposes.¹ If several concepts ought to be captured in Chapter VI, each concept should be separately named, defined and commented on.

¹ We note that the fact that the word "intangible" has a given meaning for accounting purposes did not prevent the Working Party from proposing its own definition for the purpose of applying Chapter VI.
Specifically, we believe that it would be helpful if the word *goodwill* was used in the context of Chapter VI to refer to the residual purchase price which is not allocable to any identified asset in a business acquisition context. The Discussion Draft should recognise that goodwill in that sense is an accounting concept and draw the consequences from it, as discussed below.

While we understand that some countries may use the word "goodwill" to refer to a clientele or *fonds de commerce*, we suggest that a lot of the confusion could be avoided if such a differing concept was referred to as "clientele" or otherwise, not as goodwill. By contrast to the accounting notion of goodwill referred to above, the notion of clientele, which can be relevant in transfer pricing analyses depending on the facts and circumstances of the case, is largely a legal concept.

Similarly, given that it seems some countries may be using the word "goodwill" to refer to profit potential, we suggest that the words "profit potential", not goodwill, be used when referring to such a differing concept. Profit potential is not an intangible but a valuation concept, see TPG 9.66 and the Glossary to the TPG.

Goodwill in the sense used for purchase price allocation, clientele and profit potential are differing concepts which will be encountered in different situations and may lead to differing solutions. We therefore urge the OECD to clarify the terminology in the Discussion Draft in order to avoid giving the impression that a "monetarily significant" part of MNEs' intangibles value does not need to be specifically identified. See paragraph 4 of the Discussion Draft.

Para. 22: We suggest replacing the third sentence: "When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price" with "In transactions between associated enterprises, goodwill should be taken into account in determining an arm's length price if and to the same extent as it would have been taken into account between independent parties."

Para. 22: The fourth sentence proposes a fifth definition of goodwill as "reputational value". As noted above, we find it confusing to use the word "goodwill" when referring to "reputational value". We suggest deleting the fourth sentence because we consider that the "reputational value" is not an intangible, but a characteristic (a comparability factor) of otherwise existing tangible or intangible assets, see above comment on paragraph 19.
Para. 22: The OECD states: "To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern values are treated as intangibles" for transfer pricing purposes. We find this sentence confusing because we do not know to what definition of goodwill it is referring. As indicated above, we suggest using the word goodwill to refer to a valuation concept, i.e. the difference between the price paid by an acquirer of an entire business and the value which can be allocated to specific assets of that business. This difference can be due to a number of causes, including the payment of a control premium; the payment of a price higher than fair value in order to counter an offer made by a competitor; expected synergies (which may or may not materialize); even errors made in the evaluation of the acquired entity by the acquirer's negotiation team as the latter only has incomplete information on the target until the acquisition is concluded; etc. As a consequence, we believe that goodwill as a purchase price allocation residual would be more appropriately dealt with in Section D related to pricing than in Section A related to the definition of intangibles.

Even if the discussion of goodwill is retained in Section A, we find that the last two sentences of paragraph 22 are too strong. Furthermore, the implications of the last sentence are not clear. We would suggest replacing the last two sentences with: "Such treatment does not imply that the measure of goodwill derived for accounting or business valuation purposes is necessarily determinative for transfer pricing purposes."

Para. 23: We support the conclusion that synergies are not intangibles per se. Synergies are consequences which may (or may not) be derived from the use of several assets in combination. Synergies may (or may not) contribute to the creation of value; but synergies themselves are not intangibles. Not only can synergies not be transferred independently from the intangibles to which they relate, they do not exist independently from them. We regard synergies as valuation factors for otherwise existing intangibles or activities.

Para. 24: We strongly support the clarification contained in paragraph 24.

Paras. 25-26: We suggest that this discussion should more clearly differentiate between (i) the transfer of an existing assembled workforce and (ii) secondment of individual employees.

With respect to the former, as noted in the second bullet point of paragraph 26, "the transfer of an existing assembled workforce may provide a benefit to the transfeee by saving it the expense and difficulty of hiring and training a new
workforce." We accordingly suggest that this is one case where a cost-based method can be appropriate (see paragraph 113).

With respect to the latter, the issue is the extent to which employee mobility within MNE groups should be regarded as involving transfers of intangibles. While seconded employees tend to apply know-how to the benefit of each of the operations they are seconded to, and very often train people on-site, we believe that it would neither be a good policy outcome nor be workable in practice to attempt to apply the guidance from the new Chapter VI to all secondments of employees. Many MNE groups have extensive secondment programmes for engineers and management executives. In most cases, secondments are dealt with on a cost or cost plus basis. This is to avoid the need for seconded employees to resign from one place and enter into a new employment contract each time they change location. Sometimes, employees are seconded for a few weeks or months and tend to come back to their original employer; in other cases, they spend a few years in each location and never come back to the previous one. We suggest that the draft should recognise, as a practical matter, that employee secondments will generally be regarded as service transactions appropriately compensated with a cost or cost plus method.

Box before Section B: Identification of parties entitled to Intangible Related Return

While we agree with the first sentence stating that the transfer pricing outcome should reflect the functions, assets and risks of the parties, we respectfully but strongly disagree with the second sentence reading: "This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within a MNE group to retain the benefit or return with respect to intangibles without more." We also respectfully disagree with the third sentence, because we do not think that the view expressed in the second sentence is consistent with the arm's length principle and with Chapter IX of the TPG.

The Working Party invites comments as to whether the proposed formulation contained in Section B successfully communicates the economic principles at issue. We suggest that the message would be better conveyed if it more closely followed the analytical path which was developed by WP6 in the context of risk allocation in Chapter IX. In effect, allocation of intangible related return and allocation of risks present significant similarities, because of the need to appropriately balance the role of people functions on the one hand, of capital or cost bearing and of contractual ownership on the other hand, and because of the significant consequences such an allocation may have on profit allocation. As is the case for risk, an examination of the allocation of rights in intangibles between associated enterprises is an essential part of the functional analysis.
Usually, in the open market, the ownership of intangibles would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the intangible proves successful (see TPG 9.10).

If the guidance in Chapter VI was more closely aligned to the one in Chapter IX, it would more clearly state that contractual arrangements are the starting point for determining which party to a controlled transaction is entitled to the intangible related return associated with it (unlike in the Authorized OECD Approach to Attributing Profits to Permanent Establishments). Although this point is made at paragraph 30 of the Discussion Draft, we find that the rest of Section B is unclear as to the circumstances in which a tax administration could ignore the contractual terms. Following the existing guidance in the 2010 TPG, a tax administration is entitled to challenge the purported contractual allocation of intangible related return between associated enterprises if it is not consistent with the economic substance of the transaction.

One key consideration is therefore whether the conduct of the associated enterprises conforms to the contractual allocation of intangible related return. This is a reality check. The question is whether the party which is claiming some rights in an intangible actually behaves accordingly. It does not necessarily require any function to be performed in relation to the development or use of the intangible itself.

Another key consideration is whether the contractual terms with respect to the allocation of intangible related return in the controlled transaction are arm’s length, i.e. consistent with what independent parties would have agreed in comparable circumstances. For instance, a certain level of functions or control should only be prescribed if the same level of functions or control is required between independent parties. The reference to "control" should not be a substitute for comparability analysis. Otherwise, the guidance becomes an economic substance test, which may (or may not) respond to legitimate concerns of tax administrations, but is no longer grounded in the arm's length principle, creates risks of arbitrary application, and does not belong in Chapter VI of the TPG.

Please refer to our comments in the cover letter on the interaction between the arm's length principle, economic substance, anti-abuse and base erosion concerns.

**Intangible related return:**

We believe that the discussion of intangible related return should differentiate between (i) the return attributable to the investment in the acquisition or
development of the intangible and associated risk, (ii) the return attributable to the functions leading to the development of the intangible and (iii) the return attributable to the use of the intangible and associated risk. We find that the proposed draft which does not differentiate between these components is confusing because it states that various parties should share in the intangible related return without providing any affirmative guidance on how to share such return in practice. This clarification could be made at paragraphs 27 and 38-40 in particular.

(i) Return attributable to the investment in the acquisition or development of the intangible and associated risk

A party investing in the acquisition or development of an intangible bears costs (for instance, research and development costs, or acquisition costs); financial costs and risks associated with the funding of the development or acquisition (especially for long term and monetarily significant development processes, and for monetarily significant acquisitions); risk of failure associated with the development of new intangibles and/or risk of over-valuation associated with the acquisition of existing intangibles; and risk of depreciation (or appreciation) of the developed or acquired intangible. The bearing of these risks may give rise to intangible related return if and when the developed or acquired intangible is successfully exploited. In some situations, the bearing of these risks only gives rise to losses, for instance if the intangible does not reach a successful exploitation stage.

We find that the Discussion Draft fails to explicitly recognise the significance of these costs and risks and the need to determine an arm's length compensation for bearing them.

We suggest that the determination whether the contractual allocation of the return attributable to the investment in the acquisition or development of the intangible and associated risk is arm's length should follow the same analytical path as was developed at paragraphs 9.17 to 9.32 with respect to risk allocation. We refer in particular to the role of comparables as well as to the definition and role of the notion of control, in the absence of comparables providing superior evidence that the allocation of intangible related return in the controlled transaction is arm's length.

(ii) Return attributable to the functions leading to the development of the intangible

The functions leading to the development of the intangible should be remunerated at arm's length by reference to the remuneration that independent parties would have arrived at in comparable circumstances, taking into account their assets contributed and risks assumed.

Depending on the facts and circumstances of the cases, such a remuneration may be set by applying a Comparable Uncontrolled Price method, a Cost Plus
method, a Transactional Net Margin method or a Profit Split method. The guidance in Chapters I-III should apply to select and apply the most appropriate transfer pricing method to the circumstances of the case.

In some specific circumstances, the performance of functions leading to the development of an intangible would be compensated at arm's length by the attribution, to the party performing them, of a share in the ownership rights in the intangible developed, for instance where the party performing these functions also bear significant development risk and contributes significant intangibles. This however is not the general rule and should be determined with great caution, on a case-by-case basis.

We suggest a reference to the guidance in TPG 9.26 should be included.

(iii) Return attributable to the use of the intangible

The use of the intangible, for instance through manufacturing or distribution activities, should be remunerated at arm's length by reference to the remuneration that independent parties would have arrived at in comparable circumstances.

Depending on the facts and circumstances of the cases, such a remuneration may be set by applying a Comparable Uncontrolled Price method, a Cost Plus method, a Resale Price method, a Transactional Net Margin method or a Profit Split method. The guidance in Chapters I-III should apply to select and apply the most appropriate transfer pricing method to the circumstances of the case.

In some circumstances, the entity using the intangible may itself own valuable intangibles. This determination should be made on a case by case basis, in light of the rights and other assets of the entity. For instance, some distributors hold long term contractual rights in the activity and/or own a valuable clientele which predates and is independent from the distribution of the group products, and constitutes a valuable, locally-owned intangible. Some other distributors "only" serve the group's clientele in a given territory and do not hold any long term contractual rights. It should not be assumed that all distribution functions create a valuable local marketing intangible at arm's length.

Section B

Our preference would be for Section B to be redrafted along the lines set above and more closely aligned with the existing guidance in Chapter IX. We however provide comments below on the currently proposed language in Section B.

General comment: We note that the Discussion Draft refers to "rights" or "entitlement" to claim intangible related return. We believe it would be helpful for the OECD to clarify that it does not intend such "rights" or "entitlement" to be treated as intangibles themselves. For instance, the fact that a distributor
may in certain circumstances be entitled to obtain benefits from the intangible
return from its turnover and market share (see paragraph 51) does not mean
that it should systematically be regarded as the owner of a transferable "local
marketing intangible".

Para. 28: We understand that paragraph 28 is focused on the attribution
of the return attributable to the use of the intangible ("business operations
involving use of the intangible"). We suggest that it should more explicitly
recognise the need to remunerate the investment in the acquisition or
development of the intangible and associated risk.

We understand that some countries may be concerned with certain structures
whereby the investment in the acquisition or development of the intangible is
located in a low-tax jurisdiction and/or lacks economic substance. Again, we
respectfully submit that such concerns should be dealt with within the
appropriate policy and legal parameters. We believe that it would be greatly
damaging for the arm's length principle and TPG if such concerns led the
OECD to ignore the fact that in the vast majority of cases, independent parties
do remunerate the investment in the acquisition or development of the
intangible; and that many of the entities investing in the acquisition or
development of the intangible are not located in low-tax jurisdictions.

In addition, we suggest that item (ii) should refer to arm's length returns to
business functions, assets and risks.

Paragraph 28: We agree that in a particular circumstance, intangible related
returns with respect to an intangible may be positive, negative, or zero. We
note that in audit situations, some tax authorities tend to claim that the local
entity should be entitled to intangible related return when they perceive it to be
a profit, but reject the profit split method when it is a loss, i.e. in loss-making
situations some tax authorities tend to claim that a guaranteed profit should be
attributed to the local affiliate through a cost plus method or TNMM. We
suggest the OECD should reaffirm that the assessment of entitlements to
intangible related return should be made in an objective manner, irrespective
of whether it leads to the sharing of a profit or loss.

Para. 35: This paragraph also focuses on the return from the use of the
intangible and seems to attribute it in priority to the entity which uses the
intangible. The last sentence refers to the licensee's obligation to provide arm's
length compensation for the grant of the licence; however, the Discussion
Draft does not provide any guidance on how to determine such an arm's length
remuneration. As for paragraph 28, we suggest that this paragraph should
more explicitly recognise the need to remunerate the investment in the
acquisition or development of the intangible and associated risk.
We note that the entity entitled to use the intangible is not necessarily the same as the one entitled to exclude others from using the intangible. For instance, a contract manufacturer may be entitled to use, in its manufacturing activities, a patent belonging to the principal, without being entitled to exclude others from using the patent. At arm's length, the contract manufacturer would not be entitled to the economic return from the intangible beyond the remuneration of its manufacturing functions. The owner of the patent which has invested in the development or acquisition of the patent should be compensated for such investment and associated risk.

We suggest a reference to the example at paragraph 9.27 should be made.

Paras. 38-40: We believe these paragraphs could be improved if it was made clearer that the functions related to the development, enhancement, maintenance and protection of intangibles may be performed by different parties and give rise to distinct parts of the intangible related return. It is common, both at arm's length and among associated enterprises, that not one single entity will perform all the functions related to the development, enhancement, maintenance and protection of intangibles. Paragraph 40 seems to assume that cases where such functions are performed by various entities are exceptions to the rule ("some of these functions are sometimes outsourced"). See above comment on paragraph 27.

Para. 39: We believe that the second sentence is either misleading or a departure from the arm's length principle. At arm's length, research and development and marketing functions would generally be compensated by an appropriate return on said functions taking into accounts the risks assumed and assets contributed by the parties; in some specific circumstances only, by rights in the intangible return itself. Thus, at arm's length, contract researchers do not necessarily share in the return from the outcome of the research, unless they also share in the risk of the research process itself. Advertising agencies rarely share in the return from the trademark which they are contributing to enhancing.

Paras. 42 to 45: We suggest that it would be helpful to recognise that the operational risks of the party using the intangible are not the same as the investment risks of the party owning the intangible. See paragraph 1.46 of the TPG which explicitly recognises the risks of loss associated with the investment in property and the risks of the success or failure of investment in research and development.

Para. 47: While we agree that the bearing of costs related to the development, enhancement, maintenance and protection of intangibles may

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2 The party using the intangible may also bear its own investment risk, for instance in relation to a plant and equipment necessary to manufacture products using a patent. Such investment risk is distinct from the one of the party which has invested in the development or acquisition of the intangible.
not create an entitlement to *all* the intangible related return, we respectfully but strongly disagree with the statement that such bearing of costs does not, in and of itself, create *an* entitlement to intangible related return. This is one area where we feel that the anti-avoidance focus of the paper leads to a clear departure from the arm's length principle and to the wrong policy result for the vast majority of transactions.

Para. 48: We are concerned that the first sentence of paragraph 48 as currently drafted may be read to mean that only the entities which do not claim intangible related return should be compensated with an arm's length return. In our view, it is also important to ensure that that any determination that an entity is entitled to intangible related return as well as, where applicable, of the quantum of such return, should be made in accordance with the arm's length principle. Furthermore, we do not think that the requirement to remunerate these functions with arm's length return is relevant to the question whether the contractual terms are aligned with the conduct of the parties. We therefore suggest the following edits:

"One condition for concluding that the contractual and other arrangements of an MNE group related to entitlement to intangible related returns are aligned with the conduct of the parties is that The associated enterprises that perform functions related to the development, enhancement, maintenance or protection of intangibles, but do not claim entitlement to intangible related returns, should be provided with arm’s length compensation for the functions they perform, taking into account the assets they contribute and the risks they bear. In evaluating whether associated enterprises retained to perform functions related to the development, enhancement, maintenance and protection of intangibles have been compensated on an arm’s length basis, it is necessary to consider the guidance in Chapters I-III on comparability and on the selection and application of the most appropriate transfer pricing method, both the amount of compensation paid and the level of activity undertaken. Reference should be made to both the level of activity and the compensation received by comparable uncontrolled entities performing similar functions, using similar assets and bearing similar risks in assessing whether the compensation provided is consistent with the arm’s length principle."

Para. 51: We believe that it would be helpful for the OECD to clarify that when a distributor is entitled to share in the profits derived from the use of a trademark through its turnover and market share, this does not mean that it should systematically be regarded as being the owner of a "marketing intangible" corresponding to such turnover or market share. The market share may be related to many factors including the underlying features of the product, the trademark and/or the distributor's capabilities. Furthermore, it
does not necessarily translate into something which is capable of being owned, controlled and transferred.

We find that there is an apparent contradiction between paragraph 51 and paragraph 47 as to the consequences of the bearing of costs.

Para. 52: Functions leading to process or product improvement should be remunerated at arm's length. Depending on the facts and circumstances of the case, the remuneration of such function may be embedded in the remuneration of the manufacturing activity; or it may be charged as a separate service provision; or it may give rise to an entitlement to share in the intangible return. It should not be presumed that all process or product improvements systematically lead to a co-ownership of the intangible concerned, because this is not the way independent parties operate at arm's length.

Section B.4: We suggest that the heading should be changed to "Recognition of transactions and contractual allocations of rights."

Para. 53: We suggest that the second half of the sentence ("notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles") should be deleted. As currently drafted, this sentence can be read as dismissing the guidance provided throughout Section B of the Discussion Draft.

Paras. 54 and 55: In line with our above-comments, we suggest that:

- The recognition that contractual allocations of rights should be the starting point in the analysis (first sentence of paragraph 55) should be moved upfront;
- A reference should be made to the arm's length principle, *i.e.* to what independent parties have done or would have done in comparable circumstances;
- The first bullet point should be redrafted to read "Perform and control important functions related to the development, enhancement, maintenance or protection of the intangibles";
- The discussion of the notion of "control" should be aligned with the one at TPG 9.22 - 9.28.

The Discussion Draft refers on several occasions to "risk, functions and costs being aligned with contractual allocations". We find it unclear whether this phrase is intended to apply in cases where the actual behaviour of the parties does not conform to the contractual allocation of risks and/or intangible rights, or to cases where "important functions" are performed by entities which are not the owner of the intangible. If the intention is the former, we agree with it.
and suggest it should be clarified. If the intention is the latter, we believe that any economic substance test in the TPG should be aligned with the existing guidance at TPG 1.64-1.69 and 9.161-9.194 and that the discussion of "control" should be more closely aligned with the existing guidance in TPG 9.22-9.28. If an economic substance test is set with no reference to what independent parties do or would have done in comparable circumstances, it may entail a departure from the arm's length principle. At arm's length, it is not rare that a party contributes to the development or enhancement of an intangible it does not own and is remunerated for the service provided, without being granted any right to the intangible return. See our comments in the cover letter on the interaction between economic substance, the arm's length principle and anti-abuse measures.

As currently drafted, paragraph 54 provides that the intangible related return should be shared between the parties performing or controlling certain important functions. As for paragraphs 38-40, it seems to presume that the performance of these functions by more than one entity is an exception to a base line scenario whereby all these functions would be performed and controlled by a single entity. We believe that in reality, it is common practice, both between independent parties and between associated enterprises, for these functions to be performed by distinct entities.

As a consequence, we suggest that it is not sufficient to state that in such circumstances the intangible return should be shared among the parties, without providing any affirmative guidance on how to share it. Our comments on this question are explained above (comments on the box before Section B and proposed distinction between (i) the return attributable to the investment in the acquisition or development of the intangible and associated risk, (ii) the return attributable to the functions leading to the development of the intangible and (iii) the return attributable to the use of the intangible).

Finally, we note that paragraphs 54 and 55 address situations whereby a tax administration would disregard the contractual allocation of risks and/or rights in intangibles. We therefore suggest that these paragraphs belong to Section B.4 and that there should not be a separate Section B.5 heading.

Section C: Transactions involving the use or transfer of intangibles

As mentioned at the start of our comments, we believe that the Discussion Draft could be made clearer and more efficient by focusing on situations involving the transfer of valuable intangibles (including licensing arrangements). This is because situations involving the mere use of intangibles are generally adequately dealt with applying the guidance in Chapters I-III (subject to any addition the Working Party may find necessary to those Chapters).
Section C.1: We suggest that the heading of Section C.1 should be revised to read: "Transactions involving the use of intangibles in connection with the production or sales of goods or services".

Para. 60: In the car manufacturer example, the patents are used by the manufacturer, not by the distributor. Accordingly, the example could be better placed after paragraph 72, to illustrate a case where a transfer of tangible goods (i.e., cars) does not imply a transfer of intangible (i.e., patents used to manufacture the cars) from the manufacturer to the distributor. We further suggest that the last sentence of paragraph 60 could be edited to read "In such a case, the patents are used in the manufacturing and may affect the value of the cars; but neither the patents themselves nor rights in the patents are transferred from the manufacturer to the distributor".

Transfers of combinations of intangibles

Paras. 67, 68 and 70: The question addressed in these paragraphs relates to the valuation and pricing of a transfer of a combination of intangibles. We believe that it would be better placed in Section D.2 (v) of the paper. See also our comment on a similar point currently addressed in paragraph 6.

Furthermore, we suggest that a reference to the guidance in paragraphs 3.9 to 3.12 of the TPG on the evaluation of a taxpayer’s separate and combined transactions could be added.

Finally, we believe that Chapter VI should not assume that combinations of intangibles are always more valuable than intangibles taken separately. For instance, it is conceivable that the incremental addition of one intangible to an existing bundle may have less of an effect in some cases than if that same intangible was made separately available -- the sum of the parts may be greater than the whole in some cases, rather than vice versa.

Para. 69: We do not understand what the consequences of the language in paragraph 69 are. Can the OECD provide examples of the situations which it intends to address here?

Transfers of intangibles in combination with other business transactions

This Section contains several references to the possibility that service transactions could involve the transfer of intangibles. While it appropriately notes at paragraph 72 that "in some situations it may be both possible and appropriate to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles for purposes of conducting a transfer pricing analysis" while "in other situations transactions may be so closely related that it will be difficult to segregate tangibles goods or service

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3 We further note that in such a case, there is no transfer of rights in the patent to the customer buying the car from the distributor.
transactions from transfers of intangibles", the Discussion Draft does not provide any guidance on how to differentiate between these two kinds of situations.

As indicated above, we suggest that:

- The car manufacturer example which is currently in paragraph 60 could be used to illustrate a case where a transaction in tangible goods does not involve a transfer of intangibles or rights in intangibles.

- Guidance could be provided on how to differentiate the mere provision of services (whereby the service provider uses know-how) from transactions leading to the transfer of know-how. This could possibly be done by borrowing (and adapting, to the extent felt needed) language from the existing Commentary on Article 12 of the MTC.\footnote{Without changing the OECD view that transfer pricing analyses do not need to be aligned with Article 12 characterisation analyses.}

Para. 73: We suggest deleting the last sentence. As currently drafted, it is not clear whether the intention is to suggest that the intangibles and services may still be valued separately but that a "premium" should be added to the value of each to capture synergies. If this is the intention, we do not concur with the statement. We believe that the synergy effect addressed in the last sentence of paragraph 73 is best captured by valuing the intangibles and services as a package in appropriate cases, as discussed in paragraph 74.

We further suggest that a reference to paragraphs 3.9 - 3.12 of the TPG should be added.

**Section D: Determining Arm's Length Conditions in Cases Involving Intangibles**

As a general comment, we suggest that Section D.1 on comparability analysis should be brought earlier in the document. Comparability analyses should be performed at the start of transfer pricing analyses as acknowledged in paragraph 3 of the Discussion Draft. In particular, we believe that the discussion in Section B about contractual allocation of intangible related return would be improved if it were more solidly grounded in comparability analysis, including a review of the functional analysis of the associated enterprises, of the contractual terms among them and of the conditions agreed or which would be agreed between independent parties.

Para. 85: We find this paragraph confusing. First, in practice, most if not all business transactions involve the use of some type of intangible. This is
why we suggest that the Discussion Draft should focus on valuable, unique intangibles.

Secondly, the fact that a party uses intangibles does not mean that it should systematically be entitled to the intangible related returns with respect to the intangibles used. See our comments above on the box before Section B and in particular on the determination of the return attributable to the use of the intangible.

We suggest the following edits to paragraph 85: "[...] In many cases, an arm's length price or level of profit for the tested party can be determined without the need to separately value the intangibles used in connection with the transaction. That would generally be the case where the tested party does not contribute any unique, valuable intangible to the controlled transaction. In some cases, however, the tested party may in fact use valuable, unique intangibles and may (or may not) be entitled to the corresponding intangible related returns. [Delete the end of the paragraph as the issues addressed there are better captured in paragraphs 86 and 87.]

Para. 87: We agree with the conclusions in this paragraph.

Para. 89: We suggest the following edits to the last sentence: "Potentially comparable transactions should be disregarded or adjusted on the basis of the existence and use of non-comparable intangibles [...]."

Paras. 90 to 104: While we agree that all the elements listed in these paragraphs may be relevant to assess comparability of intangibles and rights in intangibles, we believe that it would be helpful to weigh them against the backdrop of the objectives, reasonableness and workability of performing a comparability analysis. The quest for accuracy should not lead to the setting of an unrealistic comparability standard which would in fact lead to the rejection of all comparables in practice. We suggest that a reference to 1.33, 1.36-1.38 and 3.80-3.83 of the TPG could be made at paragraph 91 to balance it.

5 See for instance TPG 1.37: “The extent to which each of these factors matters in establishing comparability will depend upon the nature of the controlled transaction and the pricing method adopted” and TPG 1.38: "If it can be reasonably assumed that the unadjusted difference is not likely to have a material effect on the comparability, the uncontrolled transaction at issue should not be rejected as potentially comparable, despite some pieces of information being missing.”
Para. 93: We suggest that the heading of item (b) be amended to read "Extent and duration of legal or commercial protection" and that the discussion in paragraph 93 should also address the notion that intangible valuation would usually be affected by the parties' capacity to exclude others from using the intangible.

Para. 102: We suggest that the discussion of the various types of risks which may be attached to an intangible be supplemented with a discussion of the various types of risks which may be borne by the parties; e.g. investment risk, risk of failure of the research and development process, or operational risk linked to the use of the intangible.

Paras. 103 and 104: We believe that paragraphs 103 and 104 are not needed and that the more general statement in paragraph 79 that the guidance on comparability analyses in Chapters I and III applies to comparability analyses of transactions involving intangibles is sufficient. We suggest that the guidance on comparability in Chapter VI should be limited to specific issues related to intangibles which are not otherwise addressed in Chapters I and III.

Alternatively, if these paragraphs are retained, thus highlighting two specific aspects of the guidance provided in Chapters I and III, we suggest that the same balance as was achieved in Chapters III should be achieved here as follows:

Paragraph 103 could include a statement that comparability adjustments are only appropriate for differences that will have a material effect on the comparison. Some differences will invariably exist between the taxpayer's intangibles and third party intangibles. A comparison may be appropriate despite an unadjusted difference, provided that the difference does not have a material effect on the reliability of the comparison (see paragraph 3.51 of the TPG).

Paragraph 104 could include a statement recognising that databases can be a practical and sometimes cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. A reference to paragraphs 3.30 to 3.34 of the TPG could be included.

Para. 105: We understand paragraph 105 as referring to the same notion as the one of "valuable, unique intangibles" which was adopted by WP6 in the 2010 revision of the TPG and is used in numerous instances in Chapters II and III of the TPG. Specifically, we understand that item (i) of the definition
proposed at paragraph 105 refers to the uniqueness of the intangible, while items (ii) and (iii) are intended to refer to its value.

If our understanding is correct, we suggest that it would be clearer to use the same wording throughout the TPG. On the other hand, if this paragraph is intended to address a differing notion than the one of "valuable, unique intangibles", then we suggest that the differences between the two as well as the reasons for which the latter is not found appropriate in the context of Chapter VI should be explained.

In any event, we do not think that item (ii) of the definition proposed at paragraph 105 should be retained. This is because the use of any intangibles, even the most basic ones (e.g. a routine distribution or manufacturing know-how or a word-processing software) is expected to yield greater benefits than would be expected in their absence. This criterion is therefore not helpful in understanding the notion that the Working Party is willing to define.

Para. 110: We suggest that the last sentence of paragraph 110 should be rephrased as follows: "In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes."

Para. 116: We suggest that the last sentence of paragraph 116 be completed with "unless such a rule of thumb is in fact the most reliable method in the circumstances of the case."

Section D.3: Transactions involving the use of intangibles in connection with sales of goods or services

For the reasons outlined above, we suggest that Section D.3 should be deleted and replaced with a reference to the existing guidance in Chapters I-III. To the extent needed, relevant additions could be made to these chapters directly.

Paras. 120 to 124: Even if Section D.3 is retained, we suggest that paragraphs 120 to 124 should be deleted. Section (i) addresses situations where reliable comparables exist; we find it confusing to have at paragraphs 120-121 a discussion of cases where "D.1 (vi)" intangibles are used by the tested party, i.e. where the intangibles "are not similar to intangibles used by or available to parties to potentially comparable transactions". Furthermore, the discussion of comparability adjustments at paragraphs 122 to 124 could be replaced with a reference to paragraphs 79-105 or to paragraphs 103-104.
If paragraphs 120-124 are retained, we suggest that they should be amended.

Among other amendments, we suggest that they should refer to intangibles contributed to the controlled transaction by the tested party", not to intangibles "used". This is because the simple use of intangibles does not necessarily entitle the user to a higher profit. For instance, a contract-manufacturer which is using a patent belonging to the principal to manufacture products for the latter will generally not be entitled to a greater return for the use of such patent.

Furthermore, the list at paragraph 124 of factors that are not intangibles but that may require comparability adjustments and that "can ... have important effects on arm's length prices" (e.g. "matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors") is pretty open-ended and important, but there is currently no guidance on how to approach them from a transfer pricing point of view. We understand that they will be further addressed in the next iteration of the Discussion Draft as it includes proposed amendments to the guidance on comparability, and we look forward to the opportunity to contribute to the discussion of these factors.

Para. 126: With respect to the second and third bullet points of paragraph 126, we suggest that a reference should be made to TPG 9.50 to 9.64, in order to provide the necessary context to the discussion of business reasons and options realistically available. In effect, in accordance to the general guidance on the selection of the most appropriate method at TPG 2.2, business reasons and options realistically available are not factors affecting the intrinsic value of a transaction.

We further suggest that the first bullet point of paragraph 126 should be broadened to refer to the "comparability (including functional) analysis of the controlled transaction" and that the fourth and fifth bullet points of that paragraph should be merged with the first bullet point. In effect, comparability analyses as defined in Chapter I encompass an analysis of the functions, assets and risks as well as of the other comparability factors which may affect a controlled transaction.

Para. 127: We suggest that a reference to the discussion at TPG 1.64-1.69 of recognition of actual transactions undertaken should be included in paragraph 127.
Section D.4: Transactions involving the transfer of intangibles or rights in intangibles

In general, we find that this section mainly addresses the comparable uncontrolled price and profit split methods, and neglects other common methods set out by the TPG, and commonly used by tax authorities and taxpayers alike. If this section is retained, we recommend making it more balanced with respect to the full range of methods available.

Paras. 135-136: We suggest that these paragraphs be replaced with a reference to the guidance on the selection of the most appropriate transfer pricing method in Chapter II. As currently drafted, these paragraphs merely caution against the use of certain methods, without context for the factors that should be considered in selecting a method or providing guidance as to why or what alternatives are preferred.

The availability of evidence to apply the transactional profit split method is usually extremely limited, and may exist only within certain industries where it is common to establish intangibles-related relationships with third parties. This makes the use of the profit split method a challenging and often imprecise exercise, and we believe that the OECD should refrain from suggesting that the profit split method should become a method of first choice for transactions involving intangibles - especially given that no threshold has been set, i.e. the proposed guidance as currently drafted would apply to all intangibles, routine and non-routine.

Para. 138: While we agree that arm’s-length acquisitions may provide information relevant to the valuation of individual acquired intangibles, we believe this paragraph may be too prescriptive. In particular, the parenthetical statement seems to limit the adjustments to be performed only to the acquired assets not re-transferred, and appears to exclude the appropriateness of other adjustments which may be warranted by the facts of the case. We suggest deleting the second sentence and modifying the third sentence to say “Depending on the circumstances, the third party acquisition price, after appropriate adjustments, may inform the analysis of arm’s length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets.”

Para. 144: This paragraph effectively eliminates the use of profit split methods for valuing transfers of partially developed intangibles. While cautions regarding the extent and defensibility of assumptions required is appropriate, we see no reason for this document to effectively conclude that use of such methods is “unlikely” to yield reliable results. We believe the general reliability standards articulated in Chapters I-III of the TPG and in particular at paragraphs 2.108-2.145 are sufficient to address the factors to
Para. 147: While we understand that the Discussion Draft does not intend to provide a summary of valuation techniques, we observe that it provides several pages of commentary regarding the application of the DCF approach, and also comments on the application of the cost approach. Since valuation techniques tend to fall into three categories (market, income and cost approaches), the Discussion Draft has taken on two of these three categories already. Consequently, we believe the Discussion Draft either says too little or too much about valuation techniques in its current state.

Further, the Discussion Draft abstains on defining the standard of valuation, which is, perhaps, the single most important driver of how valuation techniques are applied. By remaining silent on this, we are concerned that the Discussion Draft may create dispute and confusion, when it could have provided greater clarity and guidance. To wit, while the text of the Discussion Draft states its abstention, numerous of the Examples in the Discussion Draft in fact suggest the use of a standard other than the fair market value standard. In so doing, it would appear that WP6 has, in fact, selected a standard of valuation, or at least has de-selected the fair market value standard.

We are particularly concerned about the failure to identify the fair market value ("FMV") standard as the appropriate standard of value if valuation techniques are to be applied in a transfer pricing setting, and we strongly recommend its outright adoption. We believe this is critical for several reasons:

1. FMV attempts to establish the value that would prevail in the "market", which is what the arm’s length principle aspires to apply.

2. FMV is the best understood and most commonly applied standard of value; thus, the vast body of evidence, literature, precedent, and experience relates to the application of the FMV standard.

3. Other standards of value (other than perhaps liquidation value) are not well-understood or frequently applied in practice. As a result, not only is there scanty evidence, analysis and precedent, but permitted use of these other standards invites speculation and excessive “creativity” on the part of the appraiser, the taxpayer, and the tax authority.

4. Not unlike the Discussion Draft’s unwillingness to define "goodwill", a failure to define the standard of value will create potentially significant disputes, solely based on the standard of value applied, and WP6 will have missed an opportunity to provide true guidance to the parties concerned.
Para. 148: The FMV standard of valuation, if adopted, could help address WP6’s concern. The FMV standard explicitly assumes that the parties to the transaction have full information, which is what related parties, in fact, have. The FMV standard goes on to assume that neither party is compelled to transact, which is equivalent to assuming that both parties are equally willing to transact, which is also the situation between related parties. We believe that adoption of the FMV standard will bring application of valuation approaches to transfer pricing more closely into alignment with the arm’s length principle, because the premises of the FMV standard essentially bridge the gap between related party and arm’s length transactions.

This paragraph also states that "the arm’s length price will fall somewhere within the range of both present values [...]." It would be helpful if the OECD could confirm that this phrase does not mean that there is only one acceptable arm’s length price, but that an arm’s length price is any price within this range, consistently with the guidance at paragraphs 3.55-3.62. If only one point within this range is accepted, then further dispute will be created as to exactly what that point is, and how similarly situated unrelated parties would have arrived at that result.

As an alternative to the language that proposes that the cash flows be calculated "from the perspectives of both parties to the transaction", we would suggest the application of the FMV standard of valuation, which normally will yield a single value for a given set of projections and other assumptions. A range of acceptable results can be created around this point by varying the key assumptions used in the valuation, such as the financial projections, the discount rate, and other similar factors. The range as defined by these scenarios could be established as "the arm’s-length range", and any result within this range would be respected as an arm’s-length result. In fact, this precise approach is suggested in Para. 151 with reference to a sensitivity analysis.

We also would like to address the issue of taxes as they relate to valuations (reference is made to taxes in the last sentence of Para. 148), but reserve our comments for paragraphs 168-170. We do note that the reference to taxes here provides no real guidance, and if guidance is to be provided, a cross-reference should be added.

Para. 155: The Discussion Draft signals its general preference for using financial projections that have been prepared for business decision making, and not just for tax or transfer pricing purposes. We generally agree with the spirit of this message; yet we note that a specific intercompany transaction that is subject to valuation may require a projection that the broader business does not need or prepare. Often business projections address far more aggregated transactions than those that take place between related parties and are subject to transfer pricing. For this reason, we suggest that the Discussion Draft be
modified to eliminate the aspersion cast on projections created for tax or transfer pricing purposes if no business projections exist that are suited to the transfer pricing transaction.

Paras. 154-159: These sections provide a variety of cautions regarding financial projections and growth rates. While we agree that caution is necessary, we also recognize that if financial valuation methods based on income (discounted cash flows) are to be pursued, projections are an inescapable part of the method. Providing a more balanced view could be helpful. Equally, the uncertainty introduced by speculative projections may undermine the reliability of a DCF method, and other methods, including conventional transfer pricing methods, may be preferable.

Para 166: The description of follow-on effects after the expiration of legal protection for intangibles may suggest this is routinely the case; given that it may not be, some balance could be useful.

Paras. 168-170: It is our view that the Discussion Draft has dealt with the effect of corporate income taxes in too cursory a fashion, and that this is an area that is commonly misunderstood. Moreover, it is our experience that tax authorities currently are raising issues related to the effect of tax rates on transaction values, and are applying approaches and assumptions that are often at odds with arm’s length behaviour.

Para. 168 introduces the notion that taxes are a cost, and that cash flows are reduced when taxes are introduced. This is a truism. Yet the Draft posits two "issues" that arise: one appears to be a question of whether a "post-tax value must be converted to a "pre-tax" value (Para. 169); and the other appears to relate to whether tax benefits stemming from the transaction should be somewhat shared between the participants to the transaction (Para. 170). We believe that both of these issues deserve further consideration and analysis.

With regard to the suggestion in Para. 169 that "appropriate adjustments" may be needed because transfer pricing "must typically be determined on a pre-tax basis", we disagree with the implication that a post-tax value must be "grossed up" to a pre-tax value to the buyer/licensee/recipient. The notion of grossing up for taxes is equivalent to requiring a buyer/licensee to pay the entire amount of taxes on the seller/licensor. Tax considerations may in some cases play a role in negotiations between independent parties, both for the transferor and the transferee. Yet empirical evidence is not conclusive on what the actual effect on the price - in the cases where there is such an effect - is.

In addition, also in relation to Para. 170, if such an analysis is conducted, it cannot be limited to the tax rate, but should theoretically address all the tax attributes of the transferor and transferee. Imagine however the complexities introduced by an attempt to reflect the actual tax situations of a given buyer or seller as they relate to a specific income stream: what tax rate applies? Does
the buyer or seller have carryover losses? Does either party benefit from a tax holiday? Is the income associated with other attributes that influence the tax rate of the company, if not the tax rate applicable to a specific cash flow? The unresolvable and unknowable aspects related to actual taxes serve to create dispute where none need exist. Here, again, adoption of the FMV standard for valuations appropriately simplifies the exercise and makes the valuation possible in a far more reliable and objective manner.

**Examples**

*Example 1.* We believe that in Example 1, the reason that Company S is not entitled to intangible related return is that it has not in substance acquired ownership of the intangible from its parent company Premiere. Company S only made a 100 Euro payment made for IP registration purposes; at the same time as it nominally acquired the intangible, it granted an exclusive, royalty free, patent license for the full life of the registered patent.

We are very concerned with the implication in Example 1 that contractual terms are not relevant to the analysis and that tax administrations may disregard the contractual allocation of rights solely based on "control" and "functions". This conclusion does not seem to be grounded in the text of the proposed revised Chapter VI. If this is the intended meaning of Example 1, we believe that at a minimum, a reference should be included to the relevant guidance on the recognition of transactions (TPG 1.64-1.69 and 9.161-9.194).

*Example 2* We find that Example 2 relates to the determination of an arm's length remuneration for the distribution function (as dealt with in Chapters I-III) and arm's length allocation of risks (as addressed at TPG 9.10-9.47). One key question in applying the arm's length principle to such a situation is whether or not comparable distributors do bear comparable risks of recall. We do not believe that Example 2 illustrates proposed guidance in Chapter VI.

*Example 5* We suggest that paragraph 201 should be amended to more clearly acknowledge the importance of comparability analysis. The proposed adjustment is based on the fact that the higher level of marketing expenses incurred by Company S results in significantly lower profits for Company S than are made by comparables.

*Example 7* We believe that the second bullet point of paragraph 206, *i.e.* that the notion that the introduction of the royalty results in Company S' profitability declining substantially, is irrelevant to the determination of a transfer pricing adjustment. Pre-royalty profits arose from controlled transactions which cannot be used as comparables. See TPG 3.25 and 9.65.

*Example 10* We suggest that an addition should be made to the last sentence of paragraph 217 to read: "Shuyona makes no or only a nominal payment to
Company S in relation to the patents developed by Company S." In effect, the conclusions of Example 10 would be different if Shuyona paid an arm's length price for the acquisition of the patents from Company S.

**Example 11** We believe that the discussion of this example should be more solidly grounded in the arm's length principle (i.e. in a reference to what independent parties do or would have done in comparable circumstances). Moreover, we believe that paragraphs 222 to 224 are not consistent with the guidance on risk allocation at TPG 9.10 to 9.47, in particular the example at TPG 9.26. Following the guidance in Chapter IX,

- The starting point in the analysis should be the contractual terms between Company T and Shuyona.
- A verification should be made whether the actual behaviour of the parties conforms to the contractual terms. In this respect, it would be relevant to determine whether in this example the R&D costs are effectively borne by Company T irrespective of the success or failure of the R&D.
- Furthermore, a determination should be made whether the contractual terms are arm's length, i.e. consistent with what independent parties agree or would have agreed in comparable circumstances. In that respect, we suggest that the word "allegedly" should be removed from the last sentence of paragraph 222. If the comparables are only "allegedly" comparables, they do not help in reaching a conclusion.
- In the absence of comparables evidencing a similar allocation of risks and intangible related return between independent parties in comparable circumstances, one relevant although non determinative factor to consider is which party exercises greater control over the R&D function.

We further suggest that the discussion of "control" be better aligned with the one in TPG 9.22-9.28.

**Example 12** We think that the question in Example 12 is not whether the contractual terms between Primarni and Company S should be recharacterised (which could only be made following the guidance in TPG 1.64-1.69 and 9.161-9.194), but rather whether an arm's length royalty should be charged by Primarni to Company S for its use of the patent and know-how in a territory broader than just Country B. We note that in the proposed fact pattern, it is likely that at least a verbal agreement exists between Primarni and Company S regarding the sale of products by Company S to related distributors. See TPG 1.52.
Example 13  It is unclear to us what the intended meaning of the reference to "goodwill and ongoing concern value" in Example 13 is. If it is meant to address the residual value in a purchase price allocation or a mere "profit potential", we disagree with the conclusions of Example 13. We believe that whether or not there should be a compensable payment from the branch to S can only be determined based on an analysis of the rights and other assets of the branch. As mentioned above in our comments related to paragraphs 19-22, we think the Discussion Draft could be improved if different phrases were used when addressing differing concepts.

Furthermore, we note that Example 13 raises questions as to the attribution of rights in intangibles to the PE or head office. This is an Article 7 question which is overlooked in the current drafting of the Example. We therefore suggest that this example does not belong to an Annex to Chapter VI of the TPG. If it is retained, we suggest that the reference in paragraph 228 to "a branch or permanent establishment" be replaced with a reference to "a branch", consistently with paragraph 229 and 230.

Example 14  We suggest the following edits to Example 14:

233. Beginning in Year 2, Company S reimburses the distribution affiliates for a portion of their advertising costs. Company S however performs no functions with regard to advertising nor does it control any risk related to marketing the products. Prices from Company S to the distribution affiliates are adjusted upward to reflect the bearing so that the distribution affiliate margins remain constant notwithstanding the shift of advertising costs to by Company S. Assume that the margins earned by the distribution affiliates are arm’s length both before and after Year 2. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

234. In Year 3, the prices charged by Första to Company S are reduced. Första and Company S claim such a reduction in price is justified because, due to the advertising costs it has borne, Company S is entitled to intangible related part of the returns associated with goodwill in respect of Product Y intangibles which were previously earned by Första created through the advertising costs it has borne.

235. In substance, Company S has no claim to a return previously earned by Första to goodwill with respect to Product Y intangibles, and transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate. Company S has not borne the costs nor performed or controlled functions and risks related to the creation, enhancement, maintenance and protection of that goodwill—intangibles previously owned by Första. A—In order to
determine whether a transfer pricing adjustment to increase the income of Första in Year 3 would be appropriate to deny any intangible related return to Company S is appropriate, the guidance in Chapters I-III should be applied, based on a comparability analysis, including a functional analysis, of the controlled transaction between Första and Company S. A mere decrease in the returns earned by Första is not sufficient by itself to substantiate a transfer pricing adjustment.

Example 15

We suggest that the second sentence of paragraph 238 should be either deleted, or amended to read "The definitions and valuations of intangibles contained in the purchase price allocation can be informative but are not determinative for transfer pricing purposes."

We do not agree with the third sentence of paragraph 238 as currently drafted. We suggest that this sentence should be amended as follows: "The 100 paid by Birincil for the shares of Company T represents a risk-adjusted arm's length price for the business of Company T taking into account the perspective of Birincil and in particular its business strategies and expected synergies. It does not necessarily exclusively correspond to the value of assets owned or controlled by Company T."

In a number of instances, goodwill corresponds to a premium paid by the acquirer above the value of the assets of the acquired entity, e.g. to exclude a competitor from the acquisition transaction, for a control premium, and/or for anticipated synergies with the acquirer's other assets and activities, which may or may not materialise. There are also cases where the price paid for the acquisition is over-valued because of an over-optimistic assessment by the acquirer, keeping in mind that in arm's length acquisitions the acquirer does not have full information on the acquired entity. There are instances where the acquisition price is negotiated at a point in time where the economic prospects are favourable, but such favourable prospects do not materialise.

In the face of the many factors which may explain that a price is paid above the value of the assets of the acquired entity, goodwill should not systematically be regarded as intangible value of the acquired company. The fact that for consolidated accounting purposes, goodwill is treated as related to the acquired entity, only reflects a mechanical, accounting consideration: the acquisition price of the shares of the acquired entity is matched against the value of the underlying assets and the differential is posted as goodwill. It does not mean that the acquired entity necessarily "owns" the goodwill.

We suggest that the Discussion Draft should include a more balanced statement on goodwill, recognising that the existence of goodwill on the
balance sheet can be informative but is not determinative for transfer pricing purposes.

Furthermore, we do not find it accurate to state at paragraph 238 that "It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring." Each case should be judged on its own merits, and such a general assumption, which is not grounded in a review of the facts and circumstances of the case and in what independent parties do or would have done in comparable circumstances, is not helpful.

Example 18 We think that the words "that is not taxable" at paragraph 248 should be deleted, as this circumstance is irrelevant to Article 9 of the MTC and the application of arm's length principle to the circumstances of the case.

We suggest that the last sentence of paragraph 249 should be either deleted, or amended to read "The value attributed to intangibles in the purchase price allocation performed for accounting purposes can be informative but are not determinative for transfer pricing purposes."

Collateral changes to the Guidelines: other methods

We understand that the Working Party's intention is to achieve balance in paragraph 2.9 of the TPG by stating that tax administrations, as taxpayers, have the possibility to use "other methods".

We note however that in the vast majority of cases, taxpayers have the burden of setting and documenting the prices of their controlled transactions. We believe that the practical value of the guidance in Chapter II of the TPG would be extraordinarily diminished and that major uncertainties would be created if tax administrations had the freedom to use "other methods" without first giving due respect to the method selected by the taxpayer when the latter has been selected in accordance with the guidance in Chapter II. In fact, we think that because taxpayers set prices while tax administrations audit prices, preference should be given to the method of the taxpayer, unless there is a good reason to reject it. Accordingly, we suggest that paragraph 2.9 either be left unchanged, or be amended as follows:

2.9 Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter “other methods”) to establish prices provided those prices satisfy the arm’s length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-
workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.

As noted in paragraph 1.64, a tax administration’s examination of a controlled transaction ordinarily should be based on the method applied by the taxpayer insofar as the selection of such method is consistent with the guidance in Chapter II. If, however, the method selected by the taxpayer is not the most appropriate to the circumstances of the case, the tax administration may substitute for it another method. In doing so, the tax administration should follow the guidance in Chapter II on the selection and application of the most appropriate method to the circumstances of the case. In the event that neither the method selected by the taxpayer, nor any of the OECD-recognised methods is appropriate to the facts and circumstances of the case, the tax administration may use an "other method". In such cases, the tax administration should provide an explanation of why the method used by the taxpayer and the OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason that the selected other method was regarded as providing a better solution.
September 14, 2012

Mr. Joseph L. Andrus  
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Re: Comments on the Discussion Draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

Mr. Andrus,

Barsalou Lawson is a Canadian law firm specialized in corporate taxation for multinationals doing business in Canada, with a particular emphasis on transfer pricing. We are regularly involved in transfer pricing discussions with the Canada Revenue Agency.

We commend the Working Party No. 6 once again for its great undertaking to update and improve the Guidelines despite the many obstacles in achieving consensus on such challenging issues as intangibles. The Discussion Draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions considerably expands the breadth and depth of the guidance provided in the current version of Chapter VI.

Please contact Sébastien Rheault (514.982.6148; s.rheault@barsalou.ca) or Sheena Bassani (514.982.2306; s.bassani@barsalou.ca) should the OECD wish that we elaborate on these submissions or that they be presented at the meetings scheduled in November 2012.*

BARSALOU LAWSON

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*Thank you to Pierre Barsalou, Karen Leiter and Anne-Cécile Gérard of Barsalou Lawson, for their contributions.
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I. Introduction

It is our understanding that the OECD delegates are opting not to adopt a definition of intangible property that would be based on property law and that a broader definition is required to gain consensus. While this may be necessary in the circumstances and recognizing that the current draft significantly improves guidance with respect to intangibles, we are concerned that certain portions of this draft will, if adopted, create uncertainty in contractual relationships and perpetuate controversy on audit.

Indeed, despite the fact that useful statements are made about recognizing contracts and domestic law, the substance of the document would appear to suggest that legal and contractual considerations may be overlooked in favour of purely economic considerations. While it may be difficult to get consensus amongst OECD members which takes into account all domestic legal aspects, given that each country has its own tax, commercial and intellectual property law, we submit that the guidelines need to more strongly recognize that economic principles may only work within the parameters of the law (including the arm’s length principle itself).

II. Comments and Suggestions

A. Primacy of The Arm’s Length Principle

In order to reduce tensions between OECD Guidelines and domestic law as well as risk of controversy, we would recommend that the importance of including a proper analysis under domestic law be more explicitly incorporated within key sections of chapter VI (rather than limited to more general and isolated statements). The OECD Guidelines must not deviate from the treaty obligations as presented in paragraph 9 of the OECD Model Tax Convention, which underlie the OECD Guidelines, as incorporated into the domestic law of member countries. Chapter VI must therefore not introduce an interpretation that mutates these treaty obligations in favour of an approach that is perhaps preferred by WP6 members, unless the OECD is prepared to modify the underlying treaty obligations themselves.¹

In short, the draft should be revised so as to ensure a proper application of the arm’s length principle taking into account legal, accounting as well as economic principles.

¹ We must always bear in mind that the arm’s length principle is derived from the language in the Model Tax Convention, specifically as it relates to conditions that “are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises.”
1. Preamble to section B

In our view, the preamble sets the tone for a framework that is not compatible with the arm’s length principle and with domestic tax legislation in some countries. We agree with Working Party No. 6 delegates that transfer pricing outcomes should reflect the functions performed, assets used and risks assumed by the parties. However, contrary to what is suggested in the preamble to section B, we submit that it does not necessarily follow that that at arm’s length, “(…) neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.” This particular question can only be answered through an analysis of third-party comparable transactions. As discussed below, this statement effectively seek to override the arm’s length principle, introducing uncertainty in transactions and on audits.

The transfer pricing analysis should not only start with the contracts and relevant registrations, but rather, such contracts and registrations must be considered throughout the transfer pricing analysis. They should only be disregarded if it can be determined that these contracts and registrations do not to fall within the spectrum of arrangements that unrelated parties might enter into in an open market, subject also to domestic tax law. Similarly, the terms of such contracts should be respected unless it can be determined that conditions made or imposed between the two enterprises in the commercial or financial relations differ from those which would be made between independent enterprises. Where such differences occur, efforts should be expended to make transfer pricing adjustments that are consistent with the intent of the parties to the contract.

We recognize that legal ownership and costs may not be the only aspects that should be considered in the transfer pricing analysis; however, it would be a mistake to suggest that they can never be sufficient, taken separately or together, to conclude as to which entities would retain the benefits or returns with respect to intangible property in an arm’s length context. This is for the open market to determine and the answer may evolve over time.

2. Written Contracts

We support the statement that legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns. We also agree that the terms of a transaction may be found in written contracts or in correspondence and/or other communications between the parties. However, we submit that the last statement of par. 30 is not entirely correct. Where no written terms exist, efforts should be made to determine whether there is a verbal or implied contract and in the affirmative, such contract should be respected.

We would recommend that the last sentence of par. 30 be revised to state that:

Where no written terms exist, the contractual relationship of the parties must be deduced from their conduct and communications. If there is no evidence of any contractual arrangements between the parties, or if it can be determined that such contractual arrangements would never

2 Discussion Draft, par. 30.
have been entered into between parties dealing at arm’s length and subject to domestic law, transfer prices may be determined on the basis of what would have been agreed between unrelated parties.

3. **Alignment of Conduct with Contracts**

Paragraph 37 of the Discussion Draft provides that:

> Where the conduct of the parties is not aligned with the terms of legal registrations and contracts, it may be appropriate to allocate all or part of the intangible related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles. The parties’ conduct should generally be taken as the best evidence concerning the true allocation of entitlement to intangible related returns.

In our view, there is a risk that this portion of paragraph 37 be interpreted as suggesting that contractual arrangements may be disregarded and recharacterized as soon as it is found that the conduct of the parties is not aligned with the terms of legal registrations and contracts. Whether at arm’s length or not, the conduct of the parties is not always entirely aligned with the terms of the registrations and contracts. Consistent with paragraph 53, contracts may only be disregarded under extraordinary circumstances and only in conformity with application laws and regulations (*e.g.*, sham, recharacterization provisions). It is only in circumstances where it is determined that the contractual arrangements would never have been entered into between parties dealing at arm’s length (subject also to domestic law) that it may be appropriate to allocate all or part of the intangible related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles, if indeed it is demonstrated that arm’s length parties would have allocated intangible related returns based on these drivers.

We would suggest that paragraph 37 be further developed to indicate that where the conduct of the parties is not aligned with the terms of legal registrations and contracts, the first step under the arm’s length principle would be to determine what parties dealing at arm’s length would do in such circumstances.

Prior to giving any consideration to the reallocation of intangible related returns, the analysis should start with a review of the contractual arrangements themselves, to determine whether compensation would have been agreed between the parties or impose by a tribunal. Such contractual terms may include compensation for certain types of breach under the terms of the contract, termination notices and price adjustment clauses, for example. Also, it would be appropriate to consider whether the misalignment could be the result of explicit or implicit amendments to the contractual arrangements. Further, it may be a matter of compensating a party for the performance of a service for example, rather than seeking to reallocate intangible related returns.

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3 Discussion Draft, par. 37.
4. Physically Performing “Important Functions”\(^4\)

We agree with the first part of draft paragraph 40, which states that:

It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm’s length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles.

However, we submit that the following portion at paragraph 40 is inconsistent with the arm’s length principle:

It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, these functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

Similarly, paragraph 54 is inconsistent with the arm’s length principle in that it suggests that the parties performing and controlling part or all of certain functions and bearing or controlling part or all of certain risks should almost automatically be entitled to part or all of the intangible related returns, even if such parties may not have received such returns under arm’s length circumstances.

As currently drafted, paragraphs 40 and 54 would effectively seek to impose certain prescribed terms and economic results, rather than to seek to achieve the closest approximation of the workings of the open market during the period in issue. Creating an expectation that the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the “important functions” related to the development, enhancement, maintenance and protection of the intangibles would appear to be an attempt to override the arm’s length principle, as set forth in Article 9 of the OECD Model Tax Convention and as incorporated into the domestic law of member countries.

While the statements made in paragraphs 40 and 54 may be reflective of certain types of arm’s length arrangements, they do not necessarily reflect all arrangements that may be entered into between unrelated parties today (much less in the future). We suggest that it would be incorrect to assume that

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\(^4\) Discussion Draft, par. 40 and 54.
unrelated parties would never enter, today or in the future, into contractual arrangements where the entity claiming entitlement to intangible related returns does no “perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles.” On the contrary, business models between unrelated parties are in constant evolution and may present different patterns. For example, there is literature documenting “non-practicing entities” (“NPEs”) and defensive patent aggregators, whose primary business model is to acquire patents and then seek licensing revenues from operating companies through litigation or the threat of litigation.5

Further, the determination of what may constitute “important functions” is subject to interpretation and would create uncertainty in transactions and audits.

We recommend that paragraphs 40 and 54, along with other sections such as paragraphs 42 and 46, be revised to raise these issues around the performance of functions and the assumption of risk as items that must be considered in the application of the arm’s length principle, but refraining from suggesting a particular outcome to the analysis. In other words, these paragraphs should provide guidance as to how the arm’s length principle may be verified but should not suggest the answer; that needs to be left for the open market to determine. Further, for greater clarity, these paragraphs should reiterate that contractual arrangements of a MNE should not be modified or disregarded for tax purposes unless it can be determined that the conditions made or imposed between the two enterprises in the commercial or financial relations differ from those which would be made between independent enterprises.

5. Disregarding Transactions6

Similarly, in order to avoid creating contractual uncertainty and controversy on audit, the following words (underlined) should be added to paragraph 53:

In the extraordinary circumstances described in paragraphs 1.64 – 1.69 and subject to the arm’s length principle and the specific legal and regulatory environment that prevails in each country, contractual allocations of entitlement to intangible related returns may be disregarded by tax authorities notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related ot the development, enhancement, maintenance and protection of the intangibles. See TPG paragraphs 9.164 – 9.167.

6. Illustrations7

Paragraph 56 should also be modified to include a statement that: “The illustrations should be adapted to the specific legal and regulatory environment that prevails in each country. Under no circumstances should these illustrations be read so as to overrule the arm’s length principle.”

6 Discussion Draft, par. 53.
7 Discussion Draft, par. 56.
B. Key Value Drivers and the Identification of Parties Entitled to Intangible Related Returns

WP6 has requested comments “at a very practical level” regarding key value driver functions for MNEs. Given the multitude of industries and business models that exist and continue to evolve in the various economies of the world, it would be neither realistic nor expedient to aim to prescribe a list of functions (or risks or assets for that matter) that are key value drivers. That question will always remain “What are the key value drivers of the particular enterprise under analysis?”

We do however commend WP6 in seeking to gain greater clarity on how to answer that question. We agree that the new Chapter VI should provide better guidance as to the drivers or factors that need to be considered (including contracts and registrations, as well as, when appropriate, functions, costs and other risks, interplay amongst assets, etc.). The great challenge is how to achieve this while not replacing arm’s length behaviour (as observed in the open market) with a one-size-fits all circumscribed list of functions and risks, etc. that may ultimately deviate from the arm’s length principle.

We suggest that an enquiry into which entity is essentially the entrepreneur is a pertinent question in refining the arm’s length criteria to assess in the determination of which parties should be entitled to intangible related returns, even if it may appear to be a simplified framing of a difficult question. Legal registrations and contractual arrangements must remain as the most fundamental consideration. However, the entrepreneurship concept will help inform the debate when attention is turned to analyzing functions, risks and costs related to the intangibles.

Below, we expand on the concept of entrepreneurship, which is not new to the OECD, followed by our suggestions regarding how to incorporate this concept into Chapter VI.

1. OECD Work on Entrepreneurship

In a capitalist society, entrepreneurs are rewarded for their contributions to economic growth.

Within the context of the OECD’s Entrepreneurship Indicators Programme (“EIP”), the concept of entrepreneurship has been the object of significant analysis in the pursuit of identifying policy areas affecting entrepreneurship performance. The stated goal of the EIP is: “to establish a framework of relevant indicators for the study of entrepreneurship and to encourage countries to use the definitions, methodologies and classifications of the framework as much as possible when producing the data.” In that same paper it is stated that: “entrepreneurship is a multifaceted concept that manifests itself in many different ways, with the result that various definitions have emerged and no single definition has been generally agreed upon.”

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8 Or, formulated in the plural, “which entities are the entrepreneurs.”
10 Ibid., p. 4.
In fact, a rather humorous parallel was made in a prior document of the EIP, between those in pursuit of defining the concept of entrepreneurship and the hunters of the infamous Heffalump in Winnie the Pooh: “Like the economists and scholars, familiar with entrepreneurs and their contribution to economic growth, and who have attempted over the years to define an entrepreneur, the hunters in Winnie the Pooh all claimed to know about the Heffalump but none could agree on its characteristics.”

The centuries-old debate on the concept of entrepreneurship may be due in part “to the fact that entrepreneurship isn’t neatly contained within any single academic domain. Indeed, many disciplines have contributed their perspectives on the concept of entrepreneurship, including psychology (Shaver & Scott, 1991), sociology (Reynolds, 1991, Thorton, 1999), economics (Cantillon, 1730; Marshall, 1890; Knight, 1921; Schumpeter, 1934 and 1949) and management (Stevenson, 1985).”

In 1934, Joseph Schumpeter hailed in a new spin on the definition of entrepreneur, which is when the “more modern interpretation, relating entrepreneurship, additionally, to innovation, entered the mainstream. Schumpeter defined entrepreneurs as innovators who implement entrepreneurial change within markets, where entrepreneurial change has 5 manifestations: 1) the introduction of a new (or improved) good; 2) the introduction of a new method of production; 3) the opening of a new market; 4) the exploitation of a new source of supply; and 5) the re-engineering/ organization of business management processes. Schumpeter’s definition therefore equates entrepreneurship with innovation in the business sense; that is identifying market opportunities and using innovative approaches to exploit them.”

2. Incorporating the Entrepreneurship Concept into Chapter VI

The concept of entrepreneurship is vast and rich enough to arguably provide a competing basis for approaching section B of the Discussion Draft. Determining who would be the entrepreneur in a given arrangement between third parties informs on the significant differences we observe in key drivers depending on the industry, market, or even business model and links the answer back to behaviour between third parties in a non-prescriptive manner. We gain insight without losing primacy of the arm’s length principle. The great number of definitions of the term entrepreneur only serves to improve the potential pool from which arm’s length experience can be drawn, since there is no need for there to be one agreed definition.

As outlined above, significant discussions on entrepreneurship have taken place at the OECD, which focussed on a concept very much similar to that which is at play in the Discussion Draft. We therefore believe it is pertinent to leverage the concept in the Discussion Draft, without necessarily needing to replace the framework for analysis as currently expressed in section B. Rather, we view it as an

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12 Ibid., par. 55.
13 Ibid., par. 58.
additional element that can be incorporated in the current framework for analysis, to capture the essence of the current expression in a more accurate and perhaps a more rational manner.

As an example, Schumpeter’s definition of entrepreneurs, above, highlights some of the arguably more valuable intangibles that can be created by the entrepreneur, which also informs on the relative value of such entrepreneurial change relative to that of others (i.e., which are key value drivers). There may be numerous other entrepreneur definitions that are and that become relevant in the future as well, and to the extent that these reflect arm’s length behaviour they could all potentially inform on the subject in a helpful manner, depending on the particular circumstances.

In addition to our comments in section A.3., above, we therefore recommend the following addition to par. 37 of the Discussion Draft in order to capture key value drivers through this concept of entrepreneurship:

...However, the relative importance of various indicators, including contractual terms and legal registrations as well as functions, risks and costs, may differ between taxpayers depending upon other factors such as the industry, market or business model in which each taxpayer operates. The precise key value drivers that are relevant in any given case, assist in the determination of which parties are entitled to intangible related returns, and may be elicited through an analysis of which entity or entities embrace the role of entrepreneur. These Guidelines intentionally do not purport to provide a definition of entrepreneur so as to avoid a prescriptive approach to defining behaviour that may or may not be observable between arm’s length parties.

The incorporation of the entrepreneurship concept in this manner would necessitate a review of other sections of Chapter VI that may also need to be modified to accommodate the addition (e.g., section B.5. of Chapter VI).

In summary, although the current presentation of section B does indeed reflect WP6’s intention for determinations to be made on the basis of relevant functions, assets and risks, there is room for improvement to incorporate this notion of entrepreneurship and thus address key value drivers in a non-prescriptive manner while ensuring adherence to the arm’s length principle.

**C. Definition of Intangible**

We have taken note of the definition of “intangible” offered in the Discussion Draft:

...something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.\(^\text{14}\)

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\(^{14}\) Discussion Draft, par. 5.
We have also noted that the aforementioned definition of intangibles is used for identification purposes and that it is clearly distinct from the question of whether an intangible deserves separate compensation or gives rise to premium returns.\textsuperscript{15}

The definition of intangible provided in the Discussion Draft underscores the importance of considering what independent parties would do, which is consistent with the OECD’s commitment to the arm’s length principle. It also goes some length in avoiding issues that could result from attaching the definition to any particular regulated profession or country. However, it is not always easy to foresee the full range of what arm’s length parties might have done in the circumstances, and so the Discussion Draft has offered numerous examples to help mitigate the effects of an intentionally broad definition. It is defined so as to not exclude on the basis of value, but rather to capture a larger base that would then be subject to further analysis regarding value.

If a broad definition is selected by WP6 to fend off fears of certain tax authorities that a more restrictive definition will be a breeding ground for taxpayer abuse, consideration should also be given to the risk that a broad definition would offer ambiguity and imprecision that would weaken contractual arrangements, discourage investments and generate controversies on audit.

\textbf{D. R&D and Marketing Activities}

We suggest the following modification to par. 6 of the Discussion Draft to alleviate ambiguity from the potential inference that intangibles would systematically result from R&D:

For example, costs associated with developing intangibles internally through expenditures such as research and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. \textit{Such Any resulting} intangibles may nevertheless carry significant economic value and may need to be considered for transfer pricing purposes.

A footnote could also accompany the sentence, for further clarity, stating: “However, it is possible that another entity, other than that which initially expensed the R&D or advertising, owns any resulting intangibles.

The Discussion Draft does however include further refinements following paragraph 6 which offer helpful guidance to this point, indicating that “not all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible....”\textsuperscript{16} The Discussion Draft goes on to say that “it is important to identify the relevant intangibles with some specificity....”; and that “it is not sufficient to suggest that vaguely specified or

\textsuperscript{15} Discussion Draft, par. 9.
\textsuperscript{16} Discussion Draft, par. 10.
undifferentiated intangibles have an effect on arm’s length prices or other conditions....”. 17 We agree with these clarifications, which may seem more obvious for some tax authorities than others.

Although the list of potential illustrations is endless, we would recommend providing a further example to cover a rather common phenomenon in practice, notably, with respect to taxpayers engaging R&D and/or marketing expenses, in addition to distribution activities, but which go beyond the expense level of typical distribution comparables. In such instances, taxpayers often seek to comply with the arm’s length principle by routinely testing the profitability outcome at year end and, on a net basis, adjusting to arm’s length pricing if the results fall below/outside the target range in a given year. 18 In the taxpayer analysis, such R&D or advertising expenditures are attributed a markup based on an additional set of relevant service company comparables. In such instances, the profitability on the distribution activities (derived from the sale price to third parties less the cost of goods sold from the foreign related entity) provides a conceptual or indirect equivalent of direct remuneration based on a cost plus calculation. This is because year-end testing accompanied by year-end adjustments, when appropriate, ensures that a certain level of profitability is associated with such activities (i.e., even in the absence of a separate transaction or transfer of money between the parties). This is sometimes referred to as a composite or synthetic approach in transfer pricing documentation, but can also be expressed as a traditional distribution range that has been adjusted to account for the additional activities.

Such an example should demonstrate that these transfer pricing arrangements exist, and should not be disregarded by tax authorities.

**E. (Local) Marketing Intangibles**

The Discussion Draft already hints at the notion of relative value of intangibles to a certain degree, for example, when it speaks of the economically significant intangibles at issue, the manner in which they create value and in which they interact with other intangibles:

> In a transfer pricing analysis of a matter involving the use or transfer of intangibles, it is important to identify the relevant intangibles with some specificity. The functional analysis should identify the economically significant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.... 19

However, we suggest this notion could be elaborated. In particular, we would recommend that section D.1 (i) of the Discussion Draft be complemented with the statement that

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17 *Ibid.*, par. 11.
18 We recognize that a transfer policy in and of itself does not typically define the nature of a relationship. However, the policy is evidence of the contractual intention of the parties, and the consistent implementation of that policy is further evidence of the contractual arrangement that exists between the parties (written or unwritten) when those transactions are settled.
19 Discussion Draft, par. 11.
"The relative value of intangibles must be considered in the comparability analysis. Economic theories of supply and demand naturally confer greater value on resources which are relatively scarcer and for which there is significant demand."

For example, there may be a number of firms who could provide marketing services of the nature required for marketing and distributing a product (and perhaps many more who would get into the market if the demand was there), however, there may only be one firm who holds patent, know-how and trademark rights to the intangibles to obtain any necessary regulatory approvals and manufacture this one particular product. This is even more obvious when the owner of the patent, know-how and trademark rights also provides the direction and inputs into the marketing plan (ultimately predicated on its data and know-how) that is executed by the marketing/distribution company.

As a result, there may be significant discrepancy between the value of any customer lists, relationships or other “marketing intangibles” when compared to the value of the patent, know-how and trademark rights of a product with no or low competition. This is the logical outcome of competition between competing marketing firms who will seek to recover their expenses associated with the functions and risks undertaken: profitability expectations will be reduced towards a routine level as marketing firms compete for the business. Since this is a phenomenon that can be observed between third parties, it would be helpful for the OECD Guidelines to address this point more directly.

The marketing intangibles point is essentially a comparability issue, and as such may appropriately be given further consideration in future interim drafts.

In the context of such future work, we recommend including a statement that it would not be appropriate to make adjustments to comparables with non-routine intangibles in order to benchmark an entity with only routine local marketing intangibles. This could also be achieved by defining routine and non-routine intangibles or returns, although we understand it is not currently the intention of WP6 to make such a distinction. However, it would be helpful to provide further clarification in one form or another in order to reduce the risk of glossing over fundamental comparability issues by adjustments that render the results unreliable.

Alternatively, the concept of entrepreneur or entrepreneurial role as a guiding principle may also be of assistance in this context. Integration of such a concept could help limit instances where the Discussion Draft omits to recognize the nature of relationships that may exist between third parties and that ultimately dictates who should be receiving the premium return.

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20 In this regard, example 2 is rather helpful. However, the ambiguity left dangling in the last sentence of paragraph 186 works against the clarity that might otherwise be achieved.

21 Discussion Draft, par. 13 has indicated that no attempt is currently made in the Guidelines to delineate various classes or categories of intangibles, such as routine and non-routine intangibles.
F. Section D.1. (vi) Intangibles

We have taken note of the definition accorded to “Section D.1. (vi) intangibles” in par. 105 of the Discussion Draft:

An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would be remunerated in dealings between independent parties, will be referred to as a Section D.1.(vi) intangible.

Although we see the above definition appropriately refines the discussion in important ways (e.g., as it precludes reassessment positions that seek justification through arguments such as economies of scale), there are further refinements that could be considered. Notably, it could be helpful to better define or frame what is meant by “not similar”, “greater”, and “future”, since these imprecise/subjective terms may generate confusion and misunderstanding.

G. Discount Rates and Financial Projections

Par. 152 discusses the relevance of examining assumptions and valuation parameters undertaken by the taxpayer for non-tax purposes in assessing the reliability of a valuation model. Although we agree with this statement, and we recognize that the same paragraph envisages that reasonable explanations may be provided by the taxpayer to justify discrepancies, it could be beneficial to further clarify that point. A footnote could be added to describe an example of such a “reasonable explanation” that could be offered by a taxpayer, such as where risk would in fact be higher for the tested party than for the comparable company/transaction due to the ability of the latter to consolidate and/or diversify risks in a manner that would be unavailable to the tested party, assuming comparability is indeed established.

Furthermore, par. 155 could be modified to add the following statement at the end:

...However, such valuations prepared for non-tax business planning purposes are unlikely to have been prepared on a separate entity basis, which could render them less useful in some instances than valuations prepared with a view to analyzing the returns to the entities separately.

Additionally, par. 161 could be followed by:

Furthermore, it is cautioned that discount rates may not take into account all of the risks associated with the activity that generates the cash flow, particularly where elevated (entity-specific or activity-specific) risks would be assumed by the tested party if it were to engage in certain activities as a stand-alone entity, as these are distinct from industry-specific risks.

22 Perhaps a name could be given to these intangibles, or at least baptizing it with a capitalized short name of “Intangibles” after the definition provided in this chapter for greater ease of reading.
H. Use of Hindsight/Timing Issues

The Secretariat of WP6 has specifically requested comments on certain timing issues relating to transfer pricing (“Request for Comment”). Two of the points raised in the request for comments concern more particularly questions involving intangibles, notably:

- Consideration of post-transaction date developments to assess reasonableness of comparability adjustments and financial projections;

- Situations where valuation of intangibles is highly uncertain as of the date the controlled transaction occurs, and whether/when tax authorities should be permitted to assume the existence of risk sharing mechanisms (e.g., price adjustment clause, milestone payment).

We reiterate our comments submitted on September 14, 2012 in reply to the Request for Comment, as this also ties into the comments to the Discussion Draft regarding timing issues and the use of hindsight. These are reproduced below.

1. Post Transaction Date Developments

With respect to how post transaction date developments should be used, the answer may depend in part on the purpose for which the transfer pricing exercise was undertaken. A benchmarking study using external comparables is inherently different than the preparation of an NPV calculation for the purpose of determining the arm’s length price of the intangibles using financial projections. On the one hand, a documentation study (e.g, to test the results of a distributor) using external comparables would typically be performed near or after year end and thus may be able to accommodate information that becomes available any time prior to the documentation due date. On the other hand, a planning study (e.g., to determine the amount payable for the transfer of an intangible) should not be expected to consider more than the relevant information that becomes known up until the date of analysis.

Tax authorities seeking to adjust the pricing of a transaction should be discouraged from relying upon information that was not available to the taxpayer when the transaction was carried out, unless the taxpayer has taken an ex-post approach in documenting the transaction. In other words, where it was the parties’ clear intention for the amount to not be revisable, or the conditions set for such revision have not been met, and those terms and conditions are observable in arm’s length dealings, the taxpayer should not have to monitor the outcome of the deal or adjust if results are significantly different from projections.

However, we understand that a rule as stated above may not be a rule that could easily attain consensus at WP6 due to certain member countries’ desire to retain a link with the outcome of the deal. With respect to a country that has clearly legislated in favour of the controlled use of hindsight, it is perhaps difficult to envisage it agreeing to a rule that states otherwise in the OECD Guidelines. The taxpayer with operations in that jurisdiction is then faced with a dilemma of which rule to follow. WP6 Delegates have a difficult task because they must bear in mind that where consensus is not achieved at the policy stage,

those issues will eventually resurface in cases before the competent authorities and may even end up before an arbitrator. With the OECD’s commitment to the simplification of transfer pricing rules and to easing of the administrative burden on resources of taxpayers and tax authorities alike, it would be surprising if the OECD were to not come to some acceptable solution for this difficult question.

If there is concern about potential taxpayer abuse of such a rule, by manipulating NPV calculations to achieve a pre-determined amount, then perhaps it would be useful to enumerate the formalities and criteria to meet in order to demonstrate a sufficiently reliable estimate or adjustment, rather than simply refuse the possibility for taxpayers to take an ex-post approach where this clearly appears to be arm’s length behaviour. It goes without saying that the retained approach must be reflective of the arm’s length standard, in compliance with the treaty obligations of OECD Member Countries.

2. **Highly Uncertain Valuations**

The above comments apply equally to situations where valuation of intangibles is highly uncertain as of the date a particular controlled transaction occurs.²⁴

Perhaps an idea for go-forward discussion would include particularly restrictive and well-defined instances when some element of hindsight would be mirrored in arm’s length behaviour. In this regard, it should be required to point to specific comparable uncontrolled internal or external terms/conditions involving these risk sharing mechanisms.²⁵ Further, it must be recognized that any such findings would only represent one or more points in the arm’s length range, and may be subject to adjustment. The taxpayer may still be able to demonstrate with real-life examples, facts and analyses that other points in the arm’s length range also exist.

Another possible solution, in addition to above-mentioned suggestions, could involve the conclusion of memorandums of understanding for hybrid real time / joint audits to specifically address these individual transactions (meeting certain threshold criteria perhaps) for taxpayers who are willing to submit such a request. The goal would be to resolve the issue before tax returns are filed in both jurisdictions. However, this solution will only work if the two tax authorities are committed to efficiently reaching agreement. This is where a memorandum of understanding could be useful, because the treaty partners could agree to a process of last resort for these specific cases, such as arbitration, even if such a process does not otherwise exist between the two countries. It could also be important to reiterate the commitment to adhering to the arm’s length principle in reaching a solution, as additional assurance that the treaty parties are following the same set of rules during their discussions.

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²⁴ Paragraph 171 of the Discussion Draft could be followed by clarification of the flipside scenario, such as the following: “Similarly, it is unlikely to produce an accurate result to benchmark the distribution of a consistent and robust portfolio of products against the results of a valuation performed for business purposes involving intangibles whose value is highly uncertain at the time of that transaction.”

²⁵ The Request for Comment enumerates several examples of risk sharing mechanisms (i.e., re-negotiation, price adjustment clauses, milestone payments). However, care must be taken to not impute such significant risk sharing mechanisms into more routine arrangements.
III. Conclusion
We reiterate our support for WP6’s agenda to achieve consensus on the many different issues that are addressed in the complex revisions of Chapter VI of the OECD Guidelines.

We hope that our submissions will assist Working Party No. 6 in their efforts to achieve that consensus and further refine the guidance offered in the revised chapter on intangibles.
Patrick Breslin Comments on

The Discussion Draft on Chapter VI of the OECD Transfer Pricing Guidelines

(submitted September 14, 2012)

I would like to thank the OECD Committee on Fiscal Affairs and Working Party No. 6 for the opportunity to comment on this very important project. I also commend the OECD for the substantial work done to date and for providing a discussion draft far ahead of schedule, further enabling business persons and practitioners to participate in the exchange of views needed to produce the anticipated revisions of the OECD guidelines Chapter VI.

In addition to many years working as a transfer pricing economist, my experience as a business executive informs my perspective. As founder and CEO of a software company, I negotiated and implemented multiple software technology license agreements and other transactions involving intangibles, including in joint venture contexts. I also hired and managed highly skilled teams of software engineers and marketing professionals, managed an intellectual property (IP) portfolio, and negotiated financial arrangements with strategic investors. These experiences provide insights on subjects relevant to Chapter VI.

While open areas remain, the draft successfully addresses many complex issues regarding intangibles in a clear, concise and comprehensive manner. Many of my comments are supportive of or elaborate on certain aspects of the existing draft, while others provide suggestions on items going forward.

Given the many interactions between issues related to intangibles, these comments often refer to sections A through D of the draft in alternative order, in order to facilitate discussion of interrelationships between various issues. The comments also highlight themes that are well-covered in the Discussion Draft, but may also benefit from some related commentary. These themes include:

1. The need to avoid “contextual mismatches” in arm’s length analysis, such as when applying valuation techniques and comparing arm’s length evidence to controlled transactions,
2. The need to analyse competitive conditions that exist between uncontrolled parties to transactions involving intangibles and how they can significantly affect an analysis of controlled transactions,

1 Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, 6 June to 14 September 2012. Hereafter, the terms “Discussion Draft” or “the draft” will refer to this publication, released on June 6, 2012 by Working Party No. 6 of the OECD Committee on Fiscal Affairs.
3. The need to account for the fact that **interrelated intangibles** are often transferred collectively when using these transfers to define an arm’s length standard for controlled transactions, and

4. The need to identify **valuable contributions** and ownership attributes that entitle parties to significant returns from intangibles.

Additionally, my comments explore the potential overlap between valuation approaches traditionally applied in transfer pricing analysis and certain tools adapted from other situations, ranging from finance-related concepts to IP infringement damages contexts.

_Avoiding Contextual Mismatches_

Some transfer pricing analyses rely upon, rather than avoid, contextual mismatches in analyzing intangibles. Such mismatches occur when applying certain valuation approaches and related assumptions, and when analyzing the comparability of transactions and other arm’s length evidence, facts and circumstances. Even when such differences are recognized, they are often insufficiently addressed through adjustments intended to overcome their effects on value. Examples of contextual mismatches provided in these comments include:

- Use of valuation approaches that are incompatible with arm’s length analysis and intended for very different purposes (e.g. purchase price allocation),

- Valuing intangibles that are only used and transferred collectively (e.g. software and software updates) as if they were not interrelated, and

- Analyzing intangibles contributed for the purposes of ongoing development as if they would be allowed to become obsolete.

The draft provides many useful references that should help practitioners avoid such contextual mismatches or appropriately address them. For example, it often highlights the tension between separate valuation of individual intangibles (or groups of intangibles) _versus_ an aggregate approach when they operate collectively with inherent interactions between them. As paragraph 7 notes,

> [...]While some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.

**Competitive Conditions: A common theme at arm’s length**

In uncontrolled contexts, valuable intangibles provide competitive advantages; thus, their owners vigorously protect them in order to preserve those advantages. Because of this, the terms of uncontrolled intangibles transactions often bring competitive concerns to the
forefront, as demonstrated by the limited scope of rights and restrictions provided in typical license agreements. A lack of focus on such competitive conditions has hindered arm’s length analysis of intangibles transactions and has contributed to controversy.

Here, I use the term “competitive conditions” to specifically refer to those conditions that exist between two parties to a transaction, as opposed to more general market conditions, such as the level of competitiveness in a market. The draft sometimes highlights the latter, but should also emphasise that at arm’s length, competitive conditions often directly affect the interactions between parties involved in an intangibles transaction and the terms under their agreements. Comparability analysis should take this into full consideration in such cases. In fact, “competitive conditions” represent a unifying theme for all of my comments and offer a useful lens through which to examine arm’s length conditions related to intangibles transactions.

**Identifying Intangibles**

**Section A.3: Comments on Categorisation of intangibles**

Paragraph 13 under section A.3 (“Categorisation of Intangibles”) properly concludes that, while it is “sometimes the case that various categories of intangibles are described and labels applied… the approach contained in this Chapter for determining arm’s length prices in cases involving intangibles does not turn on these categorisations.”

The core objective of arm’s length analysis should be to determine arm’s length value. That is, what would independent parties willingly agree to pay for the same or a similar transaction under comparable circumstances? This should be the overriding goal in arm’s length analysis.

Often independent parties do not consistently define or categorise various underlying elements of intangibles transactions in the same way, much less share equal views on the separate values of items that operate and are transacted collectively. In such cases, there is no arm’s length agreement on the separate, individual items, only one aggregate arm’s length price.

However, when different parties hold rights in and incur risks and costs associated with different intangibles, an analysis must consider their attributes and relative value contributions. Such situations occur both at arm’s length (such as joint development and marketing agreements between unrelated pharmaceutical companies) and between related parties. These issues are discussed later with respect to sections C and D.

It is also a welcome development that the draft limits its discussion on vague concepts such as “hard intangibles” and “soft intangibles” and leaves attempts to “delineate various classes or categories of intangibles” out of Chapter VI altogether. This should help focus discussion on arm’s length valuation (i.e., what price independent parties would pay given the same or a similar transaction) and away from what to call each underlying item.
In contrast, a “definitional approach” that is often advocated can shift the focus away from arm’s length value to a seemingly endless debate about various definitions of intangible (in fact, one dictionary definition of *intangible* states the meaning of the word as, “incapable of being realized or defined”\(^2\)).

It is doubtful that any categorisation exercise would ever produce consensus and even less likely that actual business persons operating at arm’s length would spend much time on it. Despite the lack of clear definitions or categorisations of intangibles in actual arm’s length settings, business is conducted and transactions are concluded. Arm’s length analysis should be conducted in the same vein.

**Section A.4 Illustrations**

Paragraphs 14-22 provide a useful representative list of commonly recognized intangibles. These illustrations give ample and proper context to Section A and later sections in the draft, which themselves add further illustrations. Nonetheless, here are a few comments:

*Illustrating Competitive Conditions*

Many references to competitive issues are already placed throughout the draft, such as with respect to certain ‘market conditions’ and ‘comparability factors’ (e.g. in paragraphs 8, 16, 25 and 26). However, as discussed above, competitive conditions that exist directly between parties to an uncontrolled transaction may have greater significance and merit further attention. Such conditions help to explain aspects of arm’s length behaviour and transactions that may not otherwise come to light.

Competitive conditions include the critical role that valuable intangibles may play in creating and enhancing the competitive advantages of firms that develop and own them; *and* the fact that parties to uncontrolled transactions involving intangibles often are (or become) competitors by leveraging the same or similar intangibles.

While paragraphs 15 (*Patents*) and 16 (*Know-how and trade secrets*) each mention competitive issues, they do not emphasize the extent of the potential role that such issues play with respect to these types of intangibles. For example, a patented invention may provide the owner with “cost advantages” that are not available to its competitors (as stated in p. 15), but even more importantly, patents very often have much greater implications for competing firms and potential competition.

Indeed, the exclusive rights to an invention are sought primarily to *exclude* competition. Patents are granted as a matter of policy to reward inventors for their investment in potentially risky research with uncertain outcomes. Thus, they preclude others with greater or different resources (i.e., those with other competitive advantages) from using the invention

\(^2\) As defined by *The Free Dictionary*, http://www.thefreedictionary.com/
to effectively compete with the inventor (or owner), without having invested in its development (or the development of competing technology).

Proprietary know-how and trade secrets also arise with competitive conditions in mind. This explains the confidentiality and secrecy surrounding them—which is just another avenue to keep competition at bay. Their close interactions with and contribution to the value of assembled workforces in place is usefully represented in paragraph 26 and elsewhere in the draft, as will be discussed further below.

As the draft notes, owners of intangibles place substantial restrictions and limitations on the rights of a licensee (or other party) to benefit from the intangibles beyond what is granted in the scope of legal agreements, such as licenses and other contracts (e.g., employment contracts).

**Interrelated Intangibles: Which hand claps the loudest?**

Paragraph 19, regarding brand intangibles, highlights another recurring theme with respect to the interrelationships that often occur between intangibles. As the paragraph notes, there is no consensus as to the uses of the terms “brand” *versus* “trademark” and “trade name,” which are often used interchangeably. In other contexts, a “brand” may “represent a combination of intangibles including, among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill,” and it may be “difficult or impossible to segregate or separately transfer the various intangibles contributing to brand value.” This example also indirectly highlights the futility of a definitional approach to classifying intangibles.

Paragraph 68 (Section C) is another useful depiction of the complex interrelationships between intangibles that are used in combination. Here, a pharmaceutical product has three or more types of intangibles associated with it (i.e., patents, regulatory approval through testing and registration processes, and a trademark). Collectively, these intangibles are extremely valuable, but in isolation they each may have much less value. This indicates that they are interdependent in achieving the commercial success of the product—something very commonly seen with respect to intangibles at arm’s length.

When one asks for the relative value contribution between two or more such intangibles, a challenging question is raised: “Which hand claps the loudest?” At arm’s length, the answer to this question is often moot—for example, when only one of the transacting parties has developed and/or owns the rights in all relevant intangibles. For the end customer of such a product, weighing the relative values of the patent, the regulatory approval, and the trademark would be nonsensical. There is simply one arm’s length price.

This also occurs in other arm’s length dealings between unrelated companies. A typical software technology license will convey rights to use multiple intangibles, including software, related copyrights, proprietary systems and methods, patents, trademarks, etc. An
unrelated licensee is willing to pay one price (a royalty) that considers these all in combination and has no use for any of these as individual “parts.”

In actual arm’s length negotiations, unless it is necessary or otherwise helpful to identify and value individual intangibles in isolation, independent parties will not do so. It is complex to negotiate an agreed price on the entire transaction, and unnecessary parsing of details is avoided. The parties will simply compare their alternatives, usually by calculating their respective costs and benefits on a net present value basis, as addressed elsewhere in the draft.

However, multinational enterprises (MNEs) encounter such issues internally with greater frequency than in their arm’s length dealings with other integrated companies. This is due to the necessary divisions of functions, assets and risks internally among their affiliates. Thus, transfer pricing analysis is often forced to grapple with such problems. Solutions will be discussed later, after examining problems with some approaches that often affect arm’s length analysis of intangibles.

The Goodwill Paradox: Why purchase price allocation (PPA) is out of context

As noted in paragraph 21, goodwill is another term often used to refer to a number of different concepts. Among these are the “expectation of future trade from existing customers” and “reputational value.” These items are difficult to disentangle from other intangibles discussed above, such as “customer relationships” and “trademarks,” respectively. Indeed, as paragraph 19 accurately states, these and other intangibles are often cited collectively (along with “goodwill” itself) as potentially contributing to “brand intangibles.” The draft considers goodwill, and all of these elements of goodwill, to be intangibles under the draft Chapter VI.

The draft raises questions about another form of goodwill derived from PPAs performed for accounting and tax purposes. In fact, paragraphs 22 and 110 properly dismiss any reliance on PPA analyses for transfer pricing purposes. On the whole, PPAs are incompatible with arm’s length analysis of controlled transactions and, in fact, do not represent the actual valuation of uncontrolled transactions.

The first indication that a PPA is not contextually relevant for transfer pricing analysis is the fact that it must be done at all. That is, if the independent parties to the original transaction had agreed on values for separately identifiable intangible assets in arriving at the purchase price, there would be no need to conduct the PPA – the allocation would already exist.

As noted above, independent parties rarely need to separately identify and value individual intangibles and other assets when they are acquired collectively, and would not do so unnecessarily. The parties to the transaction may not share the same or equal views on the
definition and value of individual, underlying items. Nevertheless, at arm’s length, business is conducted as usual.

In contrast, a PPA process occurs after an arm’s length transaction, and thus it is neither part of the actual arm’s length process, nor even a true valuation per se, but rather, an ex post allocation of a given arm’s length transaction value. From there, it applies a series of hypothetical analyses in which intangibles and other assets that operate (and were recently transacted) collectively are valued as if they were not interrelated.

PPAs help create a common misperception that intangibles must be separately identified and valued in conducting an arm’s length analysis of intangibles. Contextually, this may be done for accounting and financial reporting as well as domestic tax law purposes, but these are not contexts that reflect arm’s length conditions.

As a result, reliance on a PPA in an arm’s length analysis can introduce a range of unwanted effects, including the following:

- The PPA process uses an “item-by-item” valuation approach that will often depart dramatically from what independent parties would willingly agree and, in fact, did agree in the case of the actual transaction a PPA analyzes.

- Because the PPA process values ‘separately identifiable intangible assets’ as if they were not interrelated with the rest of the transaction as a whole, it often simultaneously undervalues such intangibles and creates a disproportionately large residual value that it then defines as “goodwill.”

- PPA goodwill often equals well over half of the original market transaction value. Paradoxically, if most of this total value does not relate to separately identifiable assets, the reliability of the values that the PPA does attribute to separately identifiable intangibles becomes highly questionable.

- Often, PPA goodwill is said to relate to the “expectation of future trade from existing customers,” while “customer relationships” are separately valued at a much lower percentage of the purchase price—without any explanation as to how one completely separates these two clearly interrelated concepts.

- Because PPA goodwill may be overstated, such value is likely related to various other intangibles, such as customer relationships, trademarks and other brand-related intangibles (i.e. in paragraph 19).

These effects arise largely because the PPA process attempts to value separately identifiable intangibles that were purchased collectively, while simultaneously being unable to identify the source of a very large portion of residual value—value then attributed to goodwill.
Transfer pricing analyses sometimes use or cite such valuation analyses with authority, even though they do not represent approaches that independent parties use or would agree to apply. However unlikely, even if unrelated parties had agreed on such separate individual values in arriving at a purchase price, the PPA would then either be redundant or depart from what the independent parties in fact agreed.

The notion that the PPA process can separately identify and account for less than half of the value of an actual arm’s length purchase price is not a strong argument for considering such an asset-by-asset valuation approach for arm’s length analysis. I refer to this conundrum as the “goodwill paradox.”

The concerns with PPAs ultimately relate more broadly to misconceptions about the valuation of interrelated intangibles. Such issues have had a substantial effect on controversies involving intangibles transactions. An important example appears in *Veritas vs. Commissioner* in U.S. Tax Court. In that case, the Court rejected the Internal Revenue Service (IRS) expert’s valuation analysis and his use of a present value of income method, in part because he valued the intercompany intangibles transaction “in the aggregate and he hasn't valued any of the intangibles separately.”

The IRS cited US regulations allowing for the aggregate valuation of interrelated items in a transaction, but did not convince the Court that doing so was common at arm’s length. In fact, the taxpayer’s own comparables aggregated multiple different intangibles and services in its licensing transactions with unrelated parties. However, the outcome in the case did not take this and related aspects of the arm’s length evidence into account. As discussed elsewhere, separate valuation of intangibles is often out of context with transactions involving commercially successful intangibles.

### Valuation examples in a proper context

Independent parties to a transaction usually compare the present values of income streams from their alternatives involving the same or similar assets and investments. This is true whether or not intangibles are defined and/or given separate consideration in other contexts. These arm’s length conditions are depicted well in Example 19, where they are applied to hypothetical related parties that operate under such conditions.

In Example 19, a parent company (P) considers transferring intangibles to a related manufacturer (Company S) in a lower cost, lower tax country. Note that in this case, as would occur at arm’s length, the starting point for the analysis involves P computing the present value attributed to its intangibles under the *status quo* (see Table 1, page 54). This could be considered a “before” scenario (or in some litigation contexts, a “but for” analysis, i.e. “but for” a subsequent event such as the proposed transfer of the intangibles). It is the baseline scenario upon which P considers its alternatives.

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This baseline net present value (“NPV”) is compared to the NPV of the alternatives faced by P. Similarly, Company S computes and compares its own alternatives on a NPV basis. These separate valuation processes done by each party form the bases upon which they negotiate (e.g., tables 2 and 3 in Example 19).

It is worth noting that the analysis in tables 1-3 does not separate or determine relative values for the different types of intangibles to be transferred (e.g., patents and trademarks). There is no need to separate them in this case because these intangibles operate collectively, and no scenario is contemplated in which they would not—suggesting that no such scenario would maximize the return on these intangibles. This often occurs in arm’s length scenarios.

However, in controlled contexts, cases where two separate parties contribute different intangibles are more common, raising challenging valuation issues. Here, a profit split is often required; the draft defers much to Chapter II on this subject. These comments will explore some variations on concepts related to profit splits, drawing from contexts outside of transfer pricing and controlled transactions.

As in Example 19, unrelated parties negotiate by formulating their own separate analyses of the returns related to their investments associated with a transaction. The acceptable threshold for investment in the transaction is that the return is equal to or better than the company’s alternatives when using the same or similar assets and resources. At arm’s length, the views of both parties must be taken into account, as both perspectives form the negotiating positions that ultimately produce an arm’s length result.

Furthermore, independent parties do not value the total transaction in the same way, much less with respect to each of the underlying intangibles or other assets combined in such a transaction. They will likely exchange forecasts and other information necessary in negotiating the deal, but they will not necessarily share equal views and assumptions regarding such information. After a negotiation, the only agreed arm’s length value is the actual transaction price.

**Identification of Parties Entitled to Intangible Related Returns**

**Valuable Contributions and Ownership of Intangibles**

Immediately preceding Section B on page 12 of the Discussion Draft is a request for comments in bold type. This request (referred to here as the “preamble” for convenience) describes potential frameworks for this section of a revised Chapter VI, including continued use of a concept of “intangible related returns” which “should follow the contributions to the value of intangibles” (i.e., the current draft approach).

The term “contribution” as used in the preamble is potentially significant, but unclear. There are overlapping relationships with the use of this term in Chapter VIII on cost
contribution arrangements (CCAs), as well as in Chapter II on profit split methods. It is worth paying attention to how the term *contribution* is applied across these areas.

In a more general context, a “contribution” (of either cash, property or services) helps form the basis of relative ownership interests in the formation of a startup company, a partnership, a joint venture or a similar enterprise consisting of multiple owner/participants. In such contexts, the significance of member contributions is clearly reflected in relevant legal documents, such as in the operating agreement of a limited liability company (LLC) under U.S. law, under which the capital accounts and profits interests of members are aligned with their contributions.

Thus, the preamble may suggest that key roles and responsibilities discussed in the draft (e.g., paragraphs 41 and 54) may constitute a *contribution* that “entitles an entity […] to retain the benefits or returns with respect to intangibles […].” Such a contribution may result in an effective ownership interest; that is, an entitlement to intangible related returns. In contrast, a legal owner of IP or an entity that bears intangible development costs “without more,” is not so entitled, according to the preamble.

Of significance to this project is this very last point, which illustrates consistency issues that should be addressed between the draft and Chapter VIII. Currently, Chapter VIII describes cash contributions as resulting in an “effective ownership interest” in the intangibles developed by a CCA. However, this would not meet with the Section B requirements for entitlement to intangible related returns.

In Section B, functions performed, assets used and risks borne remain important, but they may not alone be sufficient to entitle the relevant parties to returns from intangibles, unless they are considered *relevant* to creating value in the subject intangibles and thus are themselves seen as a *contribution*. However this *contribution* terminology is intended for the purposes of draft Chapter VI, there are also other issues to consider.

For example, Chapter VIII of the OECD guidelines regarding “cost contribution arrangements” uses the term *contribution* in both a limited sense (i.e., bearing costs) and a broader sense, including contributions “in cash or in kind” (i.e., services, intangibles and other property). Further, in a profit split method context (Chapter II), a “contribution analysis” is sometimes required to determine the proper division of profits among affiliates engaged in a transaction according to the “relative value of the functions performed (taking into account assets used and risks assumed)” by each of them. Here, less potential inconsistency arises from the current draft Section B, because a profit split method is considered best suited to situations where both parties contribute valuable intangibles; it is less likely that these contributions fall below the threshold criteria for returns from intangibles envisioned by draft Section B.

Thus, variations on the concept of value contribution appear elsewhere in the OECD guidelines. This project should ensure that there is consistency between the revised Chapter
VI guidelines and these other areas (which likewise may require revision). Furthermore, it is also worth considering the concept of a contribution as it pertains to other contexts outside of transfer pricing analysis. At least for illustration purposes, these may offer analogies relating to entitlement to intangible related returns under a revised Chapter VI. These will be revisited in later comments.

Section B also puts in place a fairly extensive description of responsibilities that entitle a party to intangible related returns, including an enhanced concept of control that connotes key decision making and risk taking activities. Paragraphs 40 and 41 note that an entitled party will in some cases “physically” perform certain of these key functions, listing examples that demonstrate a capacity to make strategic decisions, “design”, “control” and “manage” key functions such as R&D programs and related budgets, “protect” the rights in intangibles, and maintain quality control over others that have been delegated to implement decisions and perform functions in a subordinate role.

The following items are identified along a continuum of roles and activities that may (but, in some cases, may not alone) lead to entitlement to returns from intangibles:

A. Legal ownership of legally and contractually protected intangibles,

B. Bearing costs in activities and assets that create intangible value,

C. Performing functions that may have a material effect on the value of an intangible, and

D. Strategic decision making, management and control over functions, assets and risk taking that generate and protect intangible value.

In its current draft form, Section B requires more than items A or B (either together or alone) in entitling a related party to intangible related returns. Neither legal ownership nor bearing intangible development costs qualifies an entity to retain the benefits or returns with respect to intangibles “without more,” putting a question mark on many R&D-focused CCA participants.

While item D clearly qualifies (e.g., as in paragraphs 40 and 41), it also appears that item C alone is insufficient. For example, performing R&D does not appear to rise to the level of entitlement to the intangible value it creates, according to the draft. The party would also have to manage and control the R&D function, make key decisions regarding research programs such as when to start, continue, and stop them, have control over the R&D budget and contractual obligations of team members, and other similar items. All of these are encompassed in item D but not necessarily in item C.
Thus, entitlement to intangible related returns results from a very proactive role in managing and controlling the creation and development of intangibles, bearing related risks and costs, and carrying out the other activities necessary to stay in control of these key assets.

These attributes reflect those of an *active owner* and they comport with examples commonly seen at arm’s length. For example, the draft emphasises the authority and the ability to make *decisions* regarding the intangibles and related activities, and bear the consequences (i.e., risks) of those decisions and their effects on returns. Additionally, this decision-making capacity is distinguished from “day to day” management that has been delegated authority but does not have ultimate control over critical decisions and strategy, for example.

The draft does not appear to recognize more passive forms of entitlement to returns, such as financial ownership without an active management role. Many of the functional and risk profiles commonly seen among MNEs today would potentially fail these strict criteria as well, raising the threat of controversy if they are ultimately adopted.

*A shareholder analogy: entitlement to residual profits*

A very common *ownership* relationship is one between equity holders in a corporation, and the corporation itself and its creditors. This relationship is useful in illustrating aspects of Section B and the draft in general. While the analogy may not fully conform to this transfer pricing context, both similarities and differences between Section B and the shareholder analogy offer important insights.4

The shareholder and the party entitled to returns from intangibles (hereafter referred to as an “entitled party”) share some important features, including:

1) Claims on residual profits (and losses) from business assets or activities,
2) Bearing substantial risks related to item 1,
3) Returns subordinated to lower risk creditors and other entities (e.g., debt holders, suppliers, services providers),
4) Delegate business and management functions to others,
5) Have an element of control over delegated management (e.g., voting rights), and
6) May contribute cash to receive ownership interests / entitlement to returns.

The shareholder and the entitled party also lack commonality with respect to the following attributes of the latter, as specified in Section B:

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4 Credit for offering similar analogies between debt holders and parties earning limited risk returns goes to various colleagues over the years. In addition, this analogy is offered for illustration purposes only. Consistent with the draft’s views on other analogies, it is not meant to introduce or suggest any differences in tax effects based on actual treatment of debt or equity under any tax law.
7) Actively control and manage functions, assets and risks,
8) Physically perform key functions related to item 7,
9) Strategic decision making, and
10) Must contribute more than cash, including valuable functions, assets or other activities that generate or help manage and protect intangibles.

Items 6 and 10 illustrate different contribution criteria for obtaining an “effective ownership interest” an intangibles development activity under Chapter VIII and draft Chapter VI, respectively. The former, consistent with item 6 above, reflects a passive equity interest bearing financial risk but not performing key control functions. Items 1 through 4 are also consistent with this profile. Given the long-standing nature of CCAs under the current Chapter VIII, it is unclear whether the strict criteria the draft are intended to relate to such CCA participants, or whether safe harbors would be recommended if these or similar criteria were ultimately adopted.

Contract R&D is also illustrated by the shareholder analogy, if indirectly with respect to item 3—i.e., a lower risk services provider with an assured recovery of its costs and an ability to earn a cost-plus markup. As noted previously, in Section B this activity does not earn an intangibles return—nor would it in this analogy—even if it generates intangibles for entitled parties. Like a debt holder, such an entity has chosen to forego variable returns associated with its business activity in order to receive a predictably steady return. This illustrates risk-return tradeoffs faced daily in capital markets, which reflect many other key elements of arm’s length behavior.

**Determining Arm’s Length Conditions in Cases Involving Intangibles**

**Options Realistically Available**

Section D.1.(i) clearly lays out an essential concept in arm’s length transactions: taking into account the options realistically available to the parties. It is fundamental to the behavior of independent parties to compare alternatives and look for the best value at the best price. Additionally, no decision is taken that independent parties foresee would leave them worse off than if they had done nothing at all. These core concepts are well-addressed in the OECD guidelines in multiple areas, including draft Chapter VI, Section D.1(i).

Realistic alternatives undoubtedly inform independent parties’ decisions about what they will willingly pay (or receive) for goods, services, property and property rights. This is true regardless of whether or not a party to the transaction would actually choose a particular option. The option may be meaningful to the other party, or to neither of the transacting parties directly, but to the market at large. In this sense, options realistically available may be hypothetical, but they have very real effects on prices. Such opportunity costs (and benefits) are not fiction – they largely inform most commercial activity (consider comparison shopping, capital budgeting decisions, or alternatives like renting versus buying a home).
**Timing and risk effects on relative contributions**

Comments on sections C.2(ii) and (iii) regarding transfers of intangibles in combination and with other items are provided above. Overall, the descriptions provided in these sections strike a reasonable balance regarding when such intangibles can be transferred and/or analyzed separately and when they cannot. The section also gives due attention to the “economic consequences of interactions between different intangibles” and potentially between other contributions as well, whether they are intangibles or otherwise. Here, a profit split remains a primary solution, as discussed elsewhere.

The following comments focus primarily on timing and risk issues. Paragraph 68 also provides relevant insights here. There is a sequential relationship in the processes of 1) performing research and securing a patent, 2) testing and regulatory approval, and 3) use of a trademark and related marketing activities to sell an approved product. To a degree, these stages of development must be concluded in this order—although they may each progress in a non-linear fashion. If different parties are responsible for such activities and risks, the timing of their risks will have an important bearing on their relative value contributions.

Other timing effects relate to competitive conditions and are addressed in the context of comparability factors in paragraphs 92 and 93, regarding exclusivity in rights, and the extent and duration of legal protection of intangibles (e.g., patents). These are also addressed below.

**A relay race analogy**

To elaborate on these timing and risk effects, a relay race provides a useful analogy. Here, each time-based competitive factor represents a “runner” and each exchange of the baton represents a transition in competitive advantage (e.g., obtaining a patent). In reality, aspects of the competitive transitions in this analogy can occur in parallel. This allows a successful relay team to build upon its advantages in a ‘no holds barred’ way (e.g., runners can share multiple batons; Olympic rules do not apply).

So, for example, Runner 1 could represent the invention and patent approval stage, Runner 2 the duration of the exclusive rights from the patent, Runner 3 the commercialization and brand development stage, and Runner 4 the post-patent stage. The race proceeds as follows:

Runner 1 gives the team a head start in the new product area (i.e., an approved patent). Runner 2 (i.e., patent duration) substantially extends the team’s lead over all competitors. In fact, Runner 2 throws an extra baton ahead to Runner 3 (i.e., commercialization and branding), giving him a major head start. Before competitors have even left the starting block, the technology and market lead gains by runners 1, 2 and 3 are becoming insurmountable. When competitors do leave the starting block, Runner 2 obstructs them—as is his role under the rules. Finally, when Runner 4 takes the baton and Runner 2 sits down (i.e., patent expires), the team is already successful.
Runner 3 carries Runner 4 over the finish line to victory. Meanwhile, the team re-enters (i.e., reinvests) in multiple additional races – with runners 1, 2 and 3 interacting to extend large leads and again realize similar gold medal outcomes.

**Useful life and stages of development**

The use of this relay race analogy may be extended to paragraphs 95 and 96 regarding *useful life* of intangibles, which too may be extended. This is of great significance in the contexts of timing related competitive advantages. Factoring in *stages of development* and *rights to enhancements* further explains such advantages.5

It is often misconstrued that because one can hypothesize a halt in the development of commercially successful technology that this should affect the *value* of such intangibles, even when no ceasing of intangible development is contemplated. Stopping development would only diminish the value of the technology owners’ assets, making them worse off, not unlike stopping in the middle of a race when one is winning. While “possible,” this not a viable option for the owners of such intangibles. Ironically, however, such assumptions often affect the valuation of contributions to CCAs set up for the purposes of *continuing* development of intangibles in the same and similar areas. This is a clear contextual mismatch. The draft covers aspects of related issues as is appropriate.6

Limited useful life assumptions can artificially isolate intangibles into “before” and “after” development stages that in reality are ongoing and as interrelated as runners 1 through 4 in the analogy above (or even more so). Often, such assumptions are accompanied by a disregard for the value of development rights and the restrictions commonly imposed on them.

A technology’s value as a base for ongoing research may often extend to other commercial uses in yet unexploited product areas or fields of use. In areas like software technology, an installed base of existing users of a current generation product can be used to develop and market later software enhancements, updates and versions. Even shorter term technological advances may result in long term market advantages, just as the first runner in a relay race may create advantages for his team that extend to each subsequent stage in the race.

Thus, a limited life analysis should not dictate the duration of the market advantages that a technology helps create. When such advantages are coupled with development rights they may extend well beyond any measure of current product life. Some products, like software, effectively rely on a continuous development process, with each subsequent

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5 Section D
6 For example, paragraphs 95 and 96 discuss the potential that continuing development extends the useful life of existing intangibles, 143 and 144 discuss difficulties in assessing risks borne before and after partially developed intangibles are transferred, and 165 to 167 address useful life assumptions and the potential future benefits realized from an intangible after it has expired (as demonstrated by the patent in the relay race analogy illustrated in these comments).
generation built upon predecessor technology. Misconceptions about these issues also had a major effect in *Veritas*. Examples that correct this contextual mismatch are discussed below.

Paragraph 102 also deals with the risks related to future development of intangibles and obsolescence issues, if such development does not keep up a pace ahead of competition. Such risks speak to the importance of technology research leads (however short or long) and continued development efforts in competitive markets. Rights to carry on such development are valuable to their owners and rarely intentionally shared with potential competitors.

With respect to software intangibles, paragraphs 74, 99 and 100 address the interaction between rights to use software and rights to receive ongoing support and periodic updates to that software. Rights in software and updates are usually inextricably linked. The notion that rights to updates can be transferred without taking into account rights to use the software itself is virtually unheard of in uncontrolled software license contexts. The value of updates is interdependent with the value of the software intangibles. It should be obvious that these concepts further relate to development rights, including the rights to create updates, modifications, and subsequent versions of software or similar technology. Paragraph 100 reflects these issues, which also affected the outcome of the *Veritas* case.

**Using valuation techniques under arm’s length conditions**

As the draft states, a net present value (NPV) analysis that discounts future income streams should be applied from the perspectives of *both* parties to a transaction (e.g., see paragraph 148). NPV analysis is usually necessary to make an “apples to apples” comparison, given that different options may produce varying income streams and/or benefits realized over different time intervals, and facing different risks. Thus, the available options are compared on a present value basis in order to put them in the same context.

Alternatively, an analysis may rely upon market prices for the same or similar items—e.g., a comparable uncontrolled price (CUP) analysis as defined in Chapter II. A common example here is the acquisition price of an independent company focused on the same or similar technology as the controlled transaction.

It should be recognized that when valuing any single asset or investment, *both* an NPV and a market price analysis are implicit and, depending on the availability and reliability of data, both approaches may be explicitly applied. For example, in the acquisition price scenario, both the buyer and the seller would have valued the target company with each likely applying an NPV (i.e., discounted cash flow) analysis. The negotiated market price derives directly from these NPV analyses, as is well-demonstrated in Example 19.

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7 Sections D.2 and D.4
The share price of an individual stock provides another example of the nexus between NPV and market price analysis. At any point in time, the share price reflects the expected future returns associated with that asset. Stocks are constantly revalued based on new information—as reflected in changes in traded share prices. This market value thus exists precisely because cumulative expectations about a company’s future earnings and dividends are so closely reviewed by investors, along with past performance.

In this broad sense, present value analysis and market price analysis are as interrelated as day and night. Conceptually, it is hard to imagine that one exists without the other, at least implicitly—even if the availability of reliable data does not always lend itself to applying both approaches.

**Timing, Risk and Rights to Development**

Transfer pricing raises difficult timing and risk questions with respect to valuation, as addressed in paragraphs 143 and 144, for example. One party (Company X) may undertake the initial R&D and commercialization process while another (Company Y) may contribute to later development and updated versions. Here, the relative contribution of different intangibles types is less the issue. It is the timing of the development activities and related risks undertaken by different parties that must be weighed.

Some analyses effectively try to separate the contribution of Company X in period 1 from the combined contributions of X and Y in period 2. Essentially, this asks the rhetorical question, “Which hand claps the loudest? The ‘before-hand’ or the ‘after-hand’?” Usually, the answer is wrong because the question is wrong. The question from Company X’s perspective is simply to determine which of its options is most valuable. Company Y will do the same, and if the two parties’ analyses overlap within a reasonable range a deal might occur somewhere in between.

Tying this back to the same process used in Example 19, we see that the software intangibles need not be separated into those that exist exclusively “before” and “after” the transaction. Like the share price of a stock discussed above, the value of the software results from an integrated view of these periods. Furthermore, no one really contemplates discontinuing the software’s development in any event. Thus, Company X (the owner/transferor) compares the present values of two income streams that reflect its options:

A. continuing development, maintenance and exploitation of the software alone (e.g., its existing business model), **versus**

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8 “This has been the subject of major transfer pricing controversy (e.g. Veritas v. Commissioner).

9 Company X may face other alternatives as well, but these have been narrowed in this discussion for simplicity and illustration purposes.
B. joint development and ownership of future improvements and all related software intangibles with Company Y, effectively sharing the risks, costs and benefits of the intangibles from the date of the transaction forward.\textsuperscript{10}

Note as well that neither of these scenarios need consider the useful life of the current generation software alone; it doesn’t factor into these options which involve continuing its development.\textsuperscript{11} Discontinuing development would simply waste these valuable assets.

Scenarios A and B both take into account everything known about the technology to date in weighing expectations about its future prospects: its stage of development; whether it has been successfully commercialized; and whether there are licensees and an installed base of users. If such past events have occurred, they inform and explain expectations regarding future outcomes used to determine the present value of the assets.

Company Y (the transferee in the negotiation) may downplay or dismiss the value of the assets developed to date and weigh its own contributions under scenario B more heavily. It may try making a case for valuing some intangibles at cost as part of the negotiation process. But an arm’s length agreement is only reached when both parties agree—the individual perspective of just one of the parties does not determine an arm’s length result. Company X’s forecast modeling is far less likely to see such cost-based methods as realistic options for pricing its intangibles.

The critical distinctions between market value and replacement costs with respect to intangibles are well described in paragraphs 112 and 113. The latter also emphasizes the related timing effects discussed above in the relay race analogy when noting,

\[
[\ldots]\text{It is necessary to evaluate the effect of time delays associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently.}
\]

In competitive technology industries, such time delays would often render a replacement cost approach an unrealistic scenario for prudent investment. The replicated technology or workforce, for example, may never catch up with the market success or development lead achieved by the first mover, particularly if the latter obtains patents.

\textsuperscript{10} Both parties would perform such an analysis, which would take into account their respective contributions as well.

\textsuperscript{11} The option to abandon (or expand) a project is always present and contributes further to the option value of R&D projects and similar activities. This is true in the case of either A or B, but weighted less heavily when the project is achieving commercial success as in this example.
A Range of Valuation Contexts

Intangibles valuation is done in a range of contexts at arm’s length. At one end of this spectrum are market transactions involving intangibles – such as transfer of intangibles via a sale or license, and/or joint ventures and mergers involving parties with intangible assets operating as a going concern. The other end of the spectrum would include a bankruptcy context and/or liquidation of assets including intangibles.

It should be obvious that under these two extremes one would expect the highest and lowest valuations, respectively, for any intangibles (and other assets) that might be transacted, all else being equal. What also characterizes transactions along this contextual spectrum is the degree to which intangible assets operate collectively in a manner that either demonstrates or promises commercial success. In contrast, when an enterprise is in liquidation, its assets are disposed of separately and, in general, are subject to the lowest valuations.

These issues speak to the appropriate uses of net present value and market price-based analyses when intangibles:

1) are commercially successful or arising from a proven track record of development, and/or
2) operate and are transacted collectively.

The earlier discussion regarding NPV and market price analysis also relates to the potential use of more than one method, as addressed in paragraphs 114 of the draft and 2.11 of Chapter II in the guidelines. While Chapter II does not require use of multiple methods, the potential merits for comparing the results derived from NPV and market-based analyses are noteworthy, given the conceptual relationship between them. As paragraph 2.11 notes, a flexible approach that considers more than one method may be useful when sufficient information is available.

An important caveat in using multiple methods is avoiding a mismatch of contexts in combining separate valuation methods to arrive at an itemized total price for a transfer such as an intangibles contribution under a CCA. For example, a large disparity in results when comparing an NPV- or market price-based analysis of a group of intangibles with a “buildup” approach using various separately applied valuation methods for each individual intangible is revealing. One of the two approaches must be out of context with the actual transaction, especially if the buildup approach used cost- rather than market-based methods, or applied a CUP involving limited rights as if they were very broad.

Value additivity is a core tenet of finance theory that is helpful in revealing such problems when they are presented. This basic concept essentially states,

\[ PV(A) + PV(B) = PV(A,B) \]
If one is to isolate the present values of separate individual assets that operate and are transacted collectively, the sum of these individual parts must equal the whole. If they do not, something has been undervalued or is missing from the equation. Alternatively, when it is possible to determine the present value of \(A\) and \(B\) combined through an aggregate method, it will make more sense to do so in such cases. Even if items \(A\) or \(B\) can be valued separately, the sum of these separate valuations should be compared to an aggregate method to assess any differences and enable fuller consideration of the methods, data and assumptions used in such analyses.

**Profit splits and insights in other contexts**

There is much common ground between IP infringement damages estimation and transfer pricing analysis of intangibles as described in existing and draft OECD guidance. This should not be surprising, because both concern intangibles and the hypothetical processes that underlie each (i.e. “but for” analysis and the arm’s length standard) are grounded in the same economic principles.

In IP damages contexts, as in transfer pricing, facts and circumstances and the resources, capabilities and market conditions faced by the parties weigh heavily in the analysis, as do the uniqueness of the IP and its profit potential.

Interrelationships among other activities and assets are also highly relevant to this discussion, despite the fact that IP infringement damages often relate to a single intangible asset (e.g. a patent). IP damages analyses also consider interrelated assets (including production assets and potentially other intangible assets), related products and business activities, services, contributions of other parties, and other options available to both the IP owner and the infringer. Moreover, IP damages are calculated on a base of infringing product revenue that derives from the assets and resources of an entire business, in addition to the IP itself. This all sounds consistent with issues from a transfer pricing context.

Two primary approaches are used to calculate IP infringement damages: the “lost profits” method and the “reasonable royalty” method. The former measures the incremental profits lost to the IP owner that would have been earned “but for” the infringement—i.e. profits on infringed sales. The standard for awarding lost profits is higher than that for a reasonable royalty, requiring proof there were no non-infringing substitutes and that the IP owner had the capability (e.g. production capacity, distribution networks) to meet demand related to the infringing products.\(^\text{12}\)

\[\text{12} \text{ Four criteria applied in finding “lost profits” are collectively referred to as the Panduit test after Panduit Corp. v. Stahlin Brothers Fibre Works, Inc. in which they were outlined. The other two include proving the existence of demand for the patented product, and proof of the amount of profit lost per lost sale.}\]
If lost profits cannot be proven, the floor on damages is based upon a “reasonable royalty” determined based on 14 criteria that closely resemble the application of a CUP method in Chapter II.13 Items 1 and 2, respectively, are the existence, if any, of an established royalty received by the licensor for the same IP; and rates paid by the licensee for any similar IP. Item 3 asks the nature and scope of these licenses, including any restricted or non-restricted terms. Other items go down similar paths—i.e. a form of CUP analysis.

Having established comparable IP and royalty rates, the analysis turns to the commercial relationship of the licensor and licensee and whether they are competitors or collaborative (item 4). Interrelationships between patented and unpatented products and derivative business (i.e. “convoyed sales”) are then considered (item 6). Various other factors regarding both the IP itself and evidence found in comparable licenses are weighed as well.

Item 13 requires a form of a residual profit analysis. This factor allocates “but for” profits across elements that are not patented, such as services provided with the product, manufacturing processes and costs, business risks, as well as other product or feature improvements that may have been contributed by the infringer and not the IP. In other cases, infringement damages are computed by directly deducting a “normal” rate of profit earned on the infringer’s other product sales from the total profit on infringed sales. The residual forms a basis for IP profit.

Not unlike Example 19 in the draft, the reasonable royalty calculation weighs all of these factors and the opportunity costs (i.e. other options available) to both parties. A hypothetical license negotiation is premised on the minimum and maximum acceptable royalties for the licensor and licensee, given their best available alternatives.

In IP infringement suits, one of the more contentious issues is how to split the “residual” represented by the range of royalties both parties would be willing to pay (receive). Here, the guidance from case law remains somewhat limited. Nevertheless, the assets, resources and capabilities of the infringer are weighed, and it is always assumed that some of the compensation should go to his hypothetical non-infringing sales that would have occurred in a “but for” scenario.

Thus, opportunity costs weigh heavily in these analyses as well; they can relate to either or both parties and cut either way. For example, the availability of substitutes cuts into the amount of infringed sales, reducing the award to the IP owner (i.e. assuming that absent the use of the infringed IP the infringer would have used an alternative technology). Additionally, the IP owner may have lost sales of products related to the patented product (“convoyed sales”) and lost profits from these sales can increase its award (even though the infringer and other sellers did not infringe with respect to such related products).

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13 Referred to as the Georgia-Pacific Factors, these derive from case law resulting from Georgia-Pacific Corp. v. U.S. Plywood Corp.
Weighing the relative contributions of various items is often a challenge where IP-related disputes are concerned, not unlike in transfer pricing contexts.

**SECTION C: Transactions involving the use or transfer of intangibles**

*Competitive conditions and their impact on intangible rights transfers*

As discussed in paragraph 65 and relevant references in Chapter I (e.g., paragraphs 1.67 to 1.69), conflicting interests are common between independent parties but are not naturally present among affiliates in a controlled context. The effects of such differences have on comparisons of controlled and uncontrolled transactions must be taken into account in arm’s length analysis.

It is often the case that independent parties license intangibles to competitors and potential competitors. Thus, some of the most common provisions in licensing agreements relate directly to competitive concerns and seek to block the potential that the licensee could compete with the licensor with respect to the intangibles, erode the proprietary nature of the licensed intangible and thus diminish its value, and/or create alternatives that displace the need to continue to pay for a license.

Without addressing competitive conditions *per se*, subsection C.2(i) (i.e. para. 62-65) addresses important issues that result from these conditions as faced by independent parties to uncontrolled intangibles transactions. For example, competitive concerns contribute to a tension between the scope of rights in intangibles that are transferred, on the one hand, and restrictions that the licensor imposes on the licensee with respect to those rights—in particular, restrictions on rights to further develop intangibles.

Restrictions on development rights prevent competition on the part of licensees that have not yet developed the same or similar intangibles to those under the license, but have significant financial and technical capability as well as a potential interest in doing so. As often seen in technology industries, a licensee of third party developed solutions may ultimately enter the market of the licensor, perhaps by acquisition or other means, resulting in a range of potential conflicts. These issues fundamentally relate to competitive conditions between uncontrolled parties to intangibles transactions.

Aspects of this issue are addressed in the current draft, for example in paragraph 63 which highlights the need to understand the specifics of the rights transferred, *as well as “limitations and the full extent of rights transferred.”* However, this statement could be clarified to say “limitations and restrictions and the full extent of the rights that are and are not transferred.”

Although paragraph 64 allows for a range of potential rights transfers depending on the facts and circumstances, contextual mismatches related to development rights have had a
significant effect on the outcomes in transfer pricing controversies. One such mismatch is the use of uncontrolled limited license transactions with licensees known to be competitors or potential competitors to the licensor as comparable to a controlled transaction involving a transfer of development rights as part of a contribution under a CCA.

In the former (uncontrolled) case, the restrictions and limitations imposed on the licensee are typically substantial, both contractually and in practice, particularly with respect to any rights related to further development of licensed intangibles. In the latter (controlled) example, a significant interest in such development rights is exchanged outright under the CCA, along with an “effective ownership interest” in intangibles that will be developed using those rights. Relying on the uncontrolled transaction to value this controlled transaction can result in substantial undervaluation of such a contribution.

Depending on the facts and circumstances and the availability and reliability of data and assumptions, it is possible that such a comparability mismatch can be overcome with adjustments, although this is not a simple or straightforward matter. In any event, when an analysis does not take such differences into account, a contextual mismatch remains between the uncontrolled and controlled transactions, with potentially dramatic effects on valuation.

In reality, if the development rights and other broad rights granted in the controlled context (i.e., the CCA contribution) were granted to an uncontrolled licensee, the potential shift in competitive advantages could be disastrous for the licensor’s business. The magnitude of such effects are often exemplified in IP disputes regarding alleged infringement which, though contextually different, carry in mind many of the competitive conditions and effects contemplated in undisputed license agreements. Many license provisions discussed above are meant to head off such disputes and protect the licensor.

The second part of paragraph 64 is also worthy of a comment. In the analysis of uncontrolled licenses in the software industry, there can be misperceptions about the extent to which “the transferee/licensee retains the right to any enhancements it may develop, either for the term of its license or in perpetuity.”

In my experience negotiating (arm’s length) license agreements, the appearance of such rights in uncontrolled agreements often relates to a minor subset of technology rights that, in contrast to the licensor’s core technologies, are less valuable to the licensor when kept proprietary. These can include, for example, an application program interface and source code for a client device (i.e., a remote software or hardware device) that integrates with the licensee’s (and not the licensor’s) core product or technology. In such cases the licensor’s core base of source code usually remains unseen and untouched by the licensee.

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14 Client devices include software applications and hardware devices that connect with (or “talk to”) centralized software code on remote servers and databases, all of which, in contrast, most often remain fully proprietary to the licensor with restricted and limited rights granted to licensees.
Thus, client code development rights are often only pertinent to the licensee’s products to facilitate easier implementation for the licensee at less cost to the licensor (i.e., it is an exceptional case when development rights are less valuable when kept proprietary). Suffice to say, valuable development rights in a licensor’s key software technology are kept proprietary and rarely, if ever, intentionally made available to uncontrolled licensees at arm’s length.

Maintaining such control is not a simple or straightforward matter, either. The management roles, responsibilities and risks involved in protecting such rights have been addressed in draft Section B already, as discussed above.
Dear Mr. Andrus,

We refer to the Interim Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Revisions” and the opportunity to comment on such Discussion Draft.

BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 38 sector associations and represents over 100,000 large, medium-sized and small enterprises with a good eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related services.

Given the globalization of economy which goes in line with increasing “virtualization” of trade and business, the treatment of intangible values for transfer pricing purposes is rapidly gaining importance in tax practice. Accordingly BDI is very much interested in a sustainable international framework of definitions and regulations. We therefore very much appreciate your efforts in developing guidance in this highly relevant tax matter and, in particular, the release of the present interim discussion draft¹.

For sure, the draft is a milestone for further discussions. We are pleased to provide our comments on the draft and, hopefully, to contribute useful thoughts from a practical point of view. Our comments are laid out in the

¹ In the following we simply refer to the “draft”.

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25 September 2012

Interim Discussion Draft: “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Revisions”, released on June 6, 2012
Federation of German Industries (BDI) comments on OECD draft on intangibles

appendix to this letter, following the basic structure of the draft. The comments are not intended to be comprehensive but are focused on the key aspects of our concern.

Yours faithfully,

(Roland Franke)
A. Identifying Intangibles

- **Outline of Section A.**
  
  - Section A. of the draft offers a two-pronged definition of an “intangible asset” for transfer pricing purposes (paragraph 25):

    (1) something which is not a physical asset or a financial asset; and
    (2) which is capable of being owned or controlled for use in commercial activities.

  - Accounting rules are not deemed to be appropriate because they would often fail to disclose intangibles which are important to consider for transfer pricing purposes (paragraphs 5 subsequent).

  - Although the draft does not provide a normative definition of the terms “goodwill” and “ongoing concern value”, both are deemed intangibles in the meaning of paragraph 5 (cf. paragraph 21, 22). Paragraph 22 states that “[i]t is not necessary […] to establish a precise definition for transfer pricing purposes”.

- **Comments on Section A.**

  - The draft’s interpretation of an intangible asset for transfer pricing raises several issues. Although we basically agree that accounting rules might fail to disclose intangible values, in particular with regard to self-created intangibles, the draft should not conversely adopt an extensive approach. All in all, the basic definition as given in paragraph 5 seems to be too broad to ensure legal certainty from a taxpayer’s point of view. We miss a precise threshold to which significant economic values are to be qualified as an intangible asset within the meaning of paragraph 5. We therefore face the risk of discussing multiple benefits and advantages falling under the scope of Chapter VI which might be not intended to be covered or can practically not be handled.

  - We recognize the complexity of alignment of relevance of this chapter for other than transfer pricing matters. However, from our point of view, the restriction of the scope of application to Article 9 of the Model Tax Convention (paragraph 12) might create practical problems. E.g. in relation to non-relevance for Article 12 Model Tax Convention a transaction might qualify as license agreement under Article 12 and Withholding Taxes

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2 In the following, the term “paragraph(s)” refers to the paragraph(s) of the discussion draft, unless otherwise stated.
might occur, whereas for transfer pricing purposes under this chapter the same transaction is deemed to be buy-sell arrangement with no Withholding Tax. This might create discussions with tax authorities. We greatly appreciate any further effort for alignment between the Working Parties.

– We acknowledge that the definition of “goodwill” and “ongoing concern value”, and their differentiation, respectively, is not facile from both a theoretical and practical point of view. However, in the absence of any normative definition, paragraphs 22 subsequent could reinforce tax authorities to consider any “hoped-for value” as a part of the “goodwill” or “going concern value” and hence an intangible asset for transfer pricing purposes (cf. also Shapiro et al., Tax Notes International, June 25, 2012, p. 1245 subsequent). Such a consequence hardly seems to be justified. From our point of view, the draft should require that all economic values must be separately transferable to be qualified as an intangible asset.

– We agree to the exclusion of “group synergies” (paragraph 23) and “market specific characteristics” (paragraph 24) from the definition laid down in paragraph 5 as both are not capable of being owned or controlled. However, the draft points out that group synergies and market specific characteristics are “comparability factors” to be considered in the comparability analysis. As indicated in the preface (p. 3) the draft does not yet provide further guidance on “how” these comparability factors should be taken into account. From a practical point of view, it seems to be almost impossible to consider “group synergies” and “market specific characteristics” as “comparability factors” in a feasible manner because they are either not concrete enough or there is no real comparable to such factors. Reliable and undisputed determination of values will fail. Disputes with and between tax authorities would rise. This should be considered.

– The notion “assembled workforce” – being defined as “a uniquely qualified or experienced cadre of employees” (paragraph 25) – raises substantial issues. According to the draft, the existence of an “assembled workforce” “should not only be taken into account in a transfer pricing comparability analysis” (paragraph 25) with respect to the performed services, but it is indicated, however, that such an assembled workforce may constitute an intangible (paragraph 26, first bullet point) by “itself”. The concept of an “assembled

3 However, there are two restrictions: Firstly, the services must be performed on the basis of a “long term contractual agreement”. In contrary, this would imply that services which are performed on a “short term contractual agreement” would not lead to a transfer of an intangible. Secondly, the “transfer or secondment of isolated employees” does not “in and of itself” constitute the transfer of an intangible (cf. paragraph 26, third bullet point).
workforce” would particularly affect those businesses, which are highly dependent on a division of work. There is a clear tendency of increased globalization, virtualization and specialization of business. Division of labor is a common concept of global businesses. Accordingly it has become an economic necessity to cooperate on an international level, exchange specialists for projects and assign groups of international specialists to different locations in order to perform intra-group services. The notion of “assembled workforce”, however, might permit tax authorities to deem such assignments transfers of intangibles, which would prevent companies to make use of those teams of specialists. Economically useful transactions would be prevented by respective tax considerations. Consequently, companies would be virtually forced to reconsider their entire business model. This does not seem to be in the interest of a global economy. Against this background, we would appreciate clarification that an “assembled workforce” is not covered by the definition of an intangible pursuant to paragraph 5 of the draft (cf. also critical Eigelshoven/Ebering/Schmidtke, Internationales Steuer- und Wirtschaftsrecht, 13/2012, p. 489; Dommes, Steuer und Wirtschaft International, 8/2012, p. 350).

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The „transfer or secondment of isolated employees”, however, “does not, in and of itself, constitute the transfer of an intangible”; cf. paragraph 26, third bullet point.
B. Identification of Parties Entitled to Intangible Related Returns

- **Outline of Section B.**
  
  - Section B. introduces a concept referring to as “intangible related returns” (IRR). IRR are defined as “the economic return from business operations involving use of that intangible after deducting (i) the costs and expenses related to the relevant business operations; and (ii) returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments” (paragraph 28).

  - Following this IRR-concept, terms and conditions of legal arrangements are considered as a “starting point” (paragraph 30), i.e. indicators among others, but not crucial for the actual allocation of IRR.

  - However, it has to be assessed “whether the conduct of the parties is in alignment with the terms of the legal registrations and contracts or whether the parties’ conduct indicates that the legal forms and contractual terms have not been followed”.

  - The actual conduct of the parties is acknowledged as the “best evidence” concerning the “true allocation” of entitlement to IRR (cf. paragraph 37).

  - The following factors “should” be considered in allocating the IRR: (i) the terms and conditions of legal arrangements including relevant registrations, license agreements, and other relevant contracts; (ii) whether the functions performed, the assets used, the risks assumed, and the costs incurred by members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns in the relevant registrations and contracts; and (iii) whether services rendered, in connection with developing, enhancing, maintaining and protecting intangibles, by other members of the MNE group to the member or members of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm’s length basis under the relevant circumstances” (paragraph 29).

  - If necessary, IRR is to be split up according to the respective functions performed by the involved parties.

  - The draft acknowledges that some of the most important functions – namely developing, enhancing, maintaining and protecting – may be outsourced to other (related or unrelated) entities. In order to maintain “full” entitlement to IRR, however, the entity which does not perform the functions by
itself must have these functions under its control (control test). The draft does not define the term “control” by itself, but refers to paragraphs 9.23 through 9.28 of the OECD Transfer Pricing Guidelines (Business Restructuring).

- Bearing the costs related to development, enhancement, maintenance and protection of intangibles is a necessary, but not sufficient requirement for being entitled to IRR.

- From a taxpayer’s point of view, the potential consequence of the IRR-concept is to be found in paragraph 54: “Where a party is allocated intangible related returns under contracts and registrations, but fails to perform and control important functions, fails to control other related functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns” (no italics in the original).

• Comments on Section B.

- The rationale of the IRR-concept seems to be the adoption of a “functional ownership approach” (versus “legal ownership approach”) in order to target and prevent “tax base eroding” and “profit shifting” facilitated by intragroup contractual arrangements with regard to ownership and use of intangibles (cf. also Durst, Tax Notes, July 16, 2012, p. 316).

- The IRR-concept might result in an (re-) allocation of revenue streams that deviates from the allocation as determined in accordance with the terms and conditions of legal arrangements (contractual allocation).

- Various entities will be entitled to the IRR, depending on the functions which are performed respectively. However, we miss guidance on how the respective entitlements to IRR should be determined.

- IRR would affect those groups of companies, in which the “group-IP” is bundled at the level of one single group entity. In order to be regarded as the “functional owner” under the IRR regime, such IP-holdings would have to evidence their entrepreneurial substance in terms of functions, control, risks and costs. From a practical point of view, however, the application of these control rules would not work. A member of a MNE can be expected to retain either independent or associated enterprises to transact on an arm’s length basis to perform functions related to the development, enhancement, maintenance and protection of intangibles. The requirement
that the entity claiming entitlement to the IRR will physically perform, through its own employees the main functions (paragraph 40) is neither practical nor does it reflect the arm’s length return and IRR that the entity would be entitled to if the functions were performed by unrelated parties. International business is extremely globalized. Division of labor and decentralized quick decisions in an international environment are the rule. Evaluation and documentation of control and widely spread decision making is practically not possible. More than that such a concept would suspend the importance of invested capital and bearing of risks of being unsuccessful. In a real business only a small number of products and respective efforts lead to success on the market. Accordingly for a big number of projects and products efforts and investments are in vain and the IP-owner stays with the risk and losses for those products. Although the draft foresees that IRR can be negative, we do not see that practically such adverse effects are equally allocated to the different locations and it will be accepted by the tax authorities that such damage is spread beyond legal ownership. Tax laws regularly foresee anti-abuse regulations for abusive planning and missing substance. Such regulations should be sufficient to cover correct allocation of income and creating additional and unmanageable granular rules in the area of transfer pricing should be avoided.

− Issues could particularly arise in those businesses (e.g. IT) which are highly dependent on research and development (R&D). For instance, in cases of contract R&D agreements, tax authorities could assert that control over the main functions is actually exercised by the R&D provider therefore being entitled to IRR (cf. also Martin, Tax Notes International, July 16, 2012, p. 218). The funding of R&D and absorbing the risk of R&D undertaken, however, would not transfer entitlement to IRR to the funder (cf. also Durst, Tax Notes, July 16, 2012, p. 317). This does not seem to be appropriate.

− It appears that also the IRR-concept as well would be vulnerable to international tax planning by means of “tax base shifting”\(^5\) (Fig. 1) as well as a “tax base erosion”\(^6\) (Fig. 2).

\(^5\) In the following, this term is defined as a shifting of revenues from a “high tax jurisdiction” to a “low tax jurisdiction”.

\(^6\) In the following, this term is defined as an “import” of tax losses from a “low tax jurisdiction” to a “high tax jurisdiction”.
Although the implicit intention of the draft seems to be to prevent tax base shifting from high tax jurisdictions to low tax jurisdictions, the IRR-concept does not explicitly prohibit the reverse case, that is, a tax base shifting from a low tax jurisdiction to a high tax jurisdiction. However, a reallocation could happen in both directions. Consequently, it might also be the case that a certain revenue (i.e. positive IRR) being previously located to a high tax jurisdiction, however, is assumed to stream to a “low (or even zero) tax jurisdiction” considering the IRR-concept.

**(Fig. 1): Tax base shifting.**

(Fig. 2) While the draft acknowledges that the IRR may also be negative, i.e. not necessarily positive or zero, this “loss scenario” is not explicitly considered in the draft. If the IRR is negative, however, a reallocation of IRR to a high tax jurisdiction would have the consequence that this loss could be claimed\(^7\) in the jurisdiction with the relative higher statutory tax rate and thereby increasing the economic value of this tax loss for the taxpayer to the disadvantage of the high tax jurisdiction. In other words, the tax base apportioned to the high tax jurisdiction would be eroded but not protected by the help of IRR-concept.

**(Fig. 2): Tax base erosion.**

These two examples above reveal that the IRR-concept could fall short to avoid “tax base eroding” and “profit shifting” in some cases, thereby heavily complicating the transfer pricing of intangibles and increasing controversies with local tax authorities.

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\(^7\) Subject to local loss utilization rules.
tax base shifting as well as tax base eroding, it does not seem to be convincing and, in particular, not conceptually superior to existing transfer pricing rules.

- Downgrading the terms and conditions of legal arrangements to a “starting point” (paragraph 30) would suspend the freedom of contract as a widely accepted postulate (cf. also critical Eigelshoven/Ebering/Schmidtke, Internationales Wirtschaft- und Steuerrecht, 13/2012, p. 489). From our point of view, it does not seem to be justified to put contractual allocations under general suspicion of being abusive from a transfer pricing point of view and not to take into account the realities of how MNEs operate. Only in extraordinary circumstances, as in cases of abuse, may disregard of contractual allocations be justified. Such an approach is indicated in paragraph 53 and should stay as a basic concept.

- Excluding the bearing of costs and related risks for the development, enhancement, maintenance and protection of intangibles as generating any IRR would not respect economic reality. As a minimum an investor return should be included in the IRR to reflect the bearing of risks and costs.

- The IRR-concept would considerably raise documentation requirements. Any existing contract allocation would need assessment and, if necessary, amendment to be compliant with IRR as defined in the draft. This hardly seems to be achievable, in particular with respect to global operating groups of companies usually maintaining a multitude of contractual interrelations. This misallocation of companies’ resources seems not to be desirable from a (global) economic point of view. We suggest, as a basic rule, to respect contractual allocations and to limit the IRR-concept to cases of obvious abuse.

- Example 9 of the Annex, among others, illustrating the application of the principles contained in section B. (cf. paragraph 56), addresses the treatment of “personnel skill and efficiency”. It is concluded that these attributes “should be considered as comparability factor[s]”, i.e. they (positively) influence the amount of the service fee to be paid to the service provider (in example 9: “Company S”). Although as indicated in the preface the draft does not yet provide further guidance on “how” these comparability factors should be taken into account this approach is practically not feasible. The treatment of skill and efficiency is widely discussed and being recognized as being very hard to cover and to evaluate. We do not believe that practical and feasible criteria for the determination and valuation of “skill and efficiency” could ever be found.

- Notwithstanding the reference to paragraphs 9.23 through 9.28 of the OECD Guidelines, it appears that the draft advocates a stricter interpretation of “control”. For sake of consistency, we would
appreciate alignment of the term “control” as used in Chapter VI and IX, respectively.
C. Transactions involving the use or transfer of intangibles

• Outline of Section C.

  - Section C. specifies various types of “controlled transactions involving intangibles”:

    (1) Transactions involving the use of intangibles in connection with sales of goods or services.
    (2) Transactions involving transfers of intangibles, which are subdivided in:
      (2.1) “transfer of combinations of intangibles” ; and
      (2.2) “transfer of intangibles in combination with other business transactions”.

Concerning the “transfer of combinations of intangibles” (2.1) the draft observes “that some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately” (paragraph 67) and, in addition, to ensure “that all intangibles transferred in a particular transaction have been identified” (paragraph 69).

With regard to the “transfer of intangibles in combination with other business transactions” (2.2), the following two situations might occur:

(2.2.1) “some situations”, in which “it may be both possible and appropriate to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles” (paragraph 72); and

(2.2.2) “other situations”, in which “the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions” (paragraph 74).

Whereas in situations (2.2.1.) the “price of a package contract should be disaggregated” (paragraph 72), arm’s length prices in situations (2.2.2.), however, need to be determined on an “aggregate basis” (paragraph 74).

• Comments on Section C.

  - The intention of defining a transaction type “transfer of combinations of intangibles” (2.1.) is clearly to consider synergy effects in determining an arm’s length price. Although the implementation of this approach would have far-reaching consequences to companies, the draft is silent as to consider synergy effects relating to “combinations of intangibles” in a feasible manner. As mentioned earlier synergies are practically hard to cover because they either are not concrete enough or no comparables can be found. We therefore suggest to either give further guidance or to eliminate this transaction type.
Paragraph 75 contains the following statement: “For example, a cost plus approach will not be appropriate for all service transactions”. The intention of this phrase is not clear. Nor can it be derived from the context. The literature has raised concerns that paragraph 75 would question the cost plus approach in general (cf. e.g. Eigelshoven/Ebering/Schmidtke, Internationales Wirtschaft- und Steuerrecht, 13/2012, p. 492). We do not find any convincing reason why the cost plus approach should be (further) restricted in its application. From a practical point of view, the cost plus method is by far the most important method with regard to service transactions. Any limitations to its application would cause severe impacts on existing transfer pricing systems. Paragraph 75 should be clarified so that it does not intend to tighten the use of cost plus method in general.
D. Determining Arm’s Length Conditions in Cases Involving Intangibles

- **Outline of Section D.**

  **Subsection D.1**

  - *Subsection D.1* contains general remarks on the conduct of a comparability analysis.

  - Paragraph 80 states that a transfer pricing analysis must take into account the options realistically available (“ORA”) to each of the parties to the transaction (cf. paragraph 80) since a one-sided comparability analysis would not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles (cf. paragraph 81). The draft does not define this ORA-concept by itself but simply refers to paragraphs 9.59 through 9.64 of the TP Guidelines (Business Restructurings).

  - Subsection D.1 underlines the importance of comparability of the transferred intangibles in relation to intangibles transferred in potentially comparable uncontrolled transactions, in particular where CUP method is considered to be the adequate method.

  - Some of the comparability (standard) factors to be considered in a comparability analysis are mentioned and explained in paragraphs 90 subsequent: exclusivity, extent and duration of legal protection, geographic scope, useful life, stage of development, rights to enhancements, revisions and updates, expectation of future benefit.

  **Subsection D.2**

  - *Subsection D.2* offers general guidance on selecting “the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles”.

  - Paragraphs 109 subsequent generally permit the application of financial valuation techniques (e.g. DCF) for transfer pricing purposes (under certain circumstances).

  - Purchase price allocations actually prepared for accounting purposes, are explicitly refused for transfer pricing purposes (cf. paragraph 110).

  - The use of transfer pricing methods based on intangible development cost (“cost-based methods”) is “discouraged” (paragraph 112). As an exception, however, a valuation based
on the estimated cost of reproducing or replacing the intangible may be adequate with regard to the development of non-unique intangibles used for internal business operations (e.g. internal software systems) (cf. paragraph 113).

- “Rules of thumb”, however, are refused without exception (cf. paragraph 116).

**Subsection D.3**

- *Subsection D.3* attempts to provide guidance on the determination of arm’s length prices for transactions involving the use of intangibles in connection with sales of goods and services (transaction type 1, see above C.).

- If reliable comparables can be identified (“first category”), any of the transfer pricing methods described in Chapter II of the TP Guidelines might constitute the most appropriate transfer pricing method (cf. paragraph 119).

- If reliable comparables are not available (“second category”), the draft argues for the use of profit split methods (“[i]n some circumstances”) and valuation techniques (“[i]n appropriate circumstances”), which are “not dependent on the identification of reliable comparable uncontrolled transactions” (cf. paragraphs 128 subsequent and paragraph 131), respectively.

**Subsection D.4**

- *Subsection D.4* intends to provide guidance on the determination of arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles (transaction type 2, see above C.).

- If reliable comparables exist (“first category”), any of the transfer pricing methods described in Chapter II of the TP Guidelines might constitute the most appropriate transfer pricing method (cf. paragraph 134). In contrast to Subsection D.3., subsection D.4 seems to have a preference for the use of the CUP method and even more the transactional profit split method, respectively (cf. paragraph 136).

- If reliable comparables do not exist (“second category”), the draft argues for the application of profit split methods (cf. paragraphs 140 subsequent) and valuation techniques (cf. paragraphs 145 subsequent).
Paragraphs 145 subsequent provide detailed guidance on the application of valuation techniques (discount rate, growth rate etc.).

With regard to the useful life of an intangible, the draft intends to adopt a „platform contribution approach“ following the U.S. cost-sharing regulations. Paragraph 166 states: “In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products.” As a consequence, “[i]t may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist” (paragraph 166). However, “[i]t should be recognized that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that non-routine returns are attributable to such intangibles in perpetuity (paragraph 166)”

• Comments on Section D.

With regard to Subsection D.1, the planned adoption of ORA raises concerns. The ORA-concept has been already critically discussed in the ongoing debate on the treatment of business restructurings – e.g. at the IFA Congress 2011 – and it seems to be counterproductive to integrate an unsolved issue in Chapter VI (cf. also critical e.g. Rouenhoff, Internationales Steuerrecht, 17/2012, p. 657; Dommes, Steuer und Wirtschaft International, 8/2012, p. 352). Awareness of the contract partner’s options, i.e. a double-sided perspective, as presumed by the ORA-concept, is not reflecting business reality. Information asymmetry between contract partners is prevailing and this fact should be respected in determining arm’s length prices. Introduction of the ORA-concept might have the negative consequence for taxpayers that established databases and benchmark studies are no longer accepted by authorities, as far as they are based on a single-sided perspective (cf. Rouenhoff, Internationales Steuerrecht, 17/2012, p. 657).

In addition, the extension of the “comparable factors” to be considered in a comparability analysis (cf. paragraphs 90 subsequent) indicates that subsection D.1, all in all, intends to raise the bar regarding the use of the CUP method (cf. Shapiro et al., Tax Notes International, June 25, 2012, p. 1248; Rouenhoff, Internationales Steuerrecht, 17/2012, p. 657). It seems that the draft wants to expand the application of the profit split method. However, guidance on profit split is rare.
One should keep in mind that the CUP method is well-established, so that any new constraints to its application might cause severe adjustments to existing transfer pricing systems. From a practical view even transactions which can perfectly serve as comparable are seldom 100% identical to the documented transaction. Nevertheless CUP method in most cases is superior and practicably best. It is not recommended that the conditions for comparability and applying CUP are tightened.

From a practical point of view, paragraphs 165 subsequent (please see above; outline of subsection D. 4) do address a very important issue, namely the estimation of the useful life and the consideration of a terminal value, respectively, in finding an appropriate transfer price by means of financial valuation methods, like discounted cash flow (DCF). Indeed some tax authorities tend to argue to deem the useful life of the “initial” intangible to be infinite. Since such an approach would require consideration of intangible-related cash-flows into perpetuity, a terminal value might considerably raise the respective transfer price. We do believe that such an approach does not convince from a theoretical point of view and furthermore lacks in practical feasibility. Against this background, we appreciate that the draft, as well, is reluctant to posit a “mechanical” consideration of terminal values (cf. also e.g. Shapiro et al., Tax Notes International, June 25, 2012, p. 1248). We particularly support the draft’s view that “indefinite” does not equal “infinite” (paragraph 165). The draft correctly indicates that consideration of terminal values should not be the rule but the exception (paragraph 166), where it is evident that an intangible contributes to future cash-flows of other intangibles. However, this (correct) conclusion should be emphasized even stronger in the draft.

As a concluding remark we want to emphasize again that many details in the draft would – if introduced as guideline – turn practical work more complex. MNEs need practical solutions that can be rolled out across multiple jurisdictions in a consistent manner (e.g. using a group-wide transfer pricing guideline). It is impossible to assess all pertinent transactions case by case. The work on “Administrative Aspects of Transfer Pricing” shows that OECD is aware of these problems with regard to both, taxpayers and tax administrations. The draft should be refined in that sense.

We would highly welcome the opportunity to contribute to further consultations on this matter.
Dear Mr Andrus

CHAPTER VI DISCUSSION DRAFT

BDO welcomes the timeliness of the Chapter VI Discussion Draft on intangibles (the ‘Draft’) and the efforts undertaken by Working Party 6 to seek outside consultation. We appreciate the opportunity to comment on the Draft, and, in general, we are pleased with the approach taken in the Draft.

Summary

Our primary comments are as follows:

- We consider that it is reasonable, and representative of what happens at arm’s length, for a party to be entitled to intangible related returns when it controls intangibles but does not perform many of the functions required to develop, enhance, maintain, or protect the intangibles.

- The Draft raises the comparability standards for traditional benchmarking to the extent that the profit split and valuation methods will be used more frequently. These methods are more expensive to adequately support and increase uncertainty for taxpayers due to their subjective nature.

- The examples require substantial rework and need to be more closely linked to the concepts they are intended to illustrate, ideally in the main body of the Draft immediately after where the relevant concept is first discussed.

1 Identification of parties entitled to intangible related returns

1.1 Entitlement and performance

In several places the Draft links the entitlement to intangible related returns to the performance of certain functions, while reducing the emphasis on legal ownership and bearing related costs as grounds for entitlement to intangible related returns. The shift of emphasis has been towards the pre-eminence of people functions which may lead to some tax jurisdictions assigning significant intangible related returns to entities that ‘perform’ functions even though the ultimate control, Research & Development (‘R&D’), strategic direction, funding of R&D, and bearing of R&D risk may be undertaken by another entity.
Paragraph 40 appears contradictory and allows scope for tax authorities to interpret the relative importance of “physically” performing certain tasks through an entity’s own employees in order to be entitled to intangible related returns. The paragraph begins by stating that:

“It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees”.

The paragraph then goes on to state:

“It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangibles related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles”.

While we agree that an entity should control the specific functions described in paragraph 40 in order to be entitled to intangible related returns, our concern is that some tax authorities will read this section more broadly and attribute excessive profits to an entity that is performing functions, while the entity which owns the intangibles, bears the costs of development, takes the risks and controls the intangibles is under rewarded.

This emphasis on performance as a precondition for entitlement to intangible related returns is repeated in paragraph 54 which is a summary of the entitlement discussion. The first bullet point states that an entity “should in substance”:

“perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis”

This summary bullet point does not limit the performance element of entitlement in the same way paragraph 40 does, and may be read more broadly.

Also, we recognise that both paragraph 40 and paragraph 54 emphasise that the performance (paragraph 40) and the performance and control (paragraph 54) conditions applies to the ‘important functions’ although clarification of what these might consist of are limited to those briefly mentioned in paragraph 40. Further guidance on these functions and how they might typically be performed and controlled would be welcome.

It may be that the wording in the Draft is meant to be read such that ‘perform and control’ is simply the performance of a controlling function, but the Draft does not make
this explicit, and subsequent comments appear to imply that the two are unlikely to be severed (see below). The apparent insistence on linking ‘performance and control’ can be illustrated in Example 11. It appears that the issue with Company T is that it does not have the capability to supervise and control the R&D activities undertaken by Company S. This function is performed by Shuyona. However, the conclusion of the example is that:

“Company T should not be entitled to intangible related returns related to the ongoing R&D because it does not control risks or perform and control the key R&D functions.” (Paragraph 224)

Once again the ‘perform and control’ wording is used, but it is unclear how significant the ‘perform’ aspect is in the conclusion as Shuyona is engaged both in controlling the R&D programme of Company S, and has its own R&D centre in Country X, so it is engaged in both performing and controlling R&D.

Overall, the Draft does not provide for much consideration of control without performance and we would welcome further clarification on this point.

1.2 Endangering existing structures?

Many contract R&D agreements exist between related and unrelated parties. In such cases the principal controls the R&D function, takes the risks and bears the costs. The R&D entity performs the day-to-day function. In these cases the intangible property (‘IP’) resulting from the R&D is allocated to the principal. Similar structures between related parties are common and have been accepted for many years by tax authorities. The current ‘perform and control’ wording of the Draft implies a company must undertake both the performance and controlling functions to be entitled to intangible related returns. The linking of the words ‘perform and control’ creates a risk that those existing and accepted structures will be challenged in the future.

This wording also sits uncomfortably with the existing guidance on cost contribution agreements (‘CCAs’) in Chapter VIII of the Guidelines and may have a negative effect on existing R&D CCAs. It is not uncommon for only one party to the CCA to perform the R&D function. Under existing OECD guidance the benefits of such arrangements are allocated to those parties on the basis of what is expected to transpire and, as such, each participant's proportionate share of the overall contributions to the arrangement. Practically, this has meant that the participants in the CCA are treated economically as "co-owners" or that each participant is accorded other (and separate) rights to exploit the IP. Chapter VIII of the Guidelines recognises the role of funding, the bearing of risk and the role that pooling of 'resources and skills' plays in formulating a CCA. However, the current wording of section B of the Draft implies that only the party performing the R&D function would be entitled to the respective return as only this party performs the function. Again, due to the connection of the words 'perform and control' we see the risk that existing and accepted CCA's will be challenged in the future.

1.3 Control without performance

If the intent of the Draft is to assert that an entity cannot or is unlikely to split the performance of the development, enhancement, maintenance, and protection of intangibles from the controlling of some, or all of these elements, we consider that this assertion does not reflect what happens in practice.
We note in your commentary on the Draft, in relation to paragraph 40 that it:

“...does go a ways in the direction of saying that the absolute complete
segregation of performance and control of critical functions, and the
assumption and control of critical risks, is not something that we really think
happens at arm’s length in a great number of cases.”

In practice, many key functions in relation to intangibles are outsourced to third-parties. The evolution of the product in its life-cycle will determine how much performance and or control is required, and which party is best placed to deliver the relevant function.

We recommend that the Draft is amended to include commentary that is more supportive of the relevance and importance of control without performance and provide examples to illustrate this. Likewise, the Draft could be more supportive of the importance of bearing risks and providing funding within a multinational group.

We are concerned that the Draft introduces a new standard in determining if a party is entitled to intangible related returns. While we agree that it is critical that the party entitled to the intangible related returns is controlling the key functions around the development, enhancement, maintenance and protection of the intangibles, providing that the risks and functions are correctly addressed, we do not think it is necessary for an entity to perform some or all of these functions. We do not consider that it is necessary to do so with its ‘own employees’ which is suggested by paragraph 40.

1.4 Outsourcing

Outsourcing is part of modern business and it is not uncommon for business to outsource core elements of their operations, providing that suitable controls and service level agreements are in place.

We have noted in recent years that many of our clients have come to rely on Smartphone applications (‘Apps’) as a delivery channel for their services. If, for example, a cinema chain decides that it needs to provide an App to enable mobile sales of movie tickets for its customers but it does not have the in-house skills to develop and maintain the App, it could reasonably engage a third party to perform these services. It may also negotiate that the cinema company would own all the intangibles and future revenue from the App. In this instance, the company would control the intangible but it has not performed the key development, enhancement and maintenance functions for the App.

If these facts were altered slightly, and the cinema company decided to set up its own App building team in a foreign jurisdiction, such as India, and it entered into the same contractual arrangement as set out above, under the Draft, it may be argued that as it did not ‘perform’ the development, enhancement and maintenance activity for the App and that a return in excess of that paid to the third-party App developer should lie with the in-house development team. Assuming that the cinema company bore all the risks associated with the App development, negotiated to retain all the rights, and paid the developer an appropriate return; it should be entitled to the profits of the endeavour regardless of whether its own employees were engaged in the performance of the development or maintenance of the app. It would be entirely reasonable for the control and performance aspects of the arrangement to be segregated.

Bell, Kevin, A. “Silberztein Quizzes Andrus on Whether the OECD Discussion Draft Portends Policy Shift towards treatment of intangibles returns” Tax Management Transfer Pricing Report, 06/28/2012
1.5 **Impact of life-cycle on intangibles**

The Draft is silent on the impact of the stage that the intangible is at in its lifecycle and how this will alter the required amount of development, enhancement, maintenance and protection of the intangible, and which party is best placed to control and perform these functions. For example, a mature intangible may require no further development, enhancement or maintenance and a third party law firm could be engaged to take action regarding any infringements. Alternatively, a new intangible may require active development, regular enhancement and maintenance. If the intangible is particularly innovative it may also require active protection. The return attributed to these activities will also change over time, for example a mature intangible may require regular enhancements but these may not command a commensurate return from the market place, illustrated by the fact that a consumer may pay a one off fee for a software package but expect updates for free. Therefore the Draft may wish to acknowledge that it may not be appropriate to consider the development, enhancement, maintenance and protection of intangibles in all instances and the relative value over time of these elements may change. We suggest the Draft include examples that illustrate this point.

1.6 **Integrated systems**

Paragraph 23 notes a number of group synergies, including ‘integrated systems’, that cannot be owned or controlled by a single enterprise and therefore are not intangibles within the meaning of section A.1. We have clients that refer to computer systems as integrated systems, which can be owned and controlled. We suggest that the term ‘integrated systems’ is removed from the example or more clearly defined.

1.7 **Unrealistic documentation timeline**

Paragraph 36 states that:

“...it is good practice for associated enterprises to document in writing their decisions to allocate significant rights in intangibles before the time transactions leading to the development, enhancement, maintenance, or protection of intangible occur.”

This raises a question as to what ‘document’ refers to in this context. Does it mean that the allocation of rights to intangibles should be documented in an intercompany agreement or is it referring to a full transfer pricing study that has to be drafted before the transaction takes place or something else? This should be clarified in order to avoid misunderstandings.

From a practical perspective, the expectation that a full transfer pricing study should be in place prior to allocating rights is unrealistic. We agree that there should be support in place, but the taxpayer should be urged to do this in a timely manner rather than specify that it should be before the arrangement is implemented. Otherwise the new wording would not be in line with Chapter 5.5 and 5.15 of the existing OECD Transfer Pricing Guidelines. We suggest the wording of paragraph 36 be amended to utilise the term ‘contemporaneous documentation’ as opposed to suggesting documentation should be prepared before transactions occur.
2 Determining arm’s length conditions in cases involving intangibles

2.1 Increased uncertainty

The Draft increases the standards for comparables (paragraphs 84-105) which reflects other guidance issued by the OECD. It is our initial view that many of the current resources used to support intangibles, such as RoyaltyStat, are unlikely to provide sufficiently detailed information to satisfy the new requirements. As a consequence, taxpayers will be applying the alternative methods suggested (from paragraph 125 onwards) namely, the profit split and valuation methods. We have addressed our thoughts on the valuation sections of the Draft below. With respect to the profit split, it is, by its very nature, difficult to gain certainty on a transaction assessed using a profit split. The allocation of the residual element of the profit split is invariably subjective and open to challenge. The main means of gaining certainty on a profit split is to agree an Advanced Pricing Agreement (‘APA’). We note that while many tax authorities have embraced APAs there are considerable delays in key countries such as the US, and some countries, including the UK, have limited capacity to take on APAs. Additionally, the domestic laws and rulings in some countries mean that implementing an APA is not possible and in reality very few countries have APA’s in force.

Have the relevant tax authorities considered the impact on the increased demand for APAs and what steps are going to be taken to address this issue?

2.2 Impact on smaller companies

As a practice, we tend to work with a range of companies including smaller to mid-tier companies some of which can avail themselves of safeharbours (such as the SME rules in the UK) but they will face the Draft’s proposed standards in many other jurisdictions. Many of our clients do not have the resources or the scale of transactions that would warrant obtaining an APA to gain certainty on a transaction. We appreciate that the OECD have issued guidance on safeharbours and low diligence APAs. From our clients’ perspective, we ask that whatever the final version of the Draft may be that it is introduced in conjunction with initiatives that will reduce small companies’ compliance burden.

2.3 Realistically available options/one-sided analysis

Section D.1. refers to ‘realistically available options’ available to the parties to a transaction. While this appears reasonable, in practice determining what a third party would have done at arm’s length is difficult.

Paragraph 81 states that the:

“perspectives of each of the parties to the transaction must be considered”.

Ultimately, we believe that the push to higher standards of comparability and the directive that perspectives of both parties must be considered, in conjunction with their hypothetical realistically available options, may result in profit split methods being used more. As discussed in more detail below, the profit split methods reduce certainty and signal a move away from how third parties actually transact at arm’s length. Additionally, it is widely accepted that the buyer and seller do not always have the same valuation. Often in third party transactions, the buyer overpays (the ‘winners curse”).
However in the context of transfer pricing a buyer that over pays is likely to be challenged by a tax authority. The Draft is not clear on how to treat such scenarios.

We suggest amending the wording of paragraph 81 to the:

“perspectives of each of the parties to the transaction should be considered”.

Also, an assessment of the bargaining power of each of the respective parties is critical to determining what options may be available. We consider that a discussion of the impact of bargaining power would be useful to include in the Draft.

Furthermore, we would like to raise the question whether the options realistically available should ‘only’ be considered in the comparability section. In Chapter 2.122 of the Guidelines one possibility of a residual profit split is described:

“The alternative approach of how to apply a residual analysis could seek to replicate the outcome of bargaining between independent enterprises in the free market. In this context, in the first stage, the initial remuneration provided to each participant would correspond to the lowest price an independent seller reasonably would accept in the circumstances and the highest price that the buyer would be reasonably willing to pay. Any discrepancy between these two figures could result in the residual profit over which independent enterprises would bargain. In the second stage, the residual analysis therefore could divide this pool of profit based on an analysis of any factors relevant to the associated enterprises that would indicate how independent enterprises might have split the difference between the seller’s minimum price and the buyer’s maximum price.”

In a third party transaction the minimum price and the maximum price would be determined considering not only the costs of the parties involved but also the options realistically available. For example, consider the transfer of a patent to another entity. An independent transferor would first try to cover the development costs. The transferor would also consider other options realistically available, for example using the patent in its own production facilities. Therefore, the minimum price would be the potential profit that could be achieved while using the patent. We recommend providing more guidance on how options realistically available should be considered while applying the residual profit split.

2.4 Rule of thumb

The Draft states that the:

“…application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee is discouraged” (Paragraph 116).

This wording is not unexpected given the judgment in Uniloc/Microsoft case which called rules of thumb ‘arbitrary, unreliable and irrelevant’.

However, there is a body of academic research (Goldscheider et al) that is used to support this approach. Whilst we would never recommend using any rule of thumb as primary support, in practice it is used in a surprising number of transactions as a ‘sense check’. We suspect that in reality, taxpayers and tax authorities will continue to use the rule of thumb as a sense check, although they may not disclose that this is the case. We
suggest that the wording be amended to note the rule of thumb’s usefulness as a sense check.

2.5 Valuation

We are uncertain about the merits of the discussion on the use of valuation techniques in Section D. We note that a significant amount of the narrative in the Draft concentrates on valuation methods, such as Discounted Cash Flows (‘DCF’), and the issues arising from its application. In our experience valuations are seldom used in transfer pricing. We question the merits of including the discussion of valuation to the extent it is in the Draft.

2.6 Purchase price allocation valuations

Paragraph 110 of the Draft notes that:

“Caution should therefore be exercised in accepting valuations performed for accounting purposes...In particular; valuation of intangibles contained in purchase price allocations performed accounting purposes are not relevant for transfer pricing purposes.”

We disagree with this statement. In our experience methodologies adopted for valuing intangible assets as part of purchase price allocation (‘PPA’) work would be equally appropriate for transfer pricing purposes. The widely accepted methods would include the Relief-from-Royalty Method, which requires an arm’s length royalty rate to be determined through a royalty rate study. Other common methods are the Residual Return Method and the Excess Income Method.

Provided the valuation date for the PPA is the same as that for transfer pricing work, the valuations of intangible assets as part of the PPA should be considered on the merits of the analysis.

The valuations that are calculated using these methods undergo extensive scrutiny by auditors and valuers alike to ensure they are indicative of fair market value which is defined as what a knowledgeable, willing, and unpressured buyer would probably pay to a knowledgeable, willing, and unpressured seller in the market.

2.7 Functional analysis scope creep

There appears to be substantial scope creep over what should be included in a functional analysis when considering intangibles. Paragraph 108 states that:

“The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how intangibles interact with other functions, assets and risks that comprise the global business.”

We do not consider this approach to be appropriate in all cases. A functional analysis should begin with identifying the transaction/entity that is to be assessed against the arm’s length standard. The functional analysis should then consider the functions, risks and assets that directly relate to that transaction or entity. The goal of a transfer pricing analysis is not to consider the totality of a business, as implied by paragraph 108 in the text highlighted in red above.
The wording of paragraph 108 may lead some tax authorities to argue that the only way in which its focus on the ‘global business’ can effectively be followed is through the profit split methods. We urge the OECD to alter the wording of this paragraph.

We also note that there is a growing trend to consider the functions, risks and assets of entities that are not directly linked to the transaction/entity being assessed. While we understand the desire of tax authorities to consider the wider context of an arrangement, any assessment of the arm’s length nature of a transaction/entity must be based on the most limited scope possible to arrive at a reasonable conclusion in order to minimise the compliance burden for taxpayers. We therefore suggest the wording of paragraph 108 be altered to:

“The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s relevant global business processes and how intangibles interact with other relevant functions, assets and risks that comprise the global business.”

2.8 Moving away from market transactions?

The impact of the higher standard of comparability set out in the Draft is likely to move the evidence provided by taxpayers to demonstrate the arm’s length nature of their intangible transactions further and further away from real-world market transactions. If hypothetical profit splits or valuation methods, such as DCF, are used in place of less than perfect real-world CUPs these conclusions will become more esoteric and open to challenge. We have seen on numerous occasions that judges prefer flawed CUPs to hypothetical economic models. At a fundamental level, transfer pricing as a discipline needs to ground itself in real world evidence. Our concern is that the high standard of comparability that the Draft demands will lead to increased application of the profit split and valuation methods. The move towards hypothetical support for transactions is likely to be challenged by the Courts looking for a realistic, understandable and defendable conclusion to a dispute between the taxpayer and the local tax authority.

Examples

Some of the examples provided in the Draft are disjointed, unclear and at times introduce concepts that have not been established in the main body of the Draft.

The examples should be clearly linked to concepts contained in the Draft and provide practical guidance of how to apply these concepts. It is our view that the examples are the area of the Draft that need the most attention and will need to be substantially revised.

We suggest that, as done in the Australian Tax Office’s ‘International Transfer Pricing: Marketing Intangibles’ paper, that each example should begin with a short summary describing the concept that is being illustrated. However, we would prefer that the examples follow directly after the concept to be illustrated in the main body of the Draft as done in the revised Chapter IX. Where an example illustrates multiple concepts and includes a concept that may not have been introduced at that point of the Draft, then it may be beneficial to place the example at the end of the Draft once all concepts have been introduced.

We would like to thank the OECD again for this opportunity to comment and would be happy to expand on these points and contribute further to later stages of this review if required.
For clarification of any aspects of this response sent on behalf of the BDO transfer pricing network, please contact:

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Yours sincerely

Anton Hume
Global Transfer Pricing Leader
For and on behalf of BDO LLP
Acknowledgements

We would like to acknowledge the following members of the BDO team that contributed to the preparation of our comments on the Draft:

Brett Murray; Gonzalo Garcia Acebal; Therese Garcia; Pavlo Sugolov, Yesseli Gallardo; Alison Waldenberg; Chris Mangrobang; Rana Ahmad; Raoul Mendonca; Melissa Yong
September 14, 2012

BIAC Comments on the OECD Discussion Draft: Revision of Special Considerations for Intangibles in Chapter IV of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Joe,

BIAC is pleased to respond to the OECD request to send comments on the Discussion Draft on the Revision of Chapter VI of the Transfer Pricing Guidelines published 6 June 2012 (hereafter referred to as “the Draft”).

We provide more general comments in this document for each section of the Draft and separately provide a redline version of the Draft itself. We have limited our comments on the examples as we believe there are issues which we need to better understand before we can provide comments on the examples. We welcome the proposed consultation with business in November as a means of taking this forward and propose to provide additional comments on the examples, following the consultation.

The following are a number of general key concerns with the text. These are followed by points relating to sections A-D of the Draft. A redline is submitted separately.

- BIAC acknowledges that the topic of transfer pricing aspects of intangibles is an extremely complex and sensitive area and note the OECD work on base erosion and profit shifting (BEPS). We observe that substantial work has been done and generally support much of the commentary in the Draft. We recognise and welcome the fact that the Draft has been released as an “early draft”, even if as a result we have significant comments on some aspects of the drafting. For example, relating to the proposed definition and the functional approach proposed for the identification of the parties entitled to the intangible related returns; regarding the inconsistent and wide language used; the lack of cohesion between the examples themselves and the examples in the text; the lack of clarity around analytical process; and how to deal with license arrangements and when to bundle or unbundle transactions.

Mr. Joseph Andrus
Head of Transfer Pricing Unit
OECD Centre for tax Policy and Administration (CTPA)
We recognize that the Draft is not necessarily a consensus document and further work is required. We encourage OECD to continue and complete the work with an aim to reach consensus as the international tax community will greatly benefit from such agreement. Also in the event that the work will not result in a complete consensus document and reservations need to be made by certain countries, disclosure of such positions to the international tax community will have great value. We do reiterate BIAC’s general position that OECD guidelines are most valuable when the number of reservations is limited and that the more reservations there are the more difficult dispute resolution becomes.

We have concerns that the document can be read as assuming an anti-abuse standpoint. There is a concern that Profit Split as a method is overemphasised even where other better methods are available as arms length comparables and we believe that there is too much restatement rather than reference to existing guidance in the Guidelines. We would also suggest that a reference to a de minimis filter should be included to preclude a multiplication of issues where the cost benefit to both fiscal authorities and business will be unlikely. Furthermore we believe that the draft to a larger extent should aim at resolving the most common issues relating to the treatment of an intangible asset for transfer pricing purposes rather than the exceptional cases.

It is noted that the OECD Guidelines are globally the standard for dealing with intercompany transactions and the Guidelines are especially followed by member States, but also a significant number of non-member States follow them. To address application of the Draft for the non-member States, we encourage the OECD to interact with countries which are not OECD Members.

We are pleased with the acknowledgement of conditions or circumstances that do not constitute intangibles and are not compensable for transfer pricing purposes. Specifically, on group synergies and market specific characteristics we would appreciate guidance on the scope of further work proposed at ii) on page 3 of the Discussion Draft on the valuation of these issues and a timetable for this work.

We would also like to draw your attention to the fact that, as for any other transfer pricing matter, the analysis of the ownership, income deriving from the ownership and valuation of intangibles need to be articulated very precisely and need to follow a step by step process, which is sequenced as follows in the case of intangibles:

- Define if an intangible asset exists: we believe that as it is currently drafted, the Draft, as it defines an intangible as a “something” that has commercial value, is too vague and subjective and will not protect taxpayers as well as Member States. In order to avoid vagueness and appropriately recognise the treatment of intangibles in a third party situation, an intangible should be defined as an “asset” that is recognized by legal and accounting rules as being subject to ownership, control and transferability. In this connection, ownership of an intangible asset normally carries with it the right to earn
income from exploiting that asset, the right to exclude others from exploiting that asset to earn income and the right to transfer ownership or use of that asset to another.

- Determine which entity within a Group of companies has the ownership of such an asset and therefore be entitled to the intangible related returns.

- Assess the value of such an intangible asset in case of use by or transfer to another entity within the Group companies

We would propose that generally following this process could assist in making the Guidelines more transparent and have specifically proposed a “decision tree” process in Section B. The Draft deals with both the use and transfer of intangible and it would be helpful to be more explicit about each concept as there are points where the two are dealt with together.

Following this process will provide clarity and assist the international tax community to deal consistently with intercompany transactions involving intangibles. Our goal is indeed to minimise risk of double taxation by avoiding any unnecessary ambiguity on principles or lack of clarity of definitions and wording used. To this end, it would be welcome if the Draft could bring some clarity on the following items:

- Legal and accounting principles and contractual arrangements shall be systematically used in order to assess whether or not an intangible asset exists;

- Generally an entity cannot own an intangible for transfer pricing purposes if it does not simultaneously (1) own legal protection of the intangible (2) perform functions in relation to the ownership, the maintenance or the management of the intangible and (3) incur costs in relation to the intangible;

- The existence of an intangible shall always be analysed in taking into account three cumulative elements: contractual arrangements, cost analysis, and functional analysis.

We also would welcome confirmation that the Draft does not implicitly implement a “residual asset split” approach by mixing concepts such as the ownership of an intangible and an appropriate return on expenses incurred/functions performed (for example: a distributing entity which benefits from the right to use an intangible shall not be seen as the economic co-owner of the intangible, but may well be entitled to a certain level of income if its develops its own distribution intangible).

As noted above, page 3 of the Draft states that “the transfer pricing consequences of various items treated in this draft as comparability factors rather than intangibles, including market specific advantages, location-based advantages, corporate synergies and workforce issues,” are among the issues to be addressed in later...
drafts. This absence makes it difficult to assess the impact of the rules proposed in the discussion draft. Preliminarily BIAC expresses the concern that, without proper guidance on this subject, disproportionate values could be attributed to vaguely defined intangibles by analyses focusing too much on the above mentioned comparability factors. In order to prevent such issues BIAC suggests that when addressing this topic a number of steps be required before valuing any intangibles:

- Intangibles have to be clearly identified;
- They can be transferred to or provided for use by, another party; and
- They would be compensable in comparable dealings between independent parties.

The remainder of this paper will address more specific comments on sections A-D of the OECD Draft. These should be considered in conjunction with the BIAC redline comments submitted.

We will be pleased to answer any questions you may have regarding these comments, and the redline comments.

Sincerely yours,

[Signature]

Chris Lenon
Chairman
BIAC Committee on Taxation and Fiscal Affairs
Comments on Sections A-D and related examples in the OECD Discussion Draft

Section A: Identifying Intangibles

- Paragraph 3 of the Draft should reference Chapters VIII and IX of the Guidelines as well as Chapters I, II and III.

- Paragraph 5 suggest that the word “intangible” is intended to address “something” with is not a physical and financial asset and which is capable of being owned or controlled. We oppose such a vague definition, which we do not believe appropriately reflect the way intangibles are identified between independent parties as prescribed under the arm’s length principle. We therefore believe that the definition should refer to an intangible as being an asset which in addition to the cumulative requirement of being capable of being owned and controlled also should be separately transferable.

- Paragraph 7: Whereas BIAC agrees that some intangible may be transferred in combination with other intangibles, we believe an intangible would not exist when the asset does not have legal protection and where the asset is not transferrable separately. For example, under some circumstances and specific local legislations, a trademark cannot be transferred separately from the goodwill of the business associated with the trademark. Nevertheless, trademark rights can be licensed separately and the owner of the trademark can seek legal redress to exclude others from exploiting the trademark. We have grave concerns about recognizing a “something” as an intangible for transfer pricing purposes that is not subject to being transferred separately (or with goodwill) and that does not enjoy some level of legal protection.

- Paragraph 20 seems to state that all licenses are intangible, where it is not always the case. Although a license can create a value for the licensee, it is at the outset a right to use an intangible asset owned by the licensor, rather than the intangible itself. Notably a short term license is not an intangible asset by itself. This does not prevent the authorities and the taxpayer to include such licenses in a transfer pricing analysis in order to verify whether or not the right to use the intangible by another party is adequately compensated. We believe it is crucial to distinguished co-ownership of an intangible by related parties from appropriate compensation for the use of an intangible. For example, the grant of a distribution license does not trigger the transfer of the underlying intangible from the licensor to the licensee, nor any split in the ownership of the intangible.

- Paragraph 21 needs to be drafted in more precise terms as it affects a very significant concept (goodwill and ongoing concern). As non transferrable as such, BIAC considers that goodwill and ongoing concern are not intangibles, although we recognize that, in combination with an intangible, it has to be taken into account into the transfer pricing analysis in case of transfer of the underlying intangible, and this analysis is already appropriately handled under Chapter IX. We believe that treating goodwill as an intangible as such (where no clear definition exists and where it does not exist without being coupled to another asset) will allow tax authorities to label any
excess return/non defined value as intangibles value and will bring more uncertainty than clarification to the current guidelines. It should be very clearly stated that, as opposed to what paragraph 21 states, the expectation of future trade never qualifies as an asset, and is not an intangible asset. The reputational value may be a component of the valuation of an intangible asset, but is not an intangible in itself. This paragraph refers to the elements to take into account in order to value an intangible vs. being intangibles themselves. If a reference to the role that reputation and goodwill play is still relevant to the OECD, they may be quoted in another section to avoid confusion.

- BIAC strongly disagrees with the current drafting of Paragraph 26 of the Discussion Draft treating the transfer of a couple of employees as the transfer of intangible assets. BIAC believes it is not appropriate and will create non-manageable situations for both MNEs and revenues as well as many potential double taxation issues. We however recognize that such transfer may give raise to an appropriate compensation as any service may per Chapter IX of the Guidelines.

Section B: Identification of Parties Entitled to Intangible Related Returns (paragraphs 27-56 and examples 1-11)

General Comments

BIAC believes that the principle of entitlement should be rooted in Article 9 and should primarily refer to comparison with comparable uncontrolled arrangements. Assumptions about how parties behave should be replaced with comparisons with uncontrolled arrangements.

The definition of intangible related return is confusing and unnecessary in this section.

The apparent emphasis on physical performance of functions seems to impose non-arm’s length arrangements on related party transactions.

Main Comments

The principle adopted for determining entitlement to intangible related returns is critically important. The draft includes preliminary statements in bold:

“Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.”
The first sentence seems reasonable. The second sentence makes a suggestion which is partially correct: to determine “assets used” in keeping with the first sentence, then some consideration needs to be paid to ownership; to determine “risks assumed” in keeping with the first sentence, then some consideration needs to be paid to financial risk. It seems an uncontroversial observation of arm’s length arrangements that a party which is the legal owner and which makes investment is likely to have some interest in the benefits or returns arising. The key point is whether there can be functions performed, assets used, and risks assumed by parties other than the investor and legal owner which would, in comparable arm’s length situations, give rise to a benefit or return with respect to the intangibles. It is this point that the draft should clarify, and BIAC makes suggestions below which may help to provide clear guidance.

The most significant improvement to this section would be to start the analysis by reference to a comparison with comparable uncontrolled arrangements. BIAC believes that the principle of entitlement should be rooted in Article 9 and should refer to comparison with third-party arrangements. Such an approach would be similar to that adopted in Chapter IX (some of the principles of which have been incorporated into this draft) when considering risk allocation. Chapter IX requires comparison with third-party agreements; it is only when third-party comparables are inconclusive that one is required to consider which party controls risk (see 9.18). In the current draft, the principle gives primacy to control of risks, functions, and costs, and BIAC believes that the concept can cause uncertainty. Uncertainty arises because the required level of control and decision-making is not well understood, and there is no guidance on how it can be monitored and documented. In addition, large MNEs can have transnational committees exercising control with the result that control is not easily mapped to legal entities, as OECD requires.

BIAC suggests that the principle should be:

1. Is there evidence of similar entitlement to intangible related costs and return in comparable uncontrolled transactions? If so, these comparables should be sufficient to confirm entitlement and assess the consistency of the entitlement with the arm’s length principle.

2. If no reliable comparables can be found to support the determination of entitlement, then further analysis is required to determine whether the entitlement is one that might have been expected to have been agreed between independent parties in similar circumstances. The further analysis focuses on which parties perform the relevant functions, bear costs, and control risks.

3. Has the party with contractual entitlement performed functions and managed risks related to the management development and enhancement of the intangible?
   a) If yes, respect the contract.
   b) If no,
4. Has the party with contractual entitlement borne the costs (e.g. by remunerating a contract R&D developer on a cost plus basis) relating to the development and enhancement of the intangible? (this is to avoid the confusion during our last meeting on whether “bearing the cost” refers to the party taking the cost initially (i.e.; the contract R&D provider) and the party who ultimately carries the costs (the entrepreneur).

   a) If yes, respect the contract if that party also performed control functions (as described in 9.23) in relation to the risks arising from the development and enhancement of the intangible.

   b) If no, since the party with contractual entitlement has neither performed functions, borne costs, nor performed appropriately defined control functions in relation to risk, the intangible related costs and return shall not be allocated to this party despite the contract.

Such a decision tree will deal with a situation which the drafters find challenging; this is how to deal with a party which bears costs. If the entitlement meets the comparability requirements in step 1, then that should be the primary test. If no reliable comparisons can be found, then the decision-tree moves to consider the performance of functions under steps 3 and 4. Even if the party outsources functions relating to the development and enhancement of the intangible, then they will participate in the intangible related returns if they perform the control functions set out in 9.23. If they do not satisfy this requirement, then the draft should make clear the consequences. Presumably they should be entitled to a finance-type return taking into account risk of the investment, and that cost should be taken into account in computing the remaining intangible related return.

The definition of intangible related returns does not work. If a definition is required, then it should be covered in the section focussing on valuation. As drafted the definition seems to describe the process of performing a residual profit split, and confuses the principle of identifying the party entitled to the return with measurement of that return. It is not at all easy to see how a simple licensing arrangement would fit well with this definition. In addition, the definition assumes that all profit is either intangible profit or routine profit; however, the draft elsewhere points out that there are other sources of excess profits arising from features which fall short of intangibles (see paragraph 124, for example). Is there any need for a detailed definition in this section, since all the section is attempting to do is to determine which party should receive any return to the intangible, whether that return is positive, negative, or zero.

Paragraphs 38 and 40 make presumptions about conduct of parties which seem without evidence. There is certainly no reference to how parties behave in uncontrolled situations, and this absence is curious. By requiring physical performance of functions, the draft may impose non-arm’s length arrangements on related party transactions.
The concepts in this section as drafted seem focussed on the development of technology intangibles, but apply less clearly to the creation of marketing intangibles, and do not seem to work for straightforward licensing arrangements. Section B.3 and the examples do not always support the principle, and introduce different concepts, particularly focussing on the amount of expenditure. The introduction of different criteria to establish which party enjoys a return from the intangibles is not helpful.

**Section C: Transactions Involving the Use or Transfer of Intangibles (paragraphs 57-76 and examples 12-17)**

**General comments**

The guidance in this section is broadly welcomed by BIAC and some of the examples provide helpful illustrations. As in the other sections, it would be helpful if the text could cross refer to the relevant examples as it is not always clear which points the examples are aiming to illustrate and in some cases the examples and text appear inconsistent.

Section C1 provides a helpful reminder that just because intangibles exist, it should not be assumed they are transferred along with sales of goods and services.

Section C2 discusses situations where intangibles are transferred. Paragraph 65 (which refers to paragraphs 1.52 et seq. but is worded differently to the original sections) could be taken as support for potentially disregarding the transactions actually undertaken, whereas Chapter 1 at 1.64 et seq. correctly mentions that this should be done in extreme cases only.

BIAC would prefer more examples and narrative covering licensing arrangements. We would also encourage clarification that outsourcing production, services or development is a normal business activity and typically does not involve the transfer of intangibles or the right to "intangible related returns".

There is reference to the importance of the comparability analysis and we wonder if a framework could be provided, building on the one in Chapter 3. Our comments in relation to Section B above provide a possible outline for this. We note that profit split is difficult and highly subjective to apply and in our view should not become a default method wherever intangibles are found.

Further there is an implication in some of the examples in this section and also the other sections that the "intangible related returns" might be divided around the group based largely on who performs the people functions. Third parties normally jealously guard their intangibles and take strenuous steps not allow them to leach away to their customers and suppliers. The temptation to allow everyone to claim a 'slice of the pie' for transfer pricing purposes should be avoided as it is not in line with the arm's length principle, could result in more uncertainty for business, and potentially more double taxation and more disputes between territories.
We strongly welcome the clarification earlier in the text that location factors and group synergies are not intangibles but comparability factors and we suggest this clarity could better flow through into the examples (for example specifying that these factors do not per se give rise to "intangible related returns").

Paragraphs 66 through 70 discuss the transfers of combinations of intangibles, and paragraphs 71 to 75 the transfers of intangibles in combination with other transactions. These sections are not clear about when separation or aggregation will be appropriate or required, and more guidance would be appreciated here. Again, a wide spectrum is often observed in third party behaviour. BIAC believes the starting point should continue to be the actual arrangements entered into by the parties (unless the arrangement used is never observed in the market AND is impossible to price - as envisaged in chapter 9.180). In our view this is a better approach than implying as in paragraphs 69 and 70 that taxpayers may be required to aggregate or required to segregate, when the parties have done something different.

We question whether the examples in paragraphs 73 and 74 are intended to be definitive for cases involving franchises ("may be necessary to segregate") and software maintenance (aggregation "may be necessary") or not. Either way, the use of the qualifier "so-called" in relation to business franchises looks pejorative - there are very many third party examples of franchise arrangements across a variety of industries. In some cases, the payment by the franchisee will be one aggregate amount and in other cases it will be split into components, such as royalty, service charges, etc.

The reiteration in paragraph 75 of the existing guidance that not all services should be "cost plus" and "not all intangibles transactions require complex valuations or …profit splits" is welcomed.

Comments on the Section C Examples:

Several of the examples (here and in the other sections) refer to disregarding or recharacterising the transactions actually undertaken. The same examples could be worded more neutrally by simply explaining how the OECD thinks the transaction should be priced instead of outlining a purportedly incorrect view as the taxpayer's position and saying what the tax authority should do to rectify it (e.g. example 12).

Example 13 should be removed as it appears inconsistent with the arm's length principle. If Ilcha made arrangements with a third party as a licensed distributor instead of with its subsidiary S, it would seem unlikely Ilcha would charge that third party for the implicit conveyance of goodwill, or indeed that the third party would be able to re sell such rights or "ongoing concern value". If S can't sell or exploit them itself, in BIAC's view they are not intangibles for transfer pricing purposes.

Example 14 also appears unnecessary as it is unclear what it is illustrating. Given that the distribution affiliates make the same margins before and after the setup of company S, and
we are told these margins are arm’s length, one would have to assume that the advertising expenditure does not create an intangible for which supernormal returns would be expected. Hence it follows that S would not be entitled to "intangible related returns" even if it did perform the advertising or control the marketing. Furthermore, the wording in this example (e.g. "return to goodwill") is vague.

A reader might also assume from the last line of this example that (in line with the wording in the bold box in section B) the OECD believes that paying for an activity which could generate an intangible (or even ownership of the intangible) will never entitle the payer to any intangible related return. While BIAC agrees it should not be assumed that all intangible related returns necessarily flow to the entity which pays for an activity, this seems to promote the doing or control of activities (i.e. functions) over and above assets and risks in all cases, and appears to step away from the arm’s length principle.

We strongly disagree with example 15, where in our view the analysis is flawed. It appears to assume that the price paid for a limited company must all be allocable to either specific tangible or specific intangible assets for transfer pricing purposes, ignoring accounting entries. It then makes the further leap that because there is a change in activity after the takeover from entrepreneur to contract R&D provider, T should be compensated, either immediately or in the future for this bundle of “intangibles”.

Examples 16 and 17 are much clearer and more helpful, dealing with software/services respectively with and without the transfer of intangibles.

SECTION D (Determining Arm’s Length Conditions in Cases Involving Intangibles)

BIAC appreciates the fact that the current OECD Draft is the result of a significant effort to provide better guidance for complicated cases involving intangibles; however BIAC considers that additional efforts could be made to promote simplification and manageability of simpler cases involving intangibles.

In order to promote better certainty and efficient use of resources of both MNEs and Tax Authorities, BIAC would recommend a fine tuning of section D based on the following principles:

- Simpler rules for cases where sufficiently reliable comparables exist or reliable comparability adjustments can be made or the value of intangibles is low.
- Further refinement of the principles applying to complex cases.
- Better clarity on the distinction between complex cases requiring sophisticated methods and documentation, and simpler cases normally requiring less sophisticated methods and lighter documentation.
The main topics raising concerns are:

1. Guidance on the selection of method;
2. Services using intangibles;
3. Administrative burden; and
4. Example 19.

1) Selection of method:

BIAC’s main concern is that a new chapter VI could be interpreted as requiring the use of complicated and sophisticated methods in the majority of transfer pricing cases involving intangibles. BIAC strongly believes that the comparability analysis should remain the key driver to the selection of method: this appears to be also the recommended approach in section D1 of the Draft (in particular in paragraphs 87 to 89) and in paragraph 119 of section D3. However the wording of section D2 (“Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles”), addressing all types of intangibles, seems to be mainly driving cases of “Section D.1.(vi) intangibles”: this may lead to the perception that traditional transaction methods are discredited even for intangibles for which sufficiently reliable comparables exist or reliable comparability adjustments can be made. BIAC suggest therefore that also section D2 include a clearer distinction between the principles generally applying to intangibles for which comparables exist (or comparability adjustments can be made) and the principles generally applying to “Section D.1.(vi) intangibles”.

The second concern about the selection of method is that, although the wording of paragraphs 128 and 129 fully reflects the existing guidance on the application of the profit split method, certain negative wording in the Draft in relation to the application of traditional transaction methods could create a pressure for a widespread use of profit split. As outlined above, BIAC considers it very important to promote simplification and efficient use of resources wherever possible: considering the intrinsic difficulties of profit split methods, BIAC suggests the inclusion in new chapter VI of a clarification similar to that included in the OECD letter of July 2010.1

The third concern about the selection of method is related to the use of valuation techniques. The repeated reference to the usefulness of income based valuation techniques and the structure of example 19 could give the impression that valuation techniques are promoted as a primary method for valuing intangibles. BIAC observes that valuation techniques cannot be applied in a simple way, require the support of experienced specialists and a significant amount of reliable data. As a consequence it would be advisable to limit the use of valuation techniques.

1 “The OECD does not intend that the revisions of the Guidelines require more extensive use of profit split methods nor does it believe that the language of the revised Guidelines appropriately can be read to impute such a requirement. Profit split methods need not be applied to corroborate the results of other methods in every case. However, profit split approaches can be useful and can be the most appropriate transfer pricing method in some instances, following the criteria identified in paragraph 2.2 of the revised Guidelines.” Response of the Committee on Fiscal Affairs to the comments received on the September 2009 draft revised Chapters I-III of the Transfer Pricing Guidelines, 22 July 2010
techniques to particularly complex cases within “Section D.1.(vi) intangibles”. BIAC suggests to reflect this concept into the guidance about use of valuation techniques. BIAC also suggests the addition of a clear reference to the direction provided in Paragraph 2.9 of the Guidelines: “(...) other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution.”

2) Services using intangibles

The specialisation and centralisation of activities is a vital requirement for MNEs to stay competitive; this leads to a growing number of exchanges of services within multinational groups, often embedding some form of intangibles. A systematic analysis and pricing of the intangible component as a separate element would lead to intolerable levels of workload and uncertainty and would conflict with the business reality of many services being priced, at arm’s length, on a cost plus basis.

Also in this case, BIAC considers that comparability is the key driver and observes that in today’s world there is a growing tendency to outsource non-core activities, including high-value adding ones.

Many independent suppliers of services use cost based pricing methods: this is a common practice also in high value adding services like Management Consulting and Software Customization, despite the fact that these categories of services imply both the use and the transfer/creation of intangibles. BIAC suggests a change in the wording of the OECD Draft (paragraph 107 of section D and also paragraph 75 of section C) to highlight the fact that intangibles utilised or transferred within a service activity do not always drive a premium margin above that charged in comparable services and consequently a cost-plus method is not automatically invalidated because intangibles may be involved. In some transactions, however, intangibles can lead to premium pricing being agreed between independent contractors. A comparability analysis should drive the identification of cases where independent contractors would agree on a premium price due to, for example, the exceptional value of the intangible, risks assumed, or the unique competitive position of the provider.

BIAC also recommends the addition of some guidance about simplified approaches to be allowed for minor transactions (either because small or not recurring.)

3) Administrative burden

BIAC is worried about the complexities and workload that can be generated by certain administrative and documentation requirements in the Draft, also considering the growing complexity of large multinationals’ organizations and the increasing number of small and medium MNEs having to deal with these issues.
BIAC’s first concern in this area is related to the requirement of documenting the options realistically available (paragraph 80). BIAC suggests to insert an explicit reminder of the concepts expressed in chapter IX (9.64): “The reference to the notion of options realistically available is not intended to create a requirement for taxpayers to document all possible hypothetical options realistically available. As noted at paragraph 3.81, when undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Rather, the intention is to provide an indication that, if there is a realistically available option that is clearly more attractive, it should be considered in the analysis of the conditions of the restructuring.”

The second concern is related to the requirement of performing a global analysis (paragraph 108).

BIAC observes that also between independent parties often a bilateral (rather than global) analysis is conducted; in addition it should not be assumed that all MNEs have transfer pricing global information easily available: they may actually be organized more on a bilateral basis for setting their transfer prices. In all these cases it would be very difficult and burdensome for MNEs to build a global analysis only to support transactions that may be legitimately priced on the basis of comparables and on a traditional bilateral approach. BIAC suggests a redrafting of paragraph 108 to clarify that if comparables can be used, no further analysis should be required. BIAC also suggest to clarify that also for “Section D.1.(vi) intangibles” a global analysis will be required only in cases where independent parties, in comparable situations, would seek to embark in a burdensome global analysis due to the complexities and interconnections of the business model.

The third concern is related to the requirements for the comparability analysis. BIAC appreciates the useful detailed description provided in paragraphs 90 to 100; however BIAC observes that there are often limitations to the details available to both taxpayers and tax administrations to perform the comparability analysis.

BIAC suggests adding to the draft an explicit reference to Section C of Chapter III (“Compliance Issues”) and to quote the key concepts included in that section about the extent of the burden and costs that should be borne by a taxpayer to identify possible comparables and obtain detailed information thereon:

- “It is recognised that the cost of information can be a real concern, especially for small to medium sized operations, but also for those MNEs that deal with a very large number of controlled transactions in many countries.”

- “When undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Taxpayers and tax administrations should exercise judgment to determine whether particular comparables are reliable.”
• “it may be reasonable for a taxpayer to devote relatively less effort to finding information on comparables supporting less significant or less material controlled transactions.”

• “Although the arm’s length principle applies equally to small and medium sized enterprises and transactions, pragmatic solutions may be appropriate in order to make it possible to find a reasonable response to each transfer pricing case”.

This addition could potentially be made either within paragraph 91 or at the end of the section, after paragraph 100.

4) Example 19

Example 19 may represent a useful illustration, but may also convey the misleading message that simple valuation models can be used.

BIAC fears that example 19 could potentially be perceived as an approved “modus operandi” rather than just an example. There is a serious concern that this could lead taxpayers or tax administrations to believe that an intangible can be easily priced on a “residual basis” by just estimating: projected revenues, costs and expenses; routine return rates; useful life; discount rates.

In addition, the example in its current version could actually drive an interpretation that appears to be in contrast with the statement in paragraph 108: “In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns”.

Although paragraphs 149 to 170 thoroughly analyse several areas of concern in applying methods based on discounted cash flows, it can be anticipated that the example will represent the main reference for the readers: BIAC therefore suggests to include additional analytical and conceptual elements to make the example more in line with the complexities of real cases recognizing that the subject is very complicated and that reliable valuations can only be performed by specialized professionals and require a significant amount of reliable data.

BIAC also observes that even in the very simplified approach of example 19, some very difficult questions and issues arise, for which alternative and quite controversial options exist:

i) The alternative between a NAT (Net After Tax) versus an OM (Operating Margin) analysis.

ii) The tax rate to be used for the NAT analysis.

iii) The inappropriateness, in many cases, of adopting the simplifying assumption that all non-routine profit can be attributed to intangibles.
iv) The need to include into the analysis the taxes that Pervichnyi will pay if it sells the intangible (that would modify the range of realistic options for the group).

v) The need to include a reasonable assumption about the rate of return that a third party would require to make the investment (in table 2 the IRR of Company S appears to be equal to the cost of capital: a third party would be very unlikely to make such an investment).
It is proposed that the current provisions of Chapter VI of the Transfer Pricing Guidelines be deleted in their entirety, and that they be replaced by the following language.

CHAPTER VI
SPECIAL CONSIDERATIONS FOR INTANGIBLES

1. Under Article 9 of the OECD Model Tax Convention, where the conditions made or imposed in the use or transfer of intangibles between two associated enterprises differ from those that would be made between independent enterprises, then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. The purpose of this Chapter VI is to provide guidance specially tailored to determining arm’s length conditions for transactions that involve the use or transfer of intangibles. Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. The fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for purposes of Chapter VI, does not imply that the item or activity does not convey economic value or that it need not be considered in determining arm’s length prices and other conditions for controlled transactions.

3. The principles of Chapters I through III of these Guidelines apply equally to transactions involving intangibles and those transactions which do not. As is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis. That functional analysis should identify the functions performed, assets used, and risks assumed by each relevant member of the MNE group. Indeed, in cases involving the use or transfer of intangibles, it is especially important to ground the analysis on an understanding of the MNE’s global business and the manner in which intangibles are used by the MNE to add or create value.

4. In order to determine arm’s length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis in the following order: (i) the identification of specific intangibles; (ii) the identification of the party(ies) that should be entitled to retain the return derived from the use or transfer of the intangibles; (iii) the nature of the controlled transactions and whether they involve the use of intangibles and/or lead to the transfer of intangibles between the parties; and (iv) the remuneration that would be paid between independent parties for the use or transfer of such intangibles.
A. Identifying Intangibles

A.1. In general

5. **Legal registrations, Generally Accepted Accounted Principles and contractual arrangements are the starting point for determining if an intangible exists.**

In these Guidelines, the word “intangible” is intended to address something—an asset—which is not a physical asset or a financial asset, and which is capable of being owned or controlled and transferred for use in commercial activities. Rather than focusing on legal and accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

5. Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless carry significant economic value and may need to be considered for transfer pricing purposes. Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterisation for accounting purposes, but will not be determined by such characterisation only. Furthermore, the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterisation for general tax purposes, as, for example, an expense or an amortisable asset.

6. **The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it.** The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.

7. **It is important to distinguish intangibles from market conditions, expectations of future profits, or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise.** For example, features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market, or the existence of “excess profits” due to local market conditions may affect the determination of an arm’s length price for a particular transaction and should be taken into account in a comparability analysis. They are not, however, intangibles for purposes of Chapter [VI].

8. The identification of an item as an intangible is separate and distinct from the determination of the value of the item or the return attributable to the item under the facts and circumstances of a given case. Depending on the industry sector and other facts specific to a particular case, intangibles can account for

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1 As used in this paragraph, a financial asset is any asset that is cash, an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples include bonds, bank deposits, stocks, shares, forward contracts, futures contracts, and swaps.
either a large or small part of the MNE’s value creation. It should be emphasized that not all intangibles
deserve separate compensation in all circumstances, and not all intangibles give rise to premium returns in
all circumstances. For example, consider a situation in which an enterprise performs a service using non-
unique know-how, where other comparable service providers have comparable know-how. In that case,
even though know-how constitutes an intangible, it may be determined under the facts and circumstances
that the know-how does not justify allocating a premium return to the enterprise, over and above normal
returns to the functions it performs. See TPG 1.39.

9. Care should be taken in determining whether or when an intangible exists and whether an
tangible has been used or transferred. For example, not all research and development expenditures
produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of
an intangible.

10. In a transfer pricing analysis of a matter involving the use or transfer of intangibles, it is
important to identify the relevant intangibles with some specificity. The functional analysis should identify
the economically significant intangibles at issue, the manner in which they contribute to the creation of
value in the transactions under review, and the manner in which they interact with other intangibles, with
tangible assets and with business operations to create value. While it may be appropriate to aggregate
intangibles for purposes of determining arm’s length conditions for the use or transfer of the intangibles in
certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an
effect on arm’s length prices or other conditions. A thorough functional analysis, including an analysis of
the importance of identified economically significant intangibles in the MNE’s global business, should
support the determination of arm’s length conditions.

A.2. Relevance of this Chapter for other tax purposes

11. The guidance contained in this Chapter is intended to address transfer pricing matters
exclusively. It is not intended to have relevance for other tax purposes. For example, the Commentary on
Article 12 of the OECD Model Tax Convention contains a detailed discussion of the definition of royalties
under that Article (paragraphs 8 to 19). The Article 12 definition of “royalties” is not intended to provide
any guidance on whether, and if so at what price, the use or transfer of intangibles would be remunerated
between independent parties. It is therefore not relevant for transfer pricing purposes. Moreover, the
manner in which a transaction is characterised for transfer pricing purposes has no relevance to the
question of whether a particular payment constitutes a royalty or may be subjected to withholding tax
under Article 12. The concept of intangibles for transfer pricing purposes and the definition of royalties
for purposes of Article 12 of the OECD Model Tax Convention are two different notions that do not need
to be aligned. It may occur that a payment made between associated enterprises may be regarded as not
constituting a royalty for purposes of Article 12, and nevertheless be treated for transfer pricing purposes
as a payment made in remuneration for intangibles to which the principles of this Chapter apply.
Examples could include certain payments related to goodwill or ongoing concern value. It may also occur
that a payment properly treated as a royalty under Article 12 of a relevant treaty may not be made in
remuneration for intangibles for purposes of this Chapter. Examples could include certain payments for
technical services. Similarly, the guidance in this Chapter is not intended to have relevance for customs
purposes.

A.3. Categorisation of intangibles

12. In discussions of transfer pricing issues related to intangibles, it is sometimes the case that
various categories of intangibles are described and labels applied. Distinctions are sometimes made
between trade intangibles and marketing intangibles, between “soft” intangibles and “hard” intangibles,
between routine and non-routine intangibles, and between other classes and categories of intangibles. The
approach contained in this Chapter for determining arm’s length prices in cases involving intangibles does not turn on these categorisations. Accordingly, no attempt is made in these Guidelines to delineate various classes or categories of intangibles.

A.4. Illustrations

13. This section provides illustrations of items often considered in transfer pricing analyses involving intangibles. The illustrations are intended to clarify the provisions of section A.1. The illustrations are not intended to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles. Numerous items not included in this listing of illustrations may be intangibles for transfer pricing purposes. The illustrations in this section should be adapted to the specific legal and regulatory environment that prevails in each country. Furthermore, they should be viewed in the context of the comparability analysis (including the functional analysis) of the controlled transaction with the objective of better understanding how intangibles and items not treated as intangibles contribute to the creation of value.

(i) Patents

14. A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. A patent may relate to a physical object or to a process. Patentable inventions are often developed through risky and costly research and development activities. In some circumstances, however, small research and development expenditures can lead to highly valuable patentable inventions or vice-versa. The developer of a patent may try to recover its development costs (and earn a return) through the sale of products covered by the patent, by licensing others to use the patented invention, or by an outright sale of the patent. The exclusivity granted by a patent may, under some circumstances, allow the patent owner to earn premium returns from the use of its invention. In other cases, a patented invention may provide cost advantages to the owner that are not available to competitors. Patents are intangibles within the meaning of section A.1.

(ii) Know-how and trade secrets

15. Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret. The confidential nature of know-how and trade secrets may be protected to some degree (i) under unfair competition or similar laws, (ii) under employment contracts, and (iii) by economic and technological barriers to competition. Know-how and trade secrets are intangibles within the meaning of section A.1.

(iii) Trademarks, trade names and brands

16. A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities. Proprietary rights in trademarks are generally established through a registration system. The registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace. A trademark registration may continue indefinitely if the trademark is continuously used and the registration appropriately renewed. Trademarks may be established for goods or services, and may apply to a single product or service, or to a line of products or services. Trademarks are perhaps most familiar at the consumer market level, but they
are likely to be encountered at all market levels. Trademarks are intangibles within the meaning of section A.1.

(iv) **Trade names and brands**

17. A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may be seen in certain circumstances as a derivative or a declination of a trademark, and may indeed be registered in some specific form as a trademark. The trade names of certain MNEs may be readily recognised, and may be used in marketing a variety of goods and services. Trade names are intangibles within the meaning of section A.1. Further consideration needs to be given to whether trade names carry any value per se. Trademarks are intangibles within the meaning of section A.1.

18. The term “brand” is sometimes used inaccurately interchangeably with the terms “trademark” and “trade name,” but is not a legal or accounting concept. In other contexts a brand is thought of as a trademark or trade name imbued with social and commercial significance. A brand may, in fact, as an example, represent a combination of intangibles including, among others, trademarks, trade names, customer lists, relationship, reputational characteristics, know how, design and goodwill. A brand may, in fact, as an example, represent a combination of intangibles including, among others, trademarks, trade names, customer lists, relationships, reputational characteristics, knowledge, design and goodwill. It may sometimes be difficult or impossible to aggregate or separately transfer the various intangibles contributing to brand value. A brand is not as such an intangible but may consist of a single intangible, or a collection of intangibles, within the meaning of section A.1.

(iv) **Licences and similar limited rights in intangibles**

19. Rights to use intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licenced rights may be limited as to field of use, term of use, geography or in other ways. As a starting point, a license covers the right to use an intangible asset owned by a licensor, rather than an intangible itself. Nevertheless, such limited rights in intangibles are a license may be, under some circumstances, and depending on contractual arrangements, themselves intangibles within the meaning of section A.1. The following items are not intangibles within the meaning of section A.1, but should be taken into account in a transfer pricing analysis, though the required comparability analysis. See TPG Chapter III and paragraphs 9.148-9.153.

(v) **Goodwill and Ongoing Concern Value**

20. Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognized. In still other contexts, goodwill is referred to as the expectation of future trade from existing customers. The term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. It is generally recognized that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets. See TPG paragraphs 9.93 – 9.95 for a discussion of the related notion of a transfer of all of the elements of an ongoing concern in connection with a business restructuring.

21. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes as goodwill does not by itself qualify as an intangible. It is important to recognize, however, that the terms goodwill and ongoing concern value are often used to
describe an important and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm’s length price. Similarly, when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark or other license that reputational value should be taken into account in determining an appropriate royalty. To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as taken into account in the valuation of intangibles within the meaning of section A.1. Such treatment in no way implies, however, that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily the only appropriate measures of the price that would be paid for the transferred business or license rights, together with their associated goodwill and ongoing concern value, by independent parties. In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis.

(vi) Group synergies

22. In some circumstances group synergies contribute to the level of income earned by an MNE group. Such group synergies can take many different forms including streamlined management, elimination of costly duplication of effort, integrated systems, purchasing power, etc. Such features may have an effect on the determination of arm’s length conditions of controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by a single enterprise, they are not intangibles within the meaning of section A.1.

(vii) Market specific characteristics

23. Specific characteristics of a given market may affect the arm’s length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labor costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics may not, however, be owned, controlled and transferred by an individual enterprise. Such items are not intangibles within the meaning of section A.1., and should be taken into account in a transfer pricing analysis through the required comparability analysis. See TPG Chapter III and paragraphs 9.148 – 9.153.

(viii) Assembled workforce

24. Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.

25. Additionally, it should be recognised that:

- Contractual rights and obligations may be intangibles within the meaning of section A.1. so that a long term contractual commitment to make available the services of a particular group of uniquely qualified employees does not constitute an intangible, but may be taken into account in a transfer pricing analysis through the required comparability analysis, in a particular circumstance.
The transfer of an existing assembled workforce may provide a benefit to the transferee by saving it the expense and difficulty of hiring and training a new workforce, and may affect the compensation required in connection with the transaction;

While the transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of an intangible, as a factual matter such a transfer may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm’s length dealings.

In each case, the specific facts, as reflected in a detailed functional analysis, should control the transfer pricing outcome.
B. Identification of Parties Entitled to Intangible Related Returns

26. A second threshold inquiry in any transfer pricing analysis involving the use or transfer of intangibles involves the identification of the member or members of an MNE group that are entitled to intangible related returns in arm’s length transactions. Entitlement to intangible related returns for transfer pricing purposes should be determined on the basis of an analysis of the relevant facts and circumstances, by requiring the compensation of the various functions, assets and risks of the MNE members to be consistent with the intangible value they create.

27. As used in Chapter VI, the intangible related return attributable to a particular intangible is the economic return from business operations involving use of that intangible after deducting (i) the costs and expenses related to the relevant business operations; and (ii) returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments.

In a particular circumstance, intangible related returns with respect to an intangible may be positive, negative, or zero.

28. In determining which members of an MNE group are entitled to intangible related returns with respect to an intangible, the following factors should be considered: (i) the terms and conditions of legal arrangements including relevant registrations, licence agreements, and other relevant contracts; (ii) whether the functions performed, the assets used, the risks assumed, and the costs incurred by members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns in the relevant registrations and contracts; and (iii) whether services rendered, in connection with developing, enhancing, maintaining and protecting intangibles, by other members of the MNE group to the member or members of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm’s length basis under the relevant circumstances.
B.1. Registrations and contractual arrangements

29. Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns. The terms of a transaction may be found in written contracts or in correspondence and/or other communications between the parties. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct in order to create a starting point for determining which party is entitled to intangible related returns and the economic principles that generally govern relationships between independent enterprises.

30. From a legal perspective, the right to use some types of intangibles may be protected under specific intellectual property laws and registration systems. Patents, trademarks, and copyrights are examples of such intangibles. In general terms, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible and has the right to prevent others from using the intangible. These legal rights may be granted for a specific geographic area and/or for a specific period of time.

31. There are also intangibles that are not protectable under specific intellectual property registration systems, but are legally protected against unauthorised appropriation or imitation via unfair competition legislation or other enforceable laws, or by means of employment contracts. Trade dress, trade secrets, and know-how may fall under this category of intangibles. There may also be intangibles whose use is not protected under any applicable law.

32. The conditions and extent of the available protection under applicable law may vary from country to country. For instance, depending on local law, availability of legal protection may be subject to continued commercial use of the intangible or timely renewal of registrations.

33. It is often the case that an entity legally entitled to exclude others from using intangibles will enter into contracts making full or partial rights to use the intangibles available to others. A licence or other grant of partial rights can be limited in a number of ways (including as to geographical scope, time period, or class of products), and may be granted on an exclusive or non-exclusive basis. Such contracts may impose restrictions on the use, exploitation, reproduction, further transfer, and further development of the intangibles. In assessing the respective entitlements of members of an MNE group to intangible related returns, it is important to examine the specific terms of such agreements and of the restrictions imposed in the agreements, if any.

34. Except as otherwise provided in this section B, or in section C, below, where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity entitled to use the intangible and to exclude others from using the intangible, under applicable law and under relevant contracts, is the entity entitled to intangible related returns with respect to that intangible for transfer pricing purposes. In the case of a licence or similar arrangement, the licensor will be the entity entitled to intangible related returns attributable to its licensed rights, subject to its obligation to provide arm’s length compensation for the grant of the licence.

35. Because legal registrations and relevant contracts form the starting point for an analysis of which members of an MNE group are entitled to intangible related returns, it is good practice for associated enterprises to document in writing their decisions to allocate significant rights in intangibles before the time transactions leading to the development, enhancement, maintenance, or protection of intangibles occur.
B.2. Functions, risks, and costs related to intangibles

36. In evaluating which members of an MNE group are entitled to intangible related returns, it is important to examine whether the conduct of the parties is in alignment with the terms of the legal registrations and contracts or whether the parties’ conduct indicates that the legal forms and contractual terms have not been followed. When evaluating the alignment between a contractual claim to entitlement to all or part of the intangible related returns attributable to an intangible, and the conduct of the parties, examination of functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles is necessary. Where the conduct of the parties is not aligned with the terms of legal registrations and contracts, it may be appropriate to allocate all or part of the intangible related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles. The party’s conduct should generally be taken as the best evidence concerning the true allocation of entitlement to intangible related returns.

(i) Functions

37. Where the parties’ conduct is aligned with the terms of registrations and contracts, the member of the MNE group contractually entitled to intangible related returns will either perform the functions related to the development, enhancement, maintenance and protection of the intangible, or arrange to have such functions performed under its control by independent enterprises or by associated enterprises dealing on an arm’s length basis. Where intangibles are transferred, in a transaction where contractual rights and conduct are aligned, such functions will be performed or controlled by the transferee following the transfer.

38. The specific functions that should be examined in evaluating entitlement to intangible related returns will depend on the particular facts of a case. Functions leading to the development of intangibles, including research and development functions which may lead leading to the development and enhancement of product related intangibles, and sales and marketing brand development functions which may lead leading to the development and enhancement of trademarks and related intangibles will be especially important in evaluating which members of an MNE group are entitled to intangible related returns. Functions related to preserving the legal protections accorded to intangibles and the defence of intangibles against infringement similarly are often important.

39. It is not essential an observation of arm’s length behaviour that it is necessary for the party claiming entitlement to intangible related returns physically to perform all or even the majority of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some or several of these functions are sometimes often outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm’s length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform through its own employees fulfil - the important control functions related to the development, enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, and subject to the definition of control as outlined in chapter IX, these control functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control assessing the outcomes of other functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.
40. Moreover, where associated enterprises are retained to perform functions related to the development, enhancement, maintenance or protection of intangibles, it is expected that, in a situation where contractual entitlements and functions are in alignment, the party or parties claiming contractual entitlement to intangible related returns will exercise control over the performance of those functions and the associated risks, will bear the necessary costs required to support the performance of the function, and will provide arm’s length compensation to any associated enterprise physically performing a relevant function. In assessing whether the member of the MNE group claiming entitlement to intangible related returns in fact controls the performance of the relevant functions, principles analogous to those of paragraphs 9.23 through 9.28 should be applied.

(ii) Risks

41. Where the conduct of the parties is aligned with the terms of relevant registrations and contracts, the member or members of the MNE group entitled to intangible related returns will bear and control the risks associated with the development, enhancement, maintenance and protection of the intangibles. Where intangibles are transferred, in a transaction where contractual rights and conduct are aligned, such risks will be borne and controlled by the transferee following the transfer. See TPG paragraph 9.23-9.28.

42. Particular types of risk that may have importance in considering the entity or entities entitled to intangible related returns include (i) risks related to development of intangibles including the risk that costly research and development or marketing activities will prove to be unsuccessful; (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risk, including the risk that defence of intangible rights or defence against other persons’ claims of infringement may prove to be time consuming and/or costly; and (iv) product liability and similar risks related to products and services based on the intangibles.

43. In the event that costs are incurred associated with the realisation of relevant risks, it is especially important, in assessing the degree of alignment between contractual allocations of the entitlement to intangible related returns among members of the MNE group and the members’ conduct, to determine whether those costs incurred when relevant risks come to fruition are in fact borne by the entity claiming entitlement to intangible related returns. Where there is a mismatch between the contractual allocation among associated enterprises of entitlement to intangible related returns, and the allocation among those associated enterprises of related risk-associated costs, an arrangement will not have the requisite level of alignment between actual conduct and the contractual allocation of intangible related returns.

44. In assessing which members of an MNE group bear risks associated with entitlement to intangible related returns, the principles of paragraphs 9.10 through 9.46 apply.

(iii) Costs related to development, enhancement, maintenance and protection of intangibles

45. Where the parties’ conduct is aligned with the terms of registrations and contracts, costs incurred to develop, enhance, maintain and protect intangibles should be borne by the member or members of the MNE group claiming entitlement to intangible related returns. It will therefore be important in evaluating entitlement to intangible related returns to consider which entities have borne the relevant costs. In some circumstances, bearing the relevant costs may involve providing arm’s length compensation to associated enterprises for functions performed by such associated enterprises under the control of the member of the MNE group claiming contractual entitlement to intangible related returns.

46. It is important to recognise, however, that bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns.
related returns. This paragraph should clearly state that bearing the costs does refer to the party that
ultimately assumes costs and not e.g. a contract R&D-provider which takes the costs initially before being
compensated by its entrepreneur.

B.3. Arm’s length compensation for functions performed by associated enterprises related to the
development, enhancement, maintenance or protection of intangibles

47. One condition for concluding that the contractual and other arrangements of an MNE group
related to entitlement to intangible related returns are aligned with the conduct of the parties is that
associated enterprises that perform functions related to the development, enhancement, maintenance, or
protection of intangibles, but do not claim entitlement to intangible related returns, be provided with arm’s
length compensation for the functions they perform. In evaluating whether associated enterprises retained
to perform functions related to the development, enhancement, maintenance and protection of intangibles
have been compensated on an arm’s length basis, it is necessary to consider both the amount of
compensation paid and the level of activity undertaken. Reference should be made to both the level of
activity and the compensation received by comparable uncontrolled entities performing similar functions in
assessing whether the compensation provided is consistent with the arm’s length principle.

48. A common situation where these principles must be applied relates to the performance of
marketing functions by associated enterprises other than the member of the MNE group asserted, under
legal registrations and contracts, to be entitled to intangible related returns attributable to trademarks and
related customer oriented intangibles (e.g. a marketing and/or distribution arrangement). In such a case it
is necessary to determine how the marketer/distributor should be compensated for its activities. One
important issue is whether the marketer/distributor should be compensated as a service provider, i.e. for

49. The analysis of this issue requires an assessment of the obligations and rights implied by the legal
registrations and agreements between the parties, of the functions undertaken, the risks assumed, the assets
used, and the costs incurred by the parties, and of the compensation provided for the functions, risks, assets
and costs of the marketer/distributor. It will often be the case that the return on marketing functions, risks,
assets and costs will be sufficient and appropriate factors mentioned in this section. One relatively clear
case is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures and
being directed and controlled in its activities by the entity claiming entitlement to intangible related returns
with respect to the trademarks and related intangibles. In that case, the distributor ordinarily would be
entitled to compensation appropriate to its agency activities alone. It would not bear or control the risks
associated with the development of the trademark and other intangibles, and would therefore not be
to share in any intangible related returns.

50. Where the distributor actually bears the cost of its marketing activities (i.e. there is no
arrangement for the owner to reimburse the expenditures), then, as made clear by paragraph 47, the bearing
of costs alone does not create an entitlement to intangible related returns. The issue is the extent to which
the distributor is able to share in the potential benefits deriving from its functions, assets, risks and costs
currently or in the future. In general, in arm’s length transactions the ability of a party that is not the
registered or legal owner of trademarks and related intangibles to obtain the benefits of marketing activities
that increase the value of those intangibles will depend principally on the substance of the rights of that
party. For example, a distributor may have the ability to obtain benefits from its functions performed,
assets used, risks borne, and costs incurred in developing the value of a trademark from its turnover and
market share where it has a long-term contract of sole distribution rights for the trademarked product. In
such cases, the distributor’s share of benefits should be determined based on what an independent
distributor would obtain in comparable circumstances. In some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities. An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate in order to compensate it for its functions, assets, risks and costs.

51. The principles set out in the foregoing paragraphs also apply in situations involving the performance of research and development functions by a member of an MNE group under a contractual arrangement with an associated enterprise that claims entitlement to intangible related returns. Those principles similarly apply in situations where a member of an MNE group provides manufacturing services on behalf of an associated enterprise that claims entitlement to intangible related returns and the manufacturing service provider engages in functions that may lead to process or product improvements.

B.4. Disregard of transactions, registrations and contracts

52. In the extraordinary circumstances described in paragraphs 1.64 – 1.69, contractual allocations of entitlement to intangible related returns may be disregarded by tax authorities notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles. See TPG paragraphs 9.164 – 9.167.

B.5. Transfer pricing adjustments in cases involving entitlement to intangible related returns

53. In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance:

- Perform relevant control and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis;
- Bear and control the risks and costs related to developing and enhancing the intangible; and,
- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

Where a party is allocated intangible related returns under contracts and registrations, but fails to perform and relevant control important functions, fails to control other related functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.

54. Where relevant functions, risks, and costs are in alignment with legal registrations and the terms of relevant contracts, the contractual allocation of entitlement to intangible related returns should generally be respected by tax authorities and transfer pricing determinations should be made on the basis of that contractual allocation of intangible related returns. Where such risks, functions, and costs are not in alignment with contractual allocations, part or all of the intangible related returns may be allocated to parties performing such functions and bearing such risks, and transfer pricing adjustments may be appropriate to assure that each member of the group is properly rewarded for its risks, functions and costs.
B.6. Illustrations

55. For examples illustrating the application of the principles contained in this section B, see Examples 1 through 11 in the Annex to Chapter VI.

C. Transactions involving the use or transfer of intangibles

56. In addition to identifying with specificity the intangibles involved in a particular transfer pricing matter, and identifying which member or members of the MNE group are entitled to intangible related returns arising from the use or transfer of such intangibles, a third threshold issue needs to be addressed at the beginning of any transfer pricing analysis of controlled transactions involving the use or transfer of intangibles. This issue involves the identification and proper characterisation of the specific controlled transactions involving intangibles. The principles of Chapter I apply in identifying and characterising transactions involving the use or transfer of intangibles. The characterisation of a transaction for transfer pricing purposes has no relevance for determinations under Article 12 of the OECD Model Tax Convention. See paragraph 12 of the OECD Model Tax Convention.

57. There are two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes. These two categories of transactions are described in this section.

C.1. Transactions involving the use of intangibles in connection with sales of goods or services

58. In the first type of transaction, intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with the manufacture of goods sold to an associated enterprise, in connection with the marketing of goods purchased from an associated enterprise, or in connection with the performance of services on behalf of an associated enterprise. The nature of such a transaction should be clearly specified, and any intangibles used by one of the parties in connection with such a controlled transaction should be identified and taken into account in the comparability analysis (including the functional analysis), in the selection and application of the most appropriate transfer pricing method for that transaction, and in the choice of the tested party. See paragraphs 1.39, 1.42, 1.44, 2.109 and 3.18.

59. The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows. Assume that a car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume that the patents significantly contribute to the value of the cars. The patents and the value they contribute should be taken into account in the comparability analysis of the transaction consisting in the sales of cars by the car manufacturer to its associated distributors, in selecting the most appropriate transfer pricing method for the transactions, and in selecting the tested party. The associated distributors purchasing the cars do not, however, acquire any right in the manufacturer’s patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents themselves are not transferred.

60. As another example of the use of intangibles in connection with a controlled transaction, assume that an exploration company has acquired or developed valuable geological data and analysis, and sophisticated exploratory software and know-how. Assume further that it uses those intangibles in providing exploration services to an associated enterprise. Those intangibles should be taken into account in the comparability analysis of the service transactions between the exploration company and the associated enterprise, in selecting the most appropriate transfer pricing method for the transactions, and in selecting the tested party. Assuming that the associated enterprise of the exploration company does not...
acquire any rights in the exploration company’s intangibles, the intangibles are used in the performance of the services, but are not transferred.

C.2. Transactions involving transfers of intangibles

(i) Transfers of intangibles or rights in intangibles

61. In the second type of transaction, rights in intangibles themselves may be transferred in controlled transactions. Such a transfer may encompass all the rights in the intangibles in question (e.g. a sale of the intangible) or only limited rights (e.g. a licence or similar transfer of rights to use an intangible which may be subject to geographical restrictions, limited duration, restrictions with respect to the right to use, exploit, reproduce, further transfer, further develop).

62. In transactions involving the transfer of intangibles or rights in intangibles, it is essential to identify with specificity the nature of the intangibles and rights in intangibles that are transferred between associated enterprises. Where limitations are imposed on the rights transferred, it is also essential to identify the nature of such limitations and the full extent of the rights transferred.

63. Restrictions imposed in licence and similar agreements on the use of an intangible in the further development of new intangibles or new products using the intangibles are often of significant importance in a transfer pricing analysis. It is therefore important in identifying the nature of a transfer of rights in intangibles to consider whether the transferee receives the right to use the transferred intangible for the purpose of further product development. In transactions between unrelated parties, arrangements are observed where the transferor/licensor retains the full right to any enhancements of the licensed intangible that may be developed during the term of the licence. Transactions between unrelated parties are also observed where the transferee/licensee retains the right to any enhancements it may develop, either for the term of its license or in perpetuity. The nature of any limitations on further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancements, can affect the value of the rights transferred and the comparability of two transactions involving otherwise identical or closely comparable intangibles.

64. The provisions of paragraphs 1.52 – 1.54 and paragraphs 1.64 – 1.69 apply in identifying the specific nature of a transaction involving a transfer of intangibles, in identifying the nature of any intangibles transferred, and in identifying any limitations imposed by the terms of the transfer on the use of those intangibles. For example, under paragraphs 1.52 – 1.54, a written specification that a licence is non-exclusive or of limited duration need not be respected by the tax authority under extreme circumstances only if such specification is not consistent with the conduct of the parties.

(ii) Transfers of combinations of intangibles

65. Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. In considering transactions involving transfers of combinations of intangibles, two related issues often arise.

66. The first of these involves the nature and economic consequences of interactions between different intangibles. It may be the case that some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately. It is therefore important to identify the nature of the legal and economic interactions between intangibles that are transferred in combination.

67. For example, a pharmaceutical product will often have associated with it three or more types of intangibles. The active pharmaceutical ingredient may be protected by one or more patents. The product
will also have been through a testing process and a government regulatory authority may have issued an approval to market the product in a given geographic market and for specific approved indications based on that testing. The product may be marketed under a particular trademark. In combination these intangibles may be extremely valuable. In isolation, one or more of them may have much less value. For example, the trademark without the patent and regulatory marketing approval may have limited value since the product could not be sold without the marketing approval and generic competitors could not be excluded from the market without the patent. Similarly, the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval. The interactions between each of these classes of intangibles, as well as which parties incurred the risks and costs associated with securing the intangibles, are therefore very important in performing a transfer pricing analysis with regard to a transfer of the intangibles. It is important to consider the relative contribution to the value creation where different associated enterprises hold rights in the intangibles used.

68. A second and related issue involves the importance of assuring that all intangibles transferred in a particular transaction have been identified. It may be the case, for example, that intangibles are so intertwined that it is not possible, as a substantive matter, to transfer one without transferring the other. Indeed, it will often be the case that a transfer of one intangible will necessarily imply the transfer of other intangibles. In such cases it is important to identify all of the intangibles made available to the transferee as a consequence of an intangibles transfer, applying the principles of paragraphs 1.52 – 1.54.

69. Similarly, it is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of substance, cannot be separated.

(iii) **Transfers of intangibles in combination with other business transactions**

70. In some situations intangibles may be transferred in combination with tangible business assets, or in combination with services. It is important in such a situation to determine whether intangibles have in fact been transferred in connection with the transaction. It is also important that all of the intangibles transferred in connection with a particular transaction be identified and taken into account in the transfer pricing analysis.

71. In some situations it may be both possible and appropriate to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles for purposes of conducting a transfer pricing analysis. In these situations the price of a package contract should be disaggregated in order to confirm that each element of the transaction is consistent with the arm’s length principle. In other situations transactions may be so closely related that it will be difficult to segregate tangible goods or service transactions from transfers of intangibles.

72. One situation where transactions involving transfers of intangibles may be combined with other transactions involves a so-called business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee. If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be in some cases necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.

73. In other situations, the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis. For example, some transfers of rights in software may in some cases be combined with an undertaking by the transferor to provide ongoing software maintenance services, which may include...
periodic updates to the software. In situations where services and transfers of intangibles are intertwined, determining arm’s length prices on an aggregate basis may be necessary.

74. It should be emphasised that the characterisation of the transaction as the provision of products or services or the transfer of intangibles or a combination of both does not necessarily dictate the use of a particular transfer pricing method. For example, a cost plus approach will not be appropriate for all service transactions, and not all intangibles transactions require complex valuations or the application of profit split methods. The facts of each specific situation, and the results of the required functional analysis, will guide the manner in which transactions are combined, characterised and analysed for transfer pricing purposes, as well as the selection of the most appropriate transfer pricing method in a particular case. The ultimate objective is to identify the prices and other conditions that would be established between unrelated persons in comparable transactions.

C.3. Illustrations

75. For illustrations of the principles set out in this Section C., see Examples 12 through 17 in the Annex to Chapter VI.

D. Determining Arm’s Length Conditions in Cases Involving Intangibles

76. After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, and identifying which entity or entities are entitled to intangible related returns with respect to those intangibles, it should be possible to identify arm’s length conditions for the relevant transactions. The principles set out in Chapters I through III of these Guidelines should be applied in determining arm’s length conditions for transactions involving the use or transfer of intangibles. In particular, the recommended nine-step process set out in paragraph 3.4 can be helpful in identifying arm’s length conditions for transactions involving the use or transfer of intangibles. As an essential part of applying the principles of Chapter III to conduct a comparability analysis under the process described in paragraph 3.4, the principles contained in sections A., B., C., D.1., and D.2. of this Chapter should be considered.

77. However, the principles of Chapters I through III can sometimes be difficult to apply to controlled transactions involving the use or transfer of intangibles. Intangibles may have a special character complicating the search for comparables, and in some cases making value difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. See paragraph 1.11. This section D. describes special considerations that may arise in applying the principles of Chapters I through III to determine arm’s length conditions for controlled transactions involving the use or transfer of intangibles.

D.1. Conducting a comparability analysis in a matter involving intangibles

(i) In general

78. Paragraphs 1.33 through 1.63 and Chapter III contain principles to be considered and a recommended process to be followed in conducting a comparability analysis. The principles described in those sections of the Guidelines apply to controlled transactions involving the use or transfer of intangibles.

79. In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving the use or transfer of intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction. In considering the
realistically available options of the parties to a transaction, the principles of paragraphs 9.59 through 9.64 should be applied.

80. In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles.

81. While it is important to consider the perspectives of both parties to the transaction in conducting a comparability analysis, the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party. For example, a transferor would not be expected to accept a price for the transfer of an intangible or rights in the intangible that is lower than its other realistically available options (including making no transfer at all), merely because a particular associated enterprise transferee lacks the resources to effectively exploit the transferred intangible. Similarly, a transferee should not be expected to accept a price for a transferred intangible that would make it impossible for the transferee to anticipate earning a profit using the intangible in its business. Such an outcome would be less favourable to the transferee than its realistically available option of not engaging in the transfer at all.

82. It will often be the case that a price for a transaction can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations, at least on an after tax basis. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34 – 9.38 or 9.122 should be applied, or whether the conditions of the transaction should otherwise be adjusted. This discussion highlights the importance of taking all relevant facts and circumstances into account in the comparability analysis.

(ii) Intangibles as a comparability factor in transactions involving the use of intangibles

83. While the general rules of paragraphs 1.33 – 1.63 and Chapter III apply to guide the comparability analysis, the use of intangibles in connection with a controlled transaction involving the sale of goods or the performance of services may raise challenging comparability issues.

84. In a transfer pricing analysis where the most appropriate transfer pricing method is the resale price method, the cost-plus method, or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party. In many cases, an arm’s length price or level of profit for the tested party can be determined without the need to value the intangibles used in connection with the transaction. That would generally be the case where only the non-tested party uses intangibles. In some cases, however, the tested party may in fact use intangibles and be entitled to the intangible related returns with respect to such intangibles notwithstanding its relative lack of complexity. Similarly, parties to potentially comparable uncontrolled transactions may use intangibles. Where either of these is the case, it becomes necessary to consider the intangibles used by the tested party and by the parties to potentially comparable uncontrolled transactions as one comparability factor in the analysis.

85. For example, a tested party engaged in the marketing and distribution of goods purchased in controlled transactions may have developed trademarks and related intangibles in its geographic area of operation, including customer lists and customer relationships. It may also have developed advantageous logistical know-how or software and other tools that it uses in conducting its distribution business. The
impact of such intangibles on the profitability of the tested party should be considered in conducting a comparability analysis.

86. It is important to note, however, that in many cases where the tested party uses such intangibles, parties to comparable uncontrolled transactions will also have the same types of intangibles at their disposal. Thus, in the distribution company case, an uncontrolled entity engaged in providing distribution services in the tested party’s industry and market is also likely to have knowledge of and contacts with potential customers, have its own effective logistical systems, and in other respects have similar intangibles to the tested party. Where that is the case, the level of comparability may be sufficiently high that it is possible to rely on prices paid or margins earned by the potential comparables as an appropriate measure of arm’s length compensation for both the functions performed and the intangibles owned by the tested party.

87. Where the tested party and the potential comparable have similar intangibles, no comparability adjustments will be required. However, if either of them have and use in their business section D.1.(vi) intangibles, it may be necessary either to make appropriate comparability adjustments or to revert to a different transfer pricing method. (See section D.1.(iii) for matters to be considered in evaluating comparability of intangibles).

88. It is appropriate for both taxpayers and tax administrations to exercise restraint in rejecting potential comparables based on the use of intangibles by either the parties to potentially comparable transactions or by the tested party. Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill. If identified transactions or companies are otherwise comparable, they may provide the best available indication of arm’s length pricing notwithstanding the existence and use by either the tested party or the parties to the potentially comparable transactions of relatively insignificant intangibles. Potentially comparable transactions should be disregarded on the basis of the existence and use of non-comparable intangibles only where the intangibles in question can be clearly and distinctly identified and where the intangibles are manifestly section D.1.(vi) intangibles.

(iii) **Comparability of intangibles and rights in intangibles**

89. In transactions involving the use or transfer of intangibles or rights in intangibles, the comparability of the intangibles themselves must be considered. Particularly where the CUP method is considered to be the most appropriate transfer pricing method, the comparability of the transferred intangible to intangibles transferred in potentially comparable uncontrolled transactions must be evaluated. Intangibles often have unique characteristics and, as a result, have the potential for generating returns and creating future benefits that differ widely. Moreover, grants of rights to use intangibles may have important limitations that have a direct and important bearing on the price that would be paid for such rights. In conducting a comparability analysis with regard to a transfer of intangibles or rights in intangibles, it is essential to consider the unique features of the intangibles and the specific terms of the transfers, including the nature of any limitations on the rights of the transferee to use the intangibles following the transfer.

90. Set out below is a description of some of the specific features of intangibles that may prove important in a comparability analysis. The following list is not exhaustive and in a specific case consideration of additional or different factors may be an essential part of a comparability analysis.

(a) **Exclusivity**

91. Whether the rights in intangibles relevant to a particular transaction are exclusive or non-exclusive can be an important comparability consideration. Some intangibles allow the party entitled to

Comment [nmp55]: The wording of paragraph 89 is helpful, but difficult to understand; should be more clear. It should be clearly stated that comparability analysis may provide an indication for arm’s length values even if the comparability criteria are not completely fulfilled.

Comment [nmp56]: See the comments about this section in the “Third concern” of our “Administrative burden” narrative
intangible related returns to exclude others from using the intangible. A patent, for example, grants an exclusive right to use the invention covered by the patent for a period of years. If the party controlling intangible rights can exclude other enterprises from the market, or exclude them from using intangibles that provide a market advantage, that party may have a degree of market power or market influence. A party with non-exclusive rights to intangibles will not be able to exclude all competitors and will generally not have the same degree of market power or influence. Accordingly, the exclusive or non-exclusive nature of intangibles or rights in intangibles should be considered in connection with the comparability analysis.

(b) Extent and duration of legal protection

92. The extent and duration of legal protection of the intangibles relevant to a particular transaction can be an important comparability consideration. Legal protections associated with some intangibles can prevent competitors from entering a particular market. For other intangibles, such as know-how or trade secrets, available legal protections may have a different nature and not be as strong or last as long. For intangibles with limited useful lives, the duration of legal protections can be important since the duration of the intangible rights will affect the expectation of the parties to a transaction with regard to the future benefits attributable to the intangible. For example, two otherwise comparable patents will not have equivalent value if one expires at the end of one year while the other expires only after ten years.

(c) Geographic scope

93. The geographic scope of the intangibles or rights in intangibles will be an important comparability consideration. A global grant of rights to intangibles may be more valuable than a grant limited to one or a few countries, depending on the nature of the product, the nature of the intangible, and the nature of the markets in question.

(d) Useful life

94. Many intangible assets have an unlimited useful life unless properly supported e.g. through further development or marketing. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, as noted above. The useful life of some intangibles can also be affected by the rate of technological change in an industry and by the development of new and potentially improved products. It may also be the case that the useful life of particular intangibles can be extended.

95. In conducting a comparability analysis, it will therefore be important to consider the expected useful life of the intangibles in question. In general, intangibles expected to provide market advantages for a longer period of time will be more valuable than similar intangibles providing such advantages for a shorter period of time, other things being equal. In evaluating the useful life of intangibles it is also important to consider the use being made of the intangible. For example, if an intangible is used as a base for ongoing research and development, the commercial life of the current generation product line relying on that intangible may not be the relevant inquiry.

(e) Stage of development

96. In conducting a comparability analysis, it may be important to consider the stage of development of particular intangibles. It is often the case that an intangible is transferred in a controlled transaction at a point in time before it has been fully demonstrated that the intangible will support commercially viable products. A common example arises in the pharmaceutical industry, where chemical compounds may be patented, and the patents (or rights to use the patents) transferred in controlled transactions, well in
advancement of the time when further research, development and testing demonstrates that the compound constitutes a safe and effective treatment for a particular medical condition.

97. As a general rule, intangibles relating to products with established commercial viability will be more valuable than otherwise comparable intangibles relating to products whose commercial viability is yet to be established. In conducting a comparability analysis involving partially developed intangibles, it is important to evaluate the likelihood that further development will lead to commercially significant future benefits. In certain circumstances, industry averages regarding the risks associated with further development can be helpful to such evaluations. However, the specific circumstances of any individual situation should always be considered.

(f) Rights to enhancements, revisions, and updates

98. Often, an important consideration in a comparability analysis involving intangibles relates to the rights of the parties with regard to future enhancements, revisions and updates of the intangibles. Products protected by intangibles can become obsolete or uncompetitive in a relatively short period of time in the absence of continuing development and enhancement of the intangibles. As a result, having access to updates and enhancements can be the difference between deriving a short term advantage from the intangibles and deriving a longer term advantage. It is therefore necessary to consider for comparability purposes whether or not a particular grant of rights in intangibles includes access to enhancements, revisions, and updates of the intangibles.

99. A very similar question, often important in a comparability analysis, involves whether the transferee of intangibles obtains the right to use the intangibles in connection with research directed to developing new and enhanced intangibles. For example, the right to use an existing software platform as a basis for developing new software products can shorten development times and can make the difference between being the first to market with a new product or application, or being forced to enter a market already occupied by established competitive products. A comparability analysis with regard to intangibles should, therefore, consider the rights of the parties regarding the use of the intangibles in developing new and enhanced versions of products.

(g) Expectation of future benefit

100. Each of the foregoing comparability considerations has a consequence with regard to the expectation of the parties to a transaction regarding the future benefits to be derived from the use of the intangibles in question. If for any reason there is a significant discrepancy between the anticipated future benefit of using one intangible as opposed to another, it is difficult to consider the intangibles as being sufficiently comparable to support a comparables-based transfer pricing analysis in the absence of reliable comparability adjustments. Specifically, it is important to consider the actual and potential profitability of products or potential products that are based on the intangible. Intangibles that provide a basis for high profit products or services are not likely to be comparable to intangibles that support products or services with only industry average profits. Any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in conducting the comparability analysis.

(iv) Comparison of risk in cases involving intangibles

101. In conducting a comparability analysis where intangibles are present, the existence of risks related to the likelihood of obtaining future economic benefits from the intangibles must be considered. The following types of risks, among others, should be considered in evaluating whether intangibles or combinations of intangibles are comparable.
• Risks related to the future development of the intangibles. This includes an evaluation of whether the intangibles relate to commercially viable products, whether the intangibles may support commercially viable products in the future, the expected cost of required future development and testing, the likelihood that such development and testing will prove successful and similar considerations. The consideration of development risk is particularly important in situations involving partially developed intangibles.

• Risks related to product obsolescence and depreciation in the value of the intangibles. This includes an evaluation of the likelihood that competitors will introduce products or services in the future that would materially erode the market for products dependent on the intangibles being analysed.

• Risks related to infringement of the intangible rights. This includes an evaluation of the likelihood that others might successfully claim that products based on the intangibles infringe their own intangible rights and an evaluation of the likely costs of defending against such claims. It also includes an evaluation of the likelihood that the holder of intangible rights could successfully prevent others from infringing the intangibles, including the risk that counterfeit products could erode the profitability of relevant markets.

• Product liability and similar risks related to the future use of the intangibles.

(v) Comparability adjustments with regard to intangibles

102. The principles of paragraphs 3.47 – 3.54 relating to comparability adjustments apply with respect to transactions involving the use or transfer of intangibles. It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. Particularly in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, there may be reason to believe that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not sufficiently comparable to support a valid transfer pricing analysis. If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions.

103. Comparability, and the possibility of making comparability adjustments, is especially important in considering potentially comparable intangibles and related royalty rates drawn from commercial data bases or proprietary compilations of publicly available licence or similar agreements. The principles of paragraphs 3.30 through 3.34 apply fully in assessing the usefulness of transactions drawn from such sources. In particular, it is important to assess whether publicly available data drawn from commercial data bases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles described above that may be important in conducting a comparability analysis.

(vi) Section D.1.(vi) intangibles

104. An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would be remunerated in dealings between independent parties, will be referred to as a Section D.1.(vi) intangible.

Comment [nmp59]: BIAC would suggest to change the definition of “Section D.1.(vi) intangibles” into a more reader friendly definition, considering the widespread use of this definition that can be anticipated.
D.2. **Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles**

(i) **In general**

105. The principles of these Guidelines related to the selection of the most appropriate transfer pricing method to the circumstances of the case are described in paragraphs 2.1 through 2.11. Those principles apply fully to cases involving the use or transfer of intangibles. The nature of intangibles, the difficulty of identifying comparable uncontrolled transactions for all intangibles, and the difficulty of applying certain transfer pricing methods in cases involving intangibles, require consideration of several issues in connection with the selection of transfer pricing methods under the Guidelines.

106. In applying the principles of paragraphs 2.1 through 2.11 to matters involving the use or transfer of intangibles, it is important to recognise that transactions structured in different ways may have similar economic consequences. For example, the performance of a service using intangibles may have very similar economic consequences to a transaction involving the transfer of an intangible (or the transfer of rights in the intangible). Accordingly, in selecting the most appropriate transfer pricing method in connection with a transaction involving the use or transfer of intangibles, it is important to consider the economic consequences of the transactions, rather than proceeding on the basis of an arbitrary label.

107. In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify other factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions.

(ii) **Use of valuation techniques**

108. Some valuation techniques drawn from financial valuation practice may have application both in cases involving the use of intangibles in connection with sales of goods or services, and in cases involving transfers of intangibles or rights in intangibles. Depending on the circumstances, they may be used either as a part of one of the five OECD approved methods described in Chapter II (e.g. in determining how to split profits as part of a transactional profit split method), or as a tool that can be usefully applied in identifying an arm’s length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions. Sections D.3. and D.4. of this Chapter provide further guidance regarding the application of valuation techniques for transfer pricing purposes.

109. While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. In particular, it is important to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes be biased in favour of conservative estimates of the value of assets reflected in a company’s balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to
valuation approaches that are not necessarily consistent with the arm’s length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm’s length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.

110. It is essential to consider the purpose for which a valuation is conducted. Valuations conducted for business planning purposes may be either more or less relevant than valuations conducted purely for tax purposes, depending on the circumstances.

(iii) Use of transfer pricing methods based on intangible development cost

111. In a transfer pricing analysis, the use of valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return is generally discouraged. There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, financial valuation techniques based on the cost of intangible development should usually be avoided.

112. In some limited circumstances, valuations of intangibles based on the estimated cost of reproducing or replacing the intangible may be proposed. Such approaches may sometimes have valid application with regard to the development of non-unique intangibles used for internal business operations (e.g. internal software systems). Where intangibles relating to products sold in the marketplace are at issue, replacement cost valuation methods raise serious comparability issues. Among other concerns, it is necessary to evaluate the effect of time delays associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently. In such a case, the estimated replacement cost will not be a valid proxy for the value of an intangible transferred currently. Similarly, where an intangible carries legal protections or exclusivity characteristics, the value of being able to exclude competitors from using the intangible will not be reflected in an analysis based on replacement cost. Cost based valuations generally are not reliable when applied to determine the value of partially developed intangibles for transfer pricing purposes.

(iv) Use of more than one method

113. The principles set out in paragraphs 2.11, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the use or transfer of intangibles.

(v) Aggregation of transactions

114. Paragraphs 3.9 through 3.12 and paragraph 3.37 provide guidance regarding the aggregation of separate transactions for purposes of transfer pricing analysis. Those principles apply fully to cases involving the use or transfer of intangibles. Indeed, it is often the case that intangibles may be used or transferred in combination with other intangibles, or in combination with transactions involving the sale of goods or services. In such situations it may well be that the most reliable transfer pricing analysis will consider the interrelated transactions in the aggregate as necessary to improve the reliability of the analysis.

(vi) Application of rules of thumb

115. In cases involving the use or transfer of intangibles or rights in intangibles, it is sometimes suggested that certain rules of thumb may apply to determine a correct transfer price or to allocate
intangible related returns between a transferor and transferee of rights in intangibles. The application of a general rule of thumb does not provide an adequate substitute for a complete comparability analysis conducted under the principles of Chapters I through III. Accordingly, application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee is discouraged.

**D.3. Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services**

116. This section D.3. contains guidance for determining arm’s length prices and other conditions for a controlled transaction involving the sale of goods or services where intangibles are used by one or both parties in connection with the transaction.

117. Two general categories of cases can arise. In the first category of cases, the comparability analysis, including the functional analysis, will reveal the existence of sufficiently reliable comparables to permit the determination of arm’s length conditions for the transaction using a transfer pricing method based on comparables. In the second category of cases, the comparability analysis, including the functional analysis, will fail to identify reliable comparable uncontrolled transactions, often as a direct result of the use by one or both parties to the transaction of section D.1.(vi) intangibles. Transfer pricing approaches to these two categories of cases are described below.

(i) Situations where reliable comparables exist

118. It will often be the case that, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or services, reliable comparables can be identified. Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method where the transaction involves the use of intangibles in connection with a controlled sale of goods or services and reliable comparables are present.

(a) Importance of section D.1. (vi) intangibles

119. An issue commonly arising in matters involving the use of intangibles in connection with the sale of goods or services involves the nature of the intangibles used by one or both parties to the controlled transaction. In some circumstances, intangibles used by the tested party will be comparable to intangibles used by parties to comparable uncontrolled transactions. In other circumstances, the intangibles used by the tested party in connection with the transaction will be section D.1.(vi) intangibles.

120. The principles described in section D.1.(ii) of this Chapter should be applied in determining whether the use of intangibles by the tested party will preclude reliance on identified comparable uncontrolled transactions or require comparability adjustments. Only when the intangibles used by the tested party are section D.1.(vi) intangibles will the need arise to make comparability adjustments or to adopt a transfer pricing method less dependent on comparable uncontrolled transactions. Where intangibles used by the tested party are not section D.1.(vi) intangibles, prices paid or received, or margins or returns earned by parties to comparable uncontrolled transactions may provide a reliable basis for determining arm’s length conditions.

(b) Comparability adjustments

121. Paragraphs 3.47 through 3.54 and paragraph 103 contain guidance related to comparability adjustments. That guidance applies fully to matters involving the use of intangibles in connection with controlled sales of goods or services.
122. Where the need to make comparability adjustments arises because of differences in the intangibles used by the tested party in a controlled transaction and the intangibles used by a party to a potentially comparable uncontrolled transaction, difficult factual questions can arise in quantifying reliable comparability adjustments. These issues require thorough consideration of the relevant facts and circumstances and of the available data regarding the impact of the intangibles on prices and profits. Where the impact on price of a difference in the nature of the intangibles used is clearly material, but not subject to accurate estimation, it may be necessary to utilise an alternative transfer pricing method that is less dependent on identification of reliable comparables, as discussed in section D.3.(ii) of this Chapter.

123. It should also be recognised that comparability adjustments for factors other than differences in the nature of the intangibles used may be required in matters involving the use of intangibles in connection with a controlled sale of goods or services. In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. While such factors may not be intangibles as that term is described in section A.1. of this Chapter, they can nevertheless have important effects on arm’s length prices in matters involving the use of intangibles.

(ii) Situations where reliable comparables do not exist

124. In some situations it will be the case that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm’s length price for a controlled transaction involving the use of intangibles. This may be because the intangibles utilised by one or both parties to the controlled transaction are section D.1.(vi) intangibles, and that reliable comparability adjustments are not possible. It may also result from a lack of available data regarding potentially comparable transactions involving the use or transfer of intangibles or from other causes. Notwithstanding the lack of reliable comparables, it is possible to determine the arm’s length price for the controlled transaction, except in situations where paragraph 1.65 applies.

(a) Determining the price that would have been agreed between uncontrolled parties

125. Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm’s length principle nevertheless requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In making such determinations, it is important to consider:

- The functions, assets and risks of the respective parties to the transaction.
- The business reasons for engaging in the transaction.
- The perspectives of and options realistically available to each of the parties to the transaction.
- The market advantages conferred by the intangibles including especially the relative profitability of products and services related to the intangibles.
- Other important factors such as locational advantages and market differences.

126. In identifying prices that would have been agreed by uncontrolled parties under comparable circumstances, it is often essential to carefully identify idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship between the parties. There is no requirement that associated enterprises structure their transactions in precisely the same manner as unrelated parties might have done.
However, where transactional structures are utilised by associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm’s length.

(b) Application of profit split methods

127. In some circumstances where reliable uncontrolled transactions cannot be identified, transactional profit split methods may be utilised to determine an arm’s length allocation of profits for sales of goods or services involving the use of intangibles. One circumstance in which the use of transactional profit split methods may be appropriate is where both parties to the transaction make unique and valuable contributions to the transaction. See paragraph 2.109.

128. Paragraphs 2.108 through 2.145 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the use of intangibles in connection with the sale of goods or services in controlled transactions.

129. In applying a profit split method in a case involving the use of intangibles, care should be taken to identify the intangibles in question, to evaluate the manner in which those intangibles contribute to the creation of value, and to evaluate other income producing functions, risks and assets. Vague assertions of the existence and use of unspecified intangibles will not support a reliable application of a profit split method.

(c) Use of valuation techniques

130. In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions may be utilised to determine arm’s length conditions for the sale of goods or services where intangibles are used in connection with the transaction. The alternative selected should reflect the nature of the goods or services sold and the contribution of intangibles and other relevant factors to the creation of value.

D.4 Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles

131. This section D.4. contains guidance for determining arm’s length prices in a controlled transaction involving the transfer of intangibles or rights in intangibles.

132. Two general categories of cases can arise. In the first category of cases, the comparability analysis, including the functional analysis, will reveal the existence of sufficiently reliable comparables to permit the determination of arm’s length conditions for the transaction using a transfer pricing method based on comparables. In the second category of cases, the comparability analysis, including the functional analysis, will fail to identify reasonably reliable comparable uncontrolled transactions. Transfer pricing approaches to these two categories of cases are described below.

(i) Transfer pricing methods where comparable uncontrolled transactions can be identified

133. Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of intangibles or a controlled transfer of rights in intangibles. The use of other alternatives may also be appropriate.
134. Extreme caution should be used, however, in applying certain of the methods. Valuation of intangibles on the basis of mark-ups over development cost is unlikely to provide an accurate measure of value and is generally discouraged. See paragraphs 112 and 113. Moreover, application of a resale price method analysis will be unlikely to constitute the most appropriate method for determining an arm’s length price for intangibles or rights in intangibles in most situations.

135. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances.

136. Where the CUP method is utilised, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions. The comparability factors described in paragraphs 1.38 through 1.63 should be considered. The matters described in section D.1. of this Chapter are of particular importance in evaluating the comparability of specific transferred intangibles and rights in intangibles and in making comparability adjustments, where possible.

137. In some situations, intangibles acquired by an MNE group from unrelated parties are transferred to a member of the MNE group in a controlled transaction immediately following the acquisition. In such a case the price paid for the acquired intangibles will usually (after any appropriate adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm’s length price for the controlled transaction under a CUP method. Depending on the circumstances, the third party acquisition price in such situations will have relevance in determining arm’s length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets.

(ii) Situations where reliable comparables are not available

138. Where information regarding reliable comparable uncontrolled transactions cannot be identified, the principles of paragraphs 126 and 127 apply to transactions involving transfers of intangibles to the same extent as they do to transactions involving the use of intangibles in connection with the sale of goods or services.

(iii) Application of profit split methods

139. In some circumstances, a transactional profit split method can be utilised to determine the arm’s length conditions for a transfer of intangibles or rights to intangibles where it is not possible to identify reliable comparable uncontrolled transactions. Paragraphs 2.108 through 2.145 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles.

(a) Application of profit split methods in connection with licence transactions

140. Where limited rights in intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method often can be utilised to evaluate the respective contributions of the parties to earning combined income. The profit contribution of the rights in intangibles made available by the licensor or other transferor would, in such a circumstance, be one of the factors contributing to the earning of income following the transfer. However, other factors would also need to be considered. In particular, functions performed and risks assumed by the licensee/transferee should specifically be taken into account in such an analysis. Other intangibles used by the licensor/transferor and by the licensee/transferee in their respective businesses should similarly be
considered, as well as other relevant factors. Careful attention should be given in such an analysis to the limitations imposed by the terms of the transfer on the use of the intangibles by the licensee/transferee and on the rights of the licensee/transferee to use the intangibles for purposes of ongoing research and development. Further, assessing appropriate intangible related returns of the licensee for its enhancements to licensed intangibles may be important. The allocation of income in such an analysis would depend on the findings of the functional analysis, including an analysis of the relevant risks assumed. It should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement.

(b) Application of profit split methods in connection with transfers of full rights in intangibles

141. Profit split methods may also have application in connection with the sale of full rights in intangibles. As with other applications of the profit split method, a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties is an essential element of the analysis. Where a profit split analysis is based on projected revenues and expenses, the concerns with the accuracy of such projections described in paragraphs 154 through 158 should be taken into account. Some applications of valuation techniques can be characterised as applications of a profit split method.

(c) Application of profit split methods in connection with transfers of partially developed intangibles

142. It is sometimes suggested that a profit split analysis can be applied to transfers of partially developed intangibles. In such an analysis, the relative value of contributions to the development of intangibles before and after a transfer of the intangibles in question is sometimes examined. Such an approach may include an attempt to amortise the transferor’s contribution to the partially developed intangible over the asserted useful life of that contribution, assuming no further development. Such approaches are generally based on projections of cash flows and benefits expected to arise at some future date following the transfer and the assumed successful completion of further development activities.

143. It is unlikely that such approaches will readily yield a reliable estimate of the contributions of the parties to the creation of income in years following the transfer. In such an analysis, a variety of difficult to evaluate factors would need to be taken into account. These would include the relative riskiness and value of research contributions before and after the transfer, the relative risk, and the value of that risk, for other development activities carried out before and after the transfer, the useful life of the intangibles, the amortisation rate for various contributions to the intangible value, assumptions regarding the time at which speculative new products might be introduced, and the value of contributions other than intangibles to the ultimate generation of profit. Income and cash flow projections in such situations can be especially speculative. These factors can combine to call the reliability of such an analysis into serious question.

(iv) Use of valuation techniques

144. In situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified, it may be possible to use valuation techniques to estimate the arm’s length price for intangibles transferred between associated enterprises.

145. Where valuation techniques are utilised in a transfer pricing analysis, it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the principles of these Guidelines. In particular, due regard should be given to the principles contained in Chapters I through III. Principles related to realistically available options (see paragraph 1.34), perspective of the parties, attribution of risk (see paragraphs 9.10 through 9.46), and aggregation of transactions (see paragraphs 3.9 through 3.12) apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Furthermore, normal rules on selection of transfer pricing methods apply in determining when such
techniques should be used (see paragraphs 2.1 through 2.10). The principles of sections A., B., C., D.1., and D.2. of this Chapter apply where use of valuation techniques is considered.

146. It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilised by valuation or accounting professionals or to describe in detail one or more specific valuation techniques or methods that may be especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm’s length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available. See, however, paragraphs 112 and 113 for a discussion of the reliability of valuation techniques based on intangible development costs.

147. Valuation approaches that estimate the discounted value of projected future cash flows attributable to the transferred intangible or intangibles can be particularly useful analytical tools. There are many variations of valuation techniques based on the discounted value of projected future cash flows. In general terms, such valuation techniques begin by projecting the revenue anticipated to be produced in a given business over the useful life of the intangibles being valued. They then deduct, from those projected revenues, estimates of projected cost of sales and operating expenses to yield an estimated projection of operating income over the anticipated useful life of the intangible. Estimates of cash flows attributable to business activities and/or assets other than the intangible being valued may be deducted from the projections of operating income. Depending on the specific facts, these deducted cash flows can include projected routine functional returns as well as projected income attributable to other activities, attributes and other intangibles. The resulting residual stream of projected cash flows attributable to the intangible being valued is discounted to calculate the present value of the stream of intangible related cash flows. The discount rate or rates used in calculating present values of the stream of projected cash flows reflects both the time value of money and the risk that future cash flows may not materialise. Depending on the facts and circumstances of the individual case, the calculation of the discounted present value of the streams of cash flows attributable to the intangible from the perspectives of both parties to the transaction will generally be necessary. In these cases the arm’s length price will fall somewhere within the range of both present values, after taking into account taxes required to be paid with respect to the transaction.

(v) Specific areas of concern in applying methods based on the discounted value of projected cash flows

148. When applying valuation techniques, it is important to recognise that the estimates of value based on such techniques can be highly volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to extreme swings in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

149. The reliability of the intangible value produced using a valuation model is highly dependent on the reliability of the underlying assumptions and estimates on which it is based and on the due diligence and judgment exercised in confirming assumptions and in estimating valuation parameters.
Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm’s length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

It may be relevant in assessing the reliability of a valuation model to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. It would be reasonable for a tax administration to request an explanation for any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes. For example, such requests would be appropriate if high discount rates are used in a transfer pricing analysis when the company routinely uses lower discount rates in evaluating possible mergers and acquisitions, or where it is asserted that particular intangibles have short useful lives if projections used in other business planning contexts show products related to those intangibles producing cash flows in years beyond the useful life asserted for transfer pricing purposes.

The following sections identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows. These concerns are important in evaluating the reliability of the particular application of a valuation technique.

(a) Accuracy of financial projections

The reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is highly dependent on the accuracy of the projections of future cash flows or income on which the valuation is based. However, because the accuracy of financial projections will depend on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, and may be speculative, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.

In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

The length of time covered by the projections should also be considered in evaluating the reliability of the projections. Projecting cash flows or income far into the future is particularly perilous. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they relate have an established track record of financial performance. Caution should always be used in assuming that past performance is a reliable guide to the future, as many factors are subject to change. However, past operating results can provide some useful guidance as to likely future performance of products or services that rely on intangibles. Projections with
respect to products or services that have not been introduced to the market or that are still in development are inherently less reliable than those with some track record.

157. Where, for the foregoing reasons, or any other reason, there is reason to believe that the projections relied on in the valuation are unreliable or speculative, attention should be given to the guidance in section D.4.(vi) regarding situations where valuation is highly uncertain at the time of the transaction.

(b) Assumptions regarding growth rates

158. A key element of some cash flow projections that should be carefully examined is the projected growth rate. Often projections of future cash flows are based on current cash flows (or assumed initial cash flows after product introduction in the case of partially developed intangibles) expanded by reference to a percentage growth rate. Where that is the case, the basis for the assumed growth rate should be considered. In particular, it is unusual for revenues derived from a particular product to grow at a steady rate over a long period of time. Caution should therefore be exercised in too readily accepting simple models containing linear growth rates not justified on the basis of either experience with similar products and markets or a reasonable evaluation of likely future market conditions. It would generally be expected that a reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products.

(c) Discount rates

159. The discount rate or rates used in converting a stream of projected cash flows into a present value is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flows. As small variations in selected discount rates can generate very large variations in the calculated value of intangibles using these techniques, it is essential for taxpayers and tax administrations to give close attention to the analysis performed and the assumptions made in selecting the discount rate or rates utilised in the valuation model.

160. There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. Neither taxpayers nor tax authorities should assume that a discount rate that is based on a Weighted Average Cost of Capital (“WACC”) approach or any other measure should always be used in transfer pricing analyses where determination of appropriate discount rates is important. Instead the specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.

161. It should be recognised in determining and evaluating discount rates that in some instances, particularly those associated with the valuation of intangibles still in development, intangibles may be among the most risky components of a taxpayer’s business. It should also be recognised that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile than others. For example, the likelihood that a projected level of research and development expense will be incurred may be higher than the likelihood that a projected level of revenues will ultimately be generated. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case.

162. Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken to avoid double discounting for risk.
Valuation techniques are often premised on the projection of cash flows attributable to the intangible over the useful life of the intangible in question. In such circumstances, the determination of the actual useful life of the intangible will be one of the critical assumptions supporting the valuation model.

The projected useful life of particular intangibles is a question to be determined on the basis of all of the relevant facts and circumstances. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded the intangible. The useful life of intangibles also may be affected by the rate of technological change in the industry. The principles of paragraphs 95 and 96 should be observed in estimating the useful life of intangibles for purposes of applying a valuation technique.

In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that nonroutine returns are attributable to such intangibles in perpetuity.

In this regard, where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions critically examined. Often, large amounts can be associated with such terminal values such that the reasonableness of the terminal value calculation should not be overlooked in the analysis.

Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of future income taxes on the projected cash flows. Two issues can arise in this regard.

First, in practice, annual financial projections used in discounted cash flow based valuations are carried out on a post-tax basis, using discount rates that are similarly determined on a post-tax basis. However, prices for transfer pricing purposes under a discounted cash flow analysis must typically be determined on a pre-tax basis. Therefore, appropriate adjustments may need to be made to ensure both the internal consistency of the discounted cash flow model and the ultimate determination of arm’s length prices on a pre-tax basis.

Second, the question arises whether the relevant tax rates to take into account in performing a discounted cash flow based valuation are those of the transferor or the transferee. The particular facts of the case, including the specific tax situations of the transferor and transferee, should dictate adjustments to be made to take account of the impact of taxes on the valuation. It is important to take into account the perspectives of both parties to the transaction in this regard and to consider how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee following the transfer in determining the arm’s length price.
Arm’s length pricing for transfers of intangibles when valuation is highly uncertain at the time of the transaction

170. Intangible property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of a controlled transaction involving the property. When valuation of intangible property at the time of the transaction is highly uncertain, the question is raised how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction. See paragraphs 9.87 and 9.88.

171. Depending on the facts and circumstances, there are a variety of steps that independent enterprises might undertake to deal with high uncertainty in valuation when pricing a transaction. One possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction. In determining the anticipated benefits, independent enterprises would take into account the extent to which subsequent developments are foreseeable and predictable. Financial valuation techniques, particularly those based on the discounted value of projected cash flows, may be helpful tools in assessing anticipated benefits, as described above, although the uncertainty of an intangible’s value may be compounded by uncertainties regarding critical parameters and assumptions in the valuation analysis. In some cases, independent enterprises might find that the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections, without reserving the right to make future adjustments.

172. In other cases, independent enterprises might not find that pricing based on anticipated benefits alone provides an adequate protection against the risks posed by the high uncertainty in valuing the intangible property. In such cases, independent enterprises might adopt shorter-term agreements or include price adjustment clauses in the terms of the agreement, to protect against subsequent developments that might not be predictable. For example, a royalty rate could be set to increase as the sales of the licensee increase.

173. Also, independent enterprises may determine to bear the risk of unpredictable subsequent developments to a certain degree, although with the joint understanding that major unforeseen developments changing the fundamental assumptions upon which the pricing was determined would lead to the renegotiation of the pricing arrangements by mutual agreement of the parties. For example, such renegotiation might occur at arm’s length if a royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the incentive of the licensee to manufacture or sell the drug at all, in which case the agreement might be renegotiated (although whether renegotiation would take place would depend upon all the facts and circumstances).

174. When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing. In such a case, the tax administration could, for example, inquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight.

175. It is recognised that a tax administration may find it difficult, particularly in the case of an uncooperative taxpayer, to establish what profits were reasonably foreseeable at the time that the transaction was entered into. For example, such a taxpayer, at an early stage, may transfer intangibles to
an affiliate, set a royalty that does not reflect the subsequently demonstrated value of the intangible for tax or other purposes, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product. In such a case, the subsequent developments might prompt a tax administration to inquire what independent enterprises would have done on the basis of information reasonably available at the time of the transaction. In particular, consideration should be given to whether the associated enterprises intended to and did make projections that independent enterprises would have considered adequate, taking into account the reasonably foreseeable developments and in light of the risk of unforeseeable developments, and whether independent enterprises would have insisted on some additional protections against the risk of high uncertainty in valuation.

176. If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

177. It is recognised that tax administrations may not be able to conduct an audit of a taxpayer’s return until several years after it has been filed. In such a case, a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set the pricing.

(vii) Form of payment

178. Taxpayer’s have substantial discretion in defining the form of payment for transferred intangibles. In transactions between independent parties, it is common to observe payments for intangibles that take the form of a single lump sum. It is also common to observe payments for intangibles that take the form of periodic payments over time. Arrangements involving periodic payments can be structured either as a series of instalment payments fixed in amount, or may take the form of contingent payments where the amount of payments depends on the level of sales of products supported by the intangibles, on profitability, or on some other factor. Taxpayer agreements with regard to the form of payment should be respected, except as may be provided in paragraphs 1.64 through 1.69.

179. In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail greater or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales will involve greater risk to the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments, because of the existence of the contingency. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, the actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks. In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intangible, and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialise and that payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.
D.5. Illustrations

180. For illustrations of the principles of this Section D., see Examples 18 through 22 in the Annex to Chapter VI.
It is proposed that the provisions of the Annex to Chapter VI of the Transfer Pricing Guidelines be deleted in their entirety and that they be replaced by the following language.

ANNEX
EXAMPLES TO ILLUSTRATE THE GUIDANCE ON SPECIAL CONSIDERATIONS FOR INTANGIBLE PROPERTY

Examples Illustrating the Provisions of Chapter VI.B.

Example 1

Premiere is the parent company of an MNE group. Company S is a wholly owned subsidiary of Premiere and a member of the Premiere group. Premiere performs ongoing R&D functions in support of its business operations. When its R&D functions result in patentable inventions, it is the practice of the Premiere group that all rights in such inventions be assigned to Company S in order to centralise and simplify global patent administration. Company S employs three lawyers to perform its patent administration work. It does not, however, conduct or control any of the R&D activities of the Premiere group. Company S has no technical R&D personnel, nor does it incur any of the Premiere group’s R&D expense. At the time of each assignment of rights from Premiere to Company S, Company S makes a 100 Euro payment to Premiere in consideration of the assignment of rights to a patentable invention and simultaneously grants to Premiere an exclusive, royalty free, patent license for the full life of the registered patent. The nominal payments of Company S to Premiere are made purely to satisfy technical contract law requirements related to the assignments and are generally much lower than the arm’s length price of the assigned rights to patentable inventions.

Example 2

Primero is the parent company of an MNE group engaged in the pharmaceutical business. It does business in country M. Primero develops patents and other intangibles relating to Product X and registers those patents in countries around the world.

Comment [nmp70]: This is example is helpful. However, it points to a problem with the definitional concepts in part B. The example works because intangible development and enhancement are seen as the functions giving rise to intangible related returns, whereas protection does not. However, in part B there is no distinction between development, enhancement, maintenance and protection.

Comment [nmp71]: This example probably reaches the right conclusion, but it does not illustrate the conceptual steps in part B that are required to test entitlement. The example needs to explain what rights Company S has been granted under the contract, how that contract compares to uncontrolled arrangements, which party has performed development and enhancement functions, and which party controls those functions and related risks.
184. Primero retains its wholly owned country N subsidiary, Company S, to distribute Product X throughout Europe and the Middle East on a limited risk basis. Company S purchases Product X from Primero and resells Product X to unrelated customers in countries throughout its geographical area of operation. In the first three years of operations, Company S earns arm’s length returns from its distribution functions, consistent with its limited risk characterisation and the fact that Primero, and not Company S, is entitled to intangible related returns with respect to Product X. After three years of operation, it becomes apparent that Product X causes serious side effects in a significant percentage of those patients that use the product and it becomes necessary to recall the product and remove it from the market. Company S incurs substantial costs in connection with the recall. Primero does not reimburse Company S for these recall related costs or for the resulting product liability claims.

185. Under these circumstances, there is a mismatch between Primero’s asserted entitlement to intangible related returns with respect to Product X and the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the mismatch. In all likelihood, the most appropriate adjustment would be an allocation of the recall and product liability related costs from Company S to Primero, although in some circumstances an appropriate alternative may be to adjust the product pricing for all years between Primero and Company S to reflect the fact that the relationship was not actually a limited risk relationship.

Example 3

186. Primair, a resident of country X, manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Primair is the registered owner of the R trademark and trade name. The R name is widely known in countries where the watches are sold and has obtained considerable economic value in those markets through the efforts of Primair. R watches have never been marketed in country Y, however, and the R name is not known in the country Y market.

187. In Year 1, Primair decides to enter the country Y market and incorporates a wholly owned subsidiary in country Y, Company S, to act as its distributor in country Y. At the same time, Primair enters into a long-term royalty-free marketing and distribution agreement with Company S. Under the agreement, Company S is granted the exclusive right to market and distribute watches bearing the R trademark and using the R trade name in country Y for a period of five years, with an option for a further five years. Company S obtains no other rights relating to the R trademark and trade name from Primair, and in particular is prohibited from re-exporting watches bearing the trademark and trade name. The sole activity of Company S is marketing and distributing watches bearing the R trademark and trade name. It is assumed that the R watches are not part of a portfolio of products distributed by Company S in country Y. Company S undertakes no secondary processing, as it imports packaged watches into country Y ready for sale to the final customer.

188. Under the contract between Primair and Company S, Company S purchases the watches from Primair in country Y currency, takes title to the branded watches and performs the distribution function in country Y, incurs the associated carrying costs (e.g. inventory and receivables financing), and assumes the corresponding risks (e.g. inventory, credit and financing risks). Under the contract between Primair and Company S, Company S is required to act as a marketing agent to assist in developing the market for R watches in country Y. Company S consults with Primair in developing the country Y marketing strategy for R watches. Primair develops the overall marketing plan based largely on its experience in other countries, it develops and approves the marketing budgets, and it makes final decisions regarding advertising designs, product positioning and core advertising messages. The costs and risks of developing the market are primarily borne by Primair, which reimburses Company S for the cost of advertising and other marketing efforts that Company S incurs in assisting with market development for R watches in country Y. Company S consults on local market issues related to advertising, assists in executing the...
marketing strategy under Primair’s direction, and provides evaluations of the effectiveness of various elements of the marketing strategy. As compensation for providing these marketing support activities, Company S receives from Primair a fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

189. Assume for the purpose of this example that, based upon a thorough comparability analysis, including a detailed functional analysis, it is possible to conclude that the price Company S pays Primair for the R watches should be analysed separately from the compensation Company S receives for the marketing it undertakes on behalf of Primair. Assume further that based upon identified comparable transactions, the price paid for the watches is arm’s length and that this price enables Company S to earn an arm’s length level of compensation from selling the watches for the distribution function it performs and the associated risks it assumes.

190. In Years 1 to 3, Company S embarks on a strategy that is consistent with its agreement with Primair to develop the country Y market for R watches. In the process, Company S incurs marketing expenses. Consistent with the contract, Company S is reimbursed by Primair for the marketing expenses it incurs, together with a markup on those expenses. By the end of Year 2, the R trademark and trade name have become well established in country Y. The compensation derived by Company S for the marketing activities it performed on behalf of Primair is determined to be arm’s length, based upon comparison to that paid to independent advertising and marketing agents identified and determined to be comparable as part of the comparability analysis.

191. Under these circumstances, Primair is entitled to the intangible related returns attributable to the R trademark and trade name. While Company S’s performance of certain marketing functions contributes to the value of the trademark in country Y, the best measure of Company S’s arm’s length return for those contributions is determined by reference to the returns earned by identified independent advertising and marketing agents whose functions, risks and assets have been determined to be comparable to those of Company S through the comparability analysis.

Example

192. The facts in this example are the same as in Example 3, except as follows:

- Under the contract between Primair and Company S, Company S is now obligated to develop and execute the marketing plan for country Y without detailed control of specific elements of the plan by Primair. Company S bears the costs and assumes certain of the risks associated with the marketing activities. The agreement between Primair and Company S does not specify the amount of marketing expenditure Company S is expected to incur, only that Company S is required to use its best efforts to market the watches. Company S receives no reimbursement from Primair in respect of any expenditure it incurs, nor does it receive any other indirect or implied compensation from Primair, and Company S expects to earn its reward solely from its profit from the sale of R brand watches to third party customers in the country Y market.

- A thorough functional analysis reveals that Primair exercises a lower level of control over the marketing activities of Company S in that it does not review and approve the marketing budget or design details of the marketing plan. Company S bears different risks and is compensated differently than was the case in Example 3. The contractual arrangements between Primair and Company S are very different and the risks assumed by Company S are greater in Example 4 than in Example 3. Company S does not receive cost reimbursements or a separate fee for marketing activities. The only controlled transaction between Primair and
Company S in Example 4 is the transfer of the branded watches. As a result, Company S can obtain its reward only through selling R brand watches to third party customers.

- As a result of these differences, Primair and Company S adopt a lower price for watches in Example 4 than the price for watches determined for purposes of Example 3. As a result of the differences identified in the functional analysis, different criteria are used for identifying comparables and for making comparability adjustments than was the case in Example 3.

193. Assume that in Years 1 through 3, Company S embarks on a strategy that is consistent with its agreement with Primair and, in the process, incurs marketing expenses. As a result, Company S has high operating expenditures and slim margins in Years 1 through 3. By the end of Year 2, the R trademark and trade name have become established in country Y because of Company S’s efforts. Where the marketer/distributor actually bears the costs and associated risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. Assume that the enquiries of the country Y tax authorities conclude that Company S would have been expected to have incurred its actual level of marketing expense if it were unrelated to Primair.

194. Given that Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the R watches, there is an opportunity for Company S to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. Based on an analysis of reasonably reliable comparable data, it is concluded that, for purposes of this example, the benefits obtained by Company S result in profits similar to those made by independent marketers and distributors bearing the same types of risks and costs as Company S in the first few years of comparable long-term marketing and distribution agreements for similarly unknown products.

195. Based on the foregoing assumptions, Company S’s return is arm’s length and its marketing activities, as illustrated by its marketing expenses, are not significantly different than those performed by independent marketers and distributors in comparable uncontrolled transactions. Under these circumstances, while Primair and Company S may each be entitled to a portion of the intangible related returns associated with the R trademark and related intangibles, the information on comparable uncontrolled arrangements suggests that the return earned by Company S provides it with the arm’s length return for its functions, risks, costs and its resulting entitlement to intangible related returns. No separate or additional compensation is required to Company S.

Example 5

196. The facts in this example are the same as in Example 4, except that the market development functions undertaken by Company S in this Example 5 are far more extensive than those undertaken by Company S in Example 4.

197. Where the marketer/distributor actually bears the costs and risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. A thorough comparability analysis identifies several uncontrolled companies engaged in similar marketing and distribution functions under similar long-term marketing and distribution arrangements. Assume, however, that the level of marketing expense Company S incurred in Years 1 through 5 far exceeds that incurred by the identified comparable independent marketers and distributors. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has assumed significantly greater costs and risks than comparable independent enterprises (and substantially higher costs and risks than in Example 4). There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profits made by the identified comparable...
independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

198. As in Example 4, Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive marketing and distribution rights for the R watches, and therefore has an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case Company S has borne marketing expenditures beyond what independent enterprises in comparable transactions with similar rights incur for their own benefit, resulting in significantly lower profits for Company S than are made by such enterprises.

199. Based on these facts, it is evident that by incurring marketing expenditure substantially in excess of the levels of such expenditure incurred by independent marketer/distributors in comparable transactions, Company S has acted to increase the value of the intangibles of Primair and has not been adequately compensated for doing so by the margins it earns on the resale of R watches. Under such circumstances it would be appropriate for the country Y tax authority to propose a transfer pricing adjustment based on compensating Company S for the marketing activities performed and expenditure incurred for the benefit of Primair, consistent with what independent enterprises dealing at arm’s length in comparable transactions might be expected to have agreed. Depending on the facts and circumstances, such an adjustment could be based on:

- Reducing the price paid by Company S for the R brand watches purchased from Primair. Such an adjustment could be based on applying a resale price method or transactional net margin method using available data about profits made by comparable marketers and distributors with a comparable level of marketing and distribution expenditure.

- An alternative approach might apply a residual profit split method that would split the combined profits from sales of R branded watches in country Y by first giving Company S and Primair a basic return for the functions they perform and then splitting the residual profit on a basis that takes into account the relative entitlements to intangible related returns of Company S and Primair and the relative contributions of both Company S and Primair to the value of the R trademark and trade name.

- Directly compensating Company S for the excess marketing expenditure it has incurred over and above that incurred by comparable independent enterprises including an appropriate profit element for the functions and risks reflected by those expenditures.

200. In this example, the proposed adjustment is based on Company S’s having performed functions, incurred risks, and incurred costs that provide it with an entitlement to intangible related returns for which it is not adequately compensated under its arrangement with Primair. If the arrangements between Company S and Primair were such that Company S could expect to obtain an arm’s length return on its additional investment during the remaining term of the distribution agreement, a different outcome could be appropriate.

Example 6

201. The facts in this example are the same as in Example 4, except that Company S now enters into a three-year royalty-free agreement to market and distribute the watches in the country Y market, with no option to renew. At the end of the three-year period, Company S does not enter into a new contract with Primair.
202. Assume that it is demonstrated that independent enterprises do enter into short-term distribution agreements where they incur marketing and distribution expenses, but only where they stand to earn a reward commensurate with the functions performed, assets used and the risks assumed. Evidence derived from comparable independent enterprises shows that they do not invest large sums of money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation. The potential short-term nature of the marketing and distribution agreement is such that Company S could not, or may not be able to, benefit from the marketing and distribution expenditure it incurs at its own risk. The same factors mean that Company S’s efforts may well benefit Primair in the future.

203. The risks assumed by Company S are substantially higher than in Example 4 and Company S has not been compensated on an arm’s length basis for bearing these additional risks. In this case, Company S has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profits for Company S than are made by comparable enterprises. The short term nature of the contract makes it unreasonable to expect that Company S has the opportunity of obtaining appropriate benefits under the contract within the limited term of the agreement with Primair. Under these circumstances, Company S is entitled to intangible related returns in the form of higher compensation for having acted to increase the value of the R trademark and trade name during the term of its arrangement with Primair.

204. Such compensation could take the form of direct compensation from Primair to Company S for the marketing expenditures and market development functions it has undertaken. Alternatively, such an adjustment could take the form of a reduction in the price paid by Company S to Primair for R watches during Years 1 through 3.

Example 7

205. The facts in this example are the same as in Example 4 with the following additions:

- By the end of Year 3, the R brand is successfully established in the country Y market and Primair and Company S renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, which is to commence at the beginning of Year 4, is for five years with Company S having an option for a further five years. Under this agreement, Company S agrees to pay a royalty to Primair based on the gross sales of all watches bearing the R trademark. In all other respects, the new agreement has the same terms and conditions as in the previous arrangement between the parties. There is no adjustment made to the price payable by Company S for the branded watches as a result of the introduction of the royalty.

- Company S’s sales of R brand watches in Years 4 and 5 are consistent with earlier budget forecasts. However, the introduction of the royalty from the beginning of year 4 results in Company S’s profitability declining substantially.

206. Assume that there is no evidence that independent marketers/distributors of similar branded products have agreed to pay royalties. Company S’s level of marketing expenditure and activity, from Year 4 on, is consistent with that of independent enterprises, but Company S’s profits are consistently lower than the profits made by independent enterprises during the corresponding years of similar long-term marketing and distribution agreements because of the royalty.

207. For transfer pricing purposes, it would not generally be expected that a royalty would be paid in arm’s length dealings where a marketing and distribution entity obtains no rights for transfer pricing.
purposes in trademarks and similar intangibles other than the right to use such intangibles in distributing a branded product supplied by the entity entitled to the intangible related returns attributable to such intangibles. In this circumstance, the royalty causes Company S’s income to be lower than that of independent enterprises with comparable functions, risks and assets. Accordingly, a transfer pricing adjustment disallowing the royalties paid would be appropriate based on the facts of this example.

Example 8

208. The facts in this example are the same as those set out in Example 5 with the following additions:

- At the end of Year 3, Primair stops manufacturing watches and contracts with a third party to manufacture them on its behalf. As a result, Company S will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the R name and logo and package the watches before sale to the final customer. It will then sell and distribute the watches in the manner described in Example 5.

- As a consequence, at the beginning of Year 4, Primair and Company S renegotiate their earlier agreement and enter into a new long term licensing agreement. The new agreement, to start at the beginning of Year 4, is for five years, with Company S having an option for a further five years.

- Under the new agreement, Company S is granted the exclusive right within country Y to process, market and distribute watches bearing the R trademark in consideration for its agreement to pay a royalty to Primair based on the gross sales of all such watches. Company S receives no compensation from Primair in respect of the renegotiation of the original marketing and distribution agreement. It is assumed for purposes of this example that the purchase price Company S pays for the watches from the beginning of Year 4 is arm’s length and that no consideration with respect to the R name is embedded in that price.

209. In connection with a tax audit conducted by country Y tax authorities in Year 6, it is determined, based on a proper functional analysis, that the level of marketing expenses Company S incurred during Years 1 through 3 far exceeded those incurred by independent marketers and distributors with similar long term marketing and distribution agreements. It is also determined that the level of marketing activity undertaken by Company S exceeded that of independent marketers and distributors. Given the extent of the market development activities undertaken by Company S, it is evident from the comparability and functional analysis that Company S has assumed significantly greater costs and risks than comparable independent enterprises. There is also evidence that the profits realised by Company S are significantly lower than the profits made by comparable independent licensees and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

210. The country Y audit also identifies that in Years 4 and 5, Company S bears the costs and associated risks of its marketing activities under the new long-term licensing arrangement with Primair, and because of the long-term nature of the agreement has an opportunity to benefit (or suffer a loss) from those activities. However, Company S has undertaken market development activities and incurred marketing expenditure far beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit, resulting in significantly lower profits for Company S than are made by comparable enterprises.

211. Based on these facts, Company S has become entitled to intangible related returns by virtue of the functions, risks and costs it has assumed. It should be compensated by an additional return for the market development activities undertaken by Company S on Primair’s behalf. For Years 1 through 3, the
possible bases for such an adjustment would be as described in Example 5. For Years 4 and 5 the bases for an adjustment would be similar, except that the adjustment could reduce the royalty payments from Company S to Primair, rather than the purchase price of the watches. Depending on the facts and circumstances, consideration could also be given to whether Company S should have been compensated for its entitlement to intangible related returns in some manner in connection with the renegotiation of the arrangement at the end of Year 3.

Example 9

212. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X and the other operated by Company S, a subsidiary of Shuyona operating in country Y. The Shuyona R&D centre is responsible for the overall research programme of Shuyona group. The Shuyona R&D centre designs research programmes, develops and controls budgets, makes decisions as to where R&D activities will be conducted, monitors the progress on all R&D projects and, in general, controls the R&D function for the MNE group, operating under strategic direction of Shuyona group senior management.

213. The Company S R&D centre operates on a separate project by project basis to carry out specific projects assigned by the Shuyona R&D centre. Suggestions of Company S R&D personnel for modifications to the research programme are required to be formally approved by the Shuyona R&D centre. The Company S R&D centre reports on its progress on at least a monthly basis to supervisory personnel at the Shuyona R&D centre. If Company S exceeds budgets established by Shuyona for its work, the Shuyona R&D management must be sought for further expenditures. Contracts between the Shuyona R&D centre and the Company S R&D centre specify that Shuyona will bear all risks and costs related to R&D undertaken by Company S. All patents, designs and other intangibles developed by Company S research personnel are registered by Shuyona, pursuant to contracts between the two companies. Shuyona pays Company S a service fee for its research and development activities.

214. Under these circumstances, Shuyona is entitled to intangible related returns that may be derived from intangibles developed through the R&D efforts of Company S. In determining the amount of the service fee payable to Company S, the relative skill and efficiency of the Company S R&D personnel should be considered as a comparability factor. To the extent transfer pricing adjustments are required to reflect the amount a comparable R&D service provider would be paid for its services, such adjustments should generally relate to the year the service is provided and would not affect the entitlement of Shuyona to future intangible related returns derived from the Company S R&D activities.

Example 10

215. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y.

216. The Shuyona group sells two lines of products. All R&D with respect to product line A is conducted by Shuyona. All R&D with respect to product line B is conducted by the R&D centre operated by Company S. Company S also functions as the regional headquarters of the Shuyona group in North
America and has global responsibility for the operation of the business relating to product line B. However, all patents developed by Company S research efforts are registered by Shuyona.

217. The Shuyona and Company S R&D centres operate autonomously. Each bears its own operating costs. Under the general policy direction of Shuyona senior management, the Company S R&D centre develops its own research programmes, establishes its own budgets, makes determinations as to when R&D projects should be terminated or modified, and hires its own R&D staff. The R&D centre reports to the product line B management team in Company S, and does not report to the Shuyona R&D centre. Joint meetings between the Shuyona and Company S R&D teams are sometimes held to discuss research methods and common issues.

218. Under these circumstances, Company S is entitled to intangible related returns derived from the research outputs of its own R&D centre related to product line B, notwithstanding Shuyona’s registration of Company S developed patents.

Example 11

219. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y. The relationships between the Shuyona R&D centre and the Company S R&D centre are as described in Example 9.

220. In Year 1, Shuyona transfers patents and other technology related intangibles to a new subsidiary, Company T, organized in country Z. Company T establishes a manufacturing facility in country Z and begins to supply products to members of the Shuyona group around the world. For purposes of this example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles reflects the arm’s length value of the transferred intangibles.

221. At the same time as the transfer of patents and other technology related intangibles, Company T enters into a contract research agreement with Shuyona and a separate contract research agreement with Company S. Pursuant to these agreements, Company T agrees to bear the risk of future R&D activity, to assume the cost of all future R&D activity, and to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a markup equivalent to the profit markup over cost earned by allegedly comparable companies engaged in providing research services.

222. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design its own R&D programme, to establish its own R&D budgets, and to determine its own levels of R&D staffing. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 9.

223. Under these circumstances, Shuyona should be treated as the party entitled to intangible related returns with respect to R&D conducted after the date of the transfer of patents and related technology intangibles. It should be entitled to intangible related returns both with respect to its own R&D activities and to the R&D activities conducted by Company S. Company T should not be entitled to intangible related returns related to the ongoing R&D because it does not control risks or perform and control the key R&D functions.
Examples Illustrating the Provisions of Chapter VI.\[226\]

Example 12

224. Primarni is organised in and conducts business in country A. Company S is an associated enterprise of Primarni. Company S is organised in and does business in country B. Primarni develops a patented invention and manufacturing know-how related to Product X. Primarni and Company S enter into a written license agreement pursuant to which Primarni grants Company S the right to use the Product X patents and know-how to manufacture and sell Product X in country B, while Primarni retains the patent and know-how rights to Product X throughout the rest of the world.

225. Assume Company S uses the patents and know-how to manufacture Product X in country B. It sells Product X to unrelated customers in country B and also sells Product X to related distribution entities pursuant to sales agreements that call for title to the products to pass from Company S to the distribution entities at Company S’s factory in country B. The distribution entities resell the units of Product X to customers throughout Asia and Africa. The prices paid for Product X by the distribution companies enable those distribution entities to earn an arm’s length return for their distribution functions, but no return related to the Product X intangibles. Primarni does not exercise its retained patent rights for Asia and Africa to prevent the resale of Product X by the distribution entities or to demand royalties or other compensation for intangibles from the distribution entities operating in those geographies.

226. Under these circumstances, the conduct of the parties suggests that the transaction between Primarni and Company S should be characterised as a license of the Product X patent and know-how for country B, plus Asia and Africa. The provision of the agreement limiting Company S’s rights to country B should not be respected for purposes of a transfer pricing analysis of the amount of compensation due Primarni from Company S for the licensed intangibles.

Example 13

227. Ilcha is organised in country A. It has for many years manufactured and sold Product Q in country B through a branch or permanent establishment located in that country. Ilcha owns patents related to the design of Product Q and has developed a unique trademark and other brand intangibles. The patents and trademarks are registered by Ilcha in country B.

228. For sound business reasons, Ilcha determines that its business in country B would be enhanced if it were operated through a separate subsidiary in that country. Ilcha therefore organizes Company S in country B as a wholly owned subsidiary. It transfers the tangible manufacturing and marketing assets previously used by the branch to Company S and enters into a long-term license agreement with Company S granting it the exclusive right to use the Product Q patents, trademarks and other intangibles in country B. Company S thereafter conducts the Product Q business in country B.

229. Assume that over the years of its operation in branch form, Ilcha developed substantial goodwill and ongoing concern value in country B. The transfer of the going business to Company S, together with the license of rights to use the patents, trademarks and other intangibles in country B, implicitly conveys the value of that continuing goodwill to Company S. In conducting a transfer pricing analysis related to the amount to be paid by Company S to Ilcha, for the tangible assets transferred and the licensed right to use the intangibles in country B, the goodwill and ongoing concern value of the going business transferred to Company S should be taken into account.
230. Första is a consumer goods company organised and operating in country A. Prior to Year 1, Första produces Product Y in country A and sells it through affiliated distribution companies in many countries around the world. The Product Y trademark is well recognised and valuable, and Första is entitled to intangible related returns with respect to the Product Y trademark.

231. In Year 2, Första organises Company S, a wholly owned subsidiary, in country B. Company S acts as a superdistributor and invoicing centre. Första continues to ship Product Y directly to its distribution affiliates, but title to the products passes to Company S, which reinforces the distribution affiliates for the products.

232. Beginning in Year 2, Company S reimburses the distribution affiliates for a portion of their advertising costs. Prices from Company S to the distribution affiliates are adjusted upward so that the distribution affiliate margins remain constant notwithstanding the shift of advertising cost to Company S. Assume that the margins earned by the distribution affiliates are arm's length both before and after Year 2. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

233. In Year 3, the prices charged by Första to Company S are reduced. Första and Company S claim such a reduction in price is justified because Company S is entitled to intangible related returns associated with goodwill in respect of Product Y created through the advertising costs it has borne.

234. In substance, Company S has no claim to a return to goodwill with respect to Product Y and transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate. Company S has not performed or controlled functions and risks related to the creation, enhancement, maintenance and protection of that goodwill. A transfer pricing adjustment would be appropriate to deny any intangible related return to Company S.

Example 15

235. Birincil acquires all of the shares of an unrelated company, Company T for 100. Company T is a company that engages in research and development and has partially developed several promising technologies but has only minimal sales. The purchase price is justified primarily by the value of the promising, but only partly developed, technologies and by the potential of Company T personnel to develop further new technologies in the future. Birincil’s purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to tangible property and identified intangibles, including patents, and 80 to goodwill.

236. Immediately following the acquisition, Birincil causes Company T to transfer all of its rights in developed and partially developed technologies, including patents, trade secrets and technical know-how to Company S, a subsidiary of Birincil. Company S simultaneously enters into a contract research agreement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of the transferred technologies and on the development of new technologies on behalf of Company S. The agreement provides that Company T will be compensated for its research services by payments equal to its cost plus a mark-up, and that all rights to intangibles developed or enhanced under the research agreement will belong to Company S. As a result, Company S will fund all future research and will assume the financial risk that some or all of the future research will not lead to the development of commercially viable products. Company S has a large research staff, including management personnel responsible for technologies of the type acquired from Company T. Following the transactions in question, the Company S research and management personnel assume full management responsibility for the
direction and control of the work of the Company T research staff. Company S approves new projects, develops and plans budgets and in other respects controls the ongoing research work carried on at Company T. All company T research personnel will continue to be employees of Company T and will be devoted exclusively to providing services under the research agreement with Company S.

237. In conducting a transfer pricing analysis of the arm’s length price to be paid by Company S for intangibles transferred by Company T, and of the price to be paid for ongoing R&D services to be provided by Company T, it is important to identify the specific intangibles transferred to Company S and those retained by Company T. The definitions and valuations of intangibles contained in the purchase price allocation are irrelevant for transfer pricing purposes. The 100 paid by Birincil for the shares of Company T represents a risk-adjusted arm’s length price for the business of Company T. The full value of that business should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. Depending on the facts, a substantial portion of the value described in the purchase price allocation as goodwill of Company T may have been transferred to Company S together with the other Company T intangibles. Depending on the facts, some portion of the value described in the purchase price allocation as goodwill may also have been retained by Company T. Under arm’s length transfer pricing principles, Company T should be entitled to compensation for such value, either as part of the price paid by Company S for the transferred rights to technology intangibles, or through the compensation Company T is paid in years following the transaction for the R&D services of its workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.

Example 16

238. Zhu is a company engaged in software development consulting. In the past Zhu has developed software supporting ATM transactions for client Bank A. In the process of doing so, Zhu created and retained an interest in proprietary software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customisation.

239. Assume that Company S, an associated enterprise of Zhu, enters into a separate agreement to develop software supporting ATM operations for another bank, Bank B. Zhu agrees to support its associated enterprise by providing employees who worked on the Bank A engagement to work on Company S’s Bank B engagement. Those employees have access to software designs and know-how developed in the Bank A engagement, including proprietary software code. That code and the services of the Zhu employees are utilised by Company S in executing its Bank B engagement. Ultimately, Bank B is provided by Company S with a software system for managing its ATM network, including the necessary license to utilise the software developed in the project. Portions of the proprietary code developed by Zhu in its Bank A engagement are embedded in the software provided by Company S to Bank B.

240. A transfer pricing analysis of these transactions should recognise that Company S received two benefits from Zhu which require compensation. First, it received services from the Zhu employees that were made available to work on the Bank B engagement. Second, it received rights in Zhu’s proprietary software which was utilised as the foundation for the software system delivered to Bank B. The compensation to be paid by Company S to Zhu should include compensation for both the services and the rights in the software.

Example 17

241. Prathamika is the parent company of an MNE group. Prathamika has been engaged in several large litigation matters and its internal legal department has become adept at managing large scale
litigation on behalf of Prathamika. In the course of working on such litigation, Prathamika has developed proprietary document management software tools unique to its industry.

242. Company S is an associated enterprise of Prathamika. Company S becomes involved in a complex litigation similar to those with which the legal department of Prathamika has experience. Prathamika agrees to make two individuals from its legal team available to Company S to work on the Company S litigation. The individuals from Prathamika assume responsibility for managing documents related to the litigation. In undertaking this responsibility they make use of the document management software of Prathamika. They do not, however, provide Company S the right to use the document management software in other litigation matters or to make it available to Company S customers.

243. Under these circumstances, it would not be appropriate to treat Prathamika as having transferred rights in intangibles to Company S as part of the service arrangement. However, the fact that the Prathamika employees had experience and available software tools that allowed them to more effectively and efficiently perform their services should be considered in a comparability analysis related to the amount of any service fee to be charged for the services of the Prathamika employees.

Examples Illustrating the Provisions of Chapter VI.D.

Example 18

244. Osnovni is the parent company of an MNE Group engaged in the development and sale of software products. Osnovni acquires Company S, a publicly traded company organised in the same country as Osnovni, for a price equal to 160. At the time of the acquisition, Company S shares had an aggregate trading value of 100. Competitive bidders for the Company S business offered amounts ranging from 120 to 130 for Company S.

245. Company S had only a nominal amount of fixed assets at the time of the acquisition. Its value consisted primarily of rights in developed and partially developed intangibles related to software products and its skilled workforce. The purchase price allocation performed for accounting purposes by Osnovni allocated 10 to tangible assets, 60 to intangibles, and 90 to goodwill. Osnovni justified the 160 purchase price in presentations to its Board of Directors by reference to the complementary nature of the existing products of the Osnovni group and the products and potential products of Company S.

246. Company T is a wholly owned subsidiary of Osnovni. Osnovni and Company T are parties to a research and development cost contribution arrangement. By virtue of that cost contribution arrangement, Company T holds the exclusive right to produce and sell all software products of the Osnovni group in European and Asian markets. For purposes of this example it is assumed that all arrangements related to the cost contribution arrangement as regards products and intangibles in existence in the Osnovni group prior to the acquisition of Company S are arm’s length. Historically 50 percent of MNE group sales and profits have been derived from markets allocated to Company T under the cost contribution arrangement.

247. Immediately following the acquisition of Company S, Osnovni liquidates Company S in a transaction that is not taxable in Osnovni’s country, and thereafter grants an exclusive and perpetual license to Company T for intangible rights related to the Company S products. The cost contribution arrangement is amended to include the products and potential products acquired in the Company S acquisition, and the developed and partially developed intangibles related to the Company S products.

248. In determining an arm’s length price for the Company S intangibles made available to Company T under the foregoing arrangements, the premium over the original trading value of the Company S shares included in the acquisition price should be considered. To the extent that premium reflects the complementary nature of Osnovni group products with the acquired products in the European and Asian
markets allocated to Company T under the cost contribution agreement, Company T should pay an amount for the transferred Company S intangibles and rights in intangibles that includes an appropriate share of the purchase price premium. To the extent the purchase price premium is attributable exclusively to product complementarities outside of Company T’s markets, the purchase price premium should not be taken into account in determining the arm’s length price paid by Company T for Company S intangibles related to Company T’s geographic market. The value attributed to intangibles in the purchase price allocation performed for accounting purposes is irrelevant for transfer pricing purposes.

Example 19

249. Pervichnyi is the parent of an MNE group organised and doing business in country X. Prior to Year 1, Pervichnyi developed patents and trademarks related to Product F. It manufactured Product F in country X and supplied the product to distribution affiliates throughout the world. For purposes of this example assume the prices charged to distribution affiliates were consistently arm’s length.

250. At the beginning of Year 1, Pervichnyi organised a wholly owned subsidiary, Company S, in country Y. In order to save costs, Pervichnyi transfers all of its production of Product F to Company S. At the time of the organisation of Company S, Pervichnyi sells the patents and trademarks related to Product F to Company S for a lump sum.

251. Assume the following facts:

- Pervichnyi’s distribution affiliates consistently sell 1000 of Product F annually and expect to do so each year for the next five years. However, if production cost savings would support a price reduction, the distribution affiliates believe it would be in their interest to avoid long-term erosion of Pervichnyi’s market position to reduce prices by 5 percent so that total sales of the same quantity would generate 950 of revenue.

- Prior to Year 1, Pervichnyi’s cost of goods sold for Product F is consistently 600 annually and would be expected to remain at that level if production remains in country X. If production is moved to Company S in country Y, cost of goods sold for the same production volume would fall to 500 annually.

- The selling expenses of the distribution affiliates are consistently 100 annually.

- Country X imposes corporate income tax at a 30 percent rate. Country Y imposes corporate tax at a 10 percent rate.

- The distribution affiliates are subject to tax on their income at a rate of 10%.

- The transferred intangibles have a 5 year useful life.

- An appropriate return for manufacturing activities is 5 percent of COGS. An appropriate return for distribution activities is 2 percent of sales.

- An appropriate discount rate for a DCF type analysis, taking into account the risks of the Product F business, is 14 percent.

252. Under these circumstances, Pervichnyi and Company S seek to identify an arm’s length price for the transferred intangibles by utilising a discounted cash flow valuation technique. As shown in Table 1 below, viewed from the point of view of Pervichnyi, and assuming that Pervichnyi itself continues to
manufacture Product F, the residual after tax cash flows notionally attributable to the transferred intangibles have a present value of 594.

Table 1
From the Seller’s Viewpoint – Pervichnyi owns the intangible
Pervichnyi manufactures and sells to distributors

<table>
<thead>
<tr>
<th>Pervichnyi</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
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<tr>
<td>(1) Revenues</td>
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<td>594</td>
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<td>(2) COGS</td>
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<td>600</td>
<td>600</td>
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<tr>
<td>(3) Selling Expenses</td>
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<td>(4) Operating Income</td>
<td>280</td>
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<td>280</td>
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<td>(5) Tax Rate</td>
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<td>84</td>
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| (7) Income after tax (14% DR) | 196 | 196 | 196 | 196 | 196 | 673 |
| (7A) Value of intangible (14% DR) | 173 | 173 | 173 | 173 | 173 | 594 |

<table>
<thead>
<tr>
<th>Distributors</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
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<th>Total PV</th>
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<td>1000</td>
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<td>(9) COGS</td>
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<td>(11) Operating Income</td>
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<td>(12) Tax Rate</td>
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<td></td>
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</table>

| (14) Income after tax | 18 | 18 | 18 | 18 | 18 |          |

<table>
<thead>
<tr>
<th>Company S</th>
<th>DOES NOT EXIST</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Global (Consolidated) Results</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(15) Revenues</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>(16) COGS</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>(17) Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>(18) Operating Income</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>(19) Tax Rate</td>
<td>86</td>
<td>86</td>
<td>86</td>
<td>86</td>
<td>86</td>
<td></td>
</tr>
</tbody>
</table>

| (20) Income after tax | 214 | 214 | 214 | 214 | 214 | 735 |

| (21) Value of intangible (14% DR) | 173 | 173 | 173 | 173 | 173 | 594 |
If the intangibles are transferred to Company S, the residual after tax cash flows notionally attributable to intangibles would have a higher present value of 941, as reflected in Table 2. This difference results from the lower manufacturing costs at Company S and from the lower tax rate at Company S, partially offset by the lower revenue attributable to a price reduction made possible by the production cost savings.

### Table 2
From the Buyer’s Viewpoint – Company S owns the intangible
Company S manufactures and sells to distributors

<table>
<thead>
<tr>
<th>Distributors</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(29) Revenues</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>(30) COGS</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>(31) Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>(32) Operating Income</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>(33) Tax Rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>(34) Taxes</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>(35) Income after tax</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company S</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(36) Revenues</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>(37) COGS</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>(38) Selling Expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>(39) Operating Income</td>
<td>330</td>
<td>330</td>
<td>330</td>
<td>330</td>
<td>330</td>
<td></td>
</tr>
<tr>
<td>(40) Tax Rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>(41) Taxes</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td></td>
</tr>
<tr>
<td>(42) Income after tax (14% DR)</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>1020</td>
</tr>
<tr>
<td>(42A) Value of Intangible (14% DR)</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>274</td>
<td>941</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Global (Consolidated Results)</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
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</thead>
<tbody>
<tr>
<td>(43) Revenues</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>(44) COGS</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>(45) Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>(46) Operating Income</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>(47) Tax Rate</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>(48) Taxes</td>
<td>315</td>
<td>315</td>
<td>315</td>
<td>315</td>
<td>315</td>
<td>1081</td>
</tr>
</tbody>
</table>

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Another option open to Pervichnyi would be for Pervichnyi to retain ownership of the intangible, and to retain Company S or an alternative supplier to manufacture products on its behalf. The consequences of following such an option are reflected in Table 3. In this scenario, Pervichnyi would be able to capture the benefit of manufacturing Product F in a lower cost environment without transferring the intangibles to Company S. As reflected in the Table 3, the cash flows attributable to the intangible would have a present value of 735.

### Table 3

**From the Seller’s Viewpoint – Pervichnyi owns the intangible**

Pervichnyi contracts manufactures through Company S and sells to distributors

<table>
<thead>
<tr>
<th>Pervichnyi</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(22) Revenues</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>(23) COGS</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td></td>
</tr>
<tr>
<td>(24) Selling Expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>(25) Operating Income</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td></td>
</tr>
<tr>
<td>(26) Tax Rate</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>(27) Taxes</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td></td>
</tr>
<tr>
<td>(28) Income after tax (14% DR)</td>
<td>214</td>
<td>214</td>
<td>214</td>
<td>214</td>
<td>214</td>
<td>735</td>
</tr>
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<table>
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<tr>
<th>Distributors</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(29) Revenues</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>(30) COGS</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>(31) Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>(32) Operating Income</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>(33) Tax Rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>(34) Taxes</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>(35) Income after tax</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company S</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(36) Revenues</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td></td>
</tr>
<tr>
<td>(37) COGS</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>(38) Selling Expenses</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>(39) Operating Income</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>(40) Tax Rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>(41) Taxes</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>(42) Income after tax</td>
<td>23</td>
<td>23</td>
<td>23</td>
<td>23</td>
<td>23</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Global (Consolidated) Results</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>(43) Revenues</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>(44) COGS</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>(45) Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>(46) Operating Income</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>(47) Tax Rate</td>
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<td>96</td>
<td>96</td>
<td>96</td>
<td>96</td>
<td></td>
</tr>
<tr>
<td>(48) Taxes</td>
<td>254</td>
<td>254</td>
<td>254</td>
<td>254</td>
<td>254</td>
<td>872</td>
</tr>
</tbody>
</table>

| (49) Income after tax | 254    | 254    | 254    | 254    | 254    |          |
255. In defining arm’s length compensation for the intangibles it is important to take into account the perspectives of both parties and the options realistically available to each of them. Pervichnyi would certainly not sell the intangibles at a price that would yield an after tax return lower than 594, the present value of intangible related cash flows reflected in Table 1, because it could generate after tax income with a present value of that amount by continuing to operate the business as it has in the past. Moreover, there is no reason to believe Pervichnyi would sell the intangible for a price that would yield an after tax return lower than the 735 reflected in Table 3, because it could achieve such a value by outsourcing the manufacturing to a lower cost provider on an arm’s length basis.

256. Company S would not pay more than 941 for the intangibles, since if it did it would derive no return from the risks associated with intangible ownership, as reflected in Table 2. A higher price would be inconsistent with the reasonably available option to Company S of not entering into the transaction.

257. A transfer pricing analysis utilising a discounted cash flow approach would have to consider how unrelated parties dealing at arm’s length would take into account the cost savings and tax rate benefits in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield Pervichnyi an after tax return equivalent to that reflected in Table 3, and a price that would yield Company S a positive return to its investments and risks, which would be a price lower than the present value of the intangible related cash flow calculated in Table 2.

Example 20

258. Manufacturing and distribution rights for an established drug are licensed between associated enterprises under an agreement that fixes the rate of royalty for the three year term of the agreement. Those terms are found to be in accordance with industry practice and equivalent arm’s length agreements for comparable products, and the rate is accepted as being equivalent to that agreed in uncontrolled transactions based on the benefits reasonably anticipated by both parties at the time the agreement is executed.

259. In the third year of the agreement, it is discovered that the drug has capabilities in another therapeutic category in combination with another drug, and the discovery leads to a considerable increase in sales and profits for the licensee. Had the agreement been negotiated at arm’s length in year three with this knowledge, there is no doubt that a higher royalty rate would have been agreed to reflect the increased value of the intangible.

260. There is evidence to support the view (and the evidence is made available to the tax administration) that the new capabilities of the drug were unanticipated at the time the agreement was executed and that the royalty rate established in year one was adequately based on the benefits reasonably anticipated by both parties at that time. The lack of price adjustment clauses or other protection against the risk of uncertainty of valuation also is consistent with the terms of comparable uncontrolled transactions. Based on analysis of the behaviour of independent enterprises in similar circumstances, there is no reason to believe that the development in year three was so fundamental that it would have led at arm’s length to a renegotiation of the pricing of the transaction.

261. Taking all these circumstances into account, there is no reason to adjust the royalty rate in year three. Such an adjustment would be contrary to the principles set out in Chapter VI because it would represent an inappropriate use of hindsight in this case. See paragraph 173. There is no reason to consider that the valuation was sufficiently uncertain at the outset and that the parties at arm’s length would have required a price adjustment clause, or that the change in value was so fundamental a development that it would have led to a re-negotiation of the transaction. See paragraphs 174 and 175.
Example 21

262. The facts are the same as in the previous example. Assume that at the end of the three-year period the agreement was re-negotiated between the parties. At this stage it is known that the rights to the drug are considerably more valuable than they had at first appeared. However, the unexpected development of the previous year is still recent, and it cannot reliably be predicted whether sales will continue to rise, whether further beneficial effects will be discovered, and what developments in the market may affect sales as competitors piggyback on the discovery. All these considerations make the re-evaluation of the intangible rights a highly uncertain process. Nevertheless, the associated enterprises enter into a new licensing agreement for a term of ten years that significantly increases the fixed royalty rate based on speculative expectations of continuing and increasing demand.

263. It is not industry practice to enter into long-term agreements with fixed royalty rates when the intangible involved potentially has a high value, but that value has not been established by a track record. Nor is there evidence that, given the uncertainty in valuation, any projections made by the associated enterprises would have been considered adequate by independent enterprises to justify an agreement with a fixed royalty rate. Assume that there is evidence that independent enterprises would have insisted on protection in the form of prospective price adjustment clauses based on reviews undertaken annually.

264. Assume that in year 4 sales increased and the royalty rate established under the ten-year agreement is regarded as appropriate under the arm’s length principle. However, at the beginning of year 5, a competitor introduces a drug that has greater benefit than the first drug in the therapeutic category in which the first drug, in combination, unexpectedly had provided benefits, and sales of the first drug for that use rapidly decline. The royalty rate fixed at the outset of the ten-years agreement cannot be regarded as arm’s length beyond year 5, and it is justifiable for the tax administration to make a transfer price adjustment from the beginning of year 6. This adjustment is appropriate because of the evidence, mentioned in the preceding paragraph that in comparable circumstances independent enterprises would have provided in the agreement for a price adjustment based on annual review. See paragraph 177.

Example 22

265. Assume that Company X licenses the rights to produce and market a microchip to Company Y, a newly established subsidiary, for a period of five years. The royalty rate is fixed at 2 percent. This royalty rate is based on a projection of benefits to be derived from the exploitation of the intangible, which shows expected product sales of 50 to 100 million in each of the first five years.

266. It is established that contracts between independent enterprises dealing with comparable intangibles in comparable circumstances would not consider the projections sufficiently reliable to justify a fixed royalty rate, and so would normally agree upon a price adjustment clause to account for differences between actual and projected benefits. An agreement made by Company X with an independent manufacturer for a comparable intangible under comparable circumstances provides for the following adjustments to the rate:

<table>
<thead>
<tr>
<th>Sales</th>
<th>Royalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 100 million</td>
<td>2.00 %</td>
</tr>
<tr>
<td>Next 50 million</td>
<td>2.25 %</td>
</tr>
<tr>
<td>Next 50 million</td>
<td>2.50 %</td>
</tr>
<tr>
<td>In excess of 200 million</td>
<td>2.75%</td>
</tr>
</tbody>
</table>
267. In fact, although sales by Y in year 1 are 50 million, in subsequent years sales are three times greater than the projected figures. In accordance with the principles of this section, for these subsequent years the tax administration would be justified in determining the royalty rate on the basis of the adjustment clause that would be provided in a comparable uncontrolled transaction such as that between Company X and the independent manufacturer. See paragraphs 174, 176, and 177.
COLLATERAL CHANGES TO THE GUIDELINES

It is proposed that paragraph 2.9 of Chapter II of the existing Transfer Pricing Guidelines be modified in the manner indicated below:

2.9 Moreover, MNE groups and tax administrations retain the freedom to apply methods not described in Chapter II of these Guidelines (hereafter "other methods") to establish prices or to demonstrate that the prices charged either do or do not provide those prices satisfy the arm’s length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.
Dear Joe,

I have a very brief comment to make about the OECD Discussion Draft on intangibles. The text should make very clear the difference between intangible property and an intangible asset. Intangible property is an idea, such as a chemical formula, an invention, or a trademark, whereas an intangible asset is some right in intangible property. The simple word “intangible” should refer to intangible property.

Hope all is well.

Best regards,
Herm

Herman B. Bouma
Buchanan Ingersoll & Rooney PC
1700 K Street, NW, Suite 300
Washington, DC 20006-3807
phone: 202-452-7979
fax: 202-452-7989
e-mail: Herman.Bouma@bipc.com
Via mail and email

Re: Comments on the Proposed Revision of the Section on Safe Harbors in Chapter IV of the OECD Transfer Pricing Guidelines from Mark Bronson, Ceteris; Michelle Johnson, Ceteris; Simon Webber, Ceteris.¹

Dear Mr. Andrus,

This letter is in response to the announcement posted on the OECD website requesting comment on its discussion draft of the Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (“Discussion Draft”).

We applaud the OECD Working Party 6 for issuing an early draft for review and comments. Additional guidance on this topic is an urgent need for tax authorities and taxpayers alike, and the efforts of Working Party 6 to help clarify issues in an accelerated timeframe are to be praised.

Executive Summary

1. When discussing the identification of parties entitled to intangible-related returns (Section B), the Discussion Draft seems to overemphasize reliance on functions and potentially underemphasize the returns that may be associated with investments in the development of intangibles. The current draft states that entities earning intangible returns should “physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles.” Given the way that intangible returns are defined, readers might conclude that returns attributable to an

¹ The discussion presented in this letter was prepared by the authors and does not necessarily reflect the views of Ceteris or its clients.
entity that does not physically perform such functions through its own employees should be fairly limited. This ignores the fact that many structures set up between third parties are designed to reward intangible investment risk with substantial returns (which, given the definitions set forth in the draft, might be considered intangibles-related returns). We recommend that the language be revised to unambiguously ensure that entities assuming intangible investment risks be allowed to earn returns that are consistent with the arm’s length standard.

2. The Discussion Draft creates much uncertainty for taxpayers around potential ex-post adjustments and should be modified to provide more clarity on what constitutes reasonable efforts to prevent such adjustments. The Discussion Draft also creates potential uncertainty around the ability of tax authorities to recharacterize the actual transactions that related parties have entered into. This may lead to results that are inconsistent with the intention of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Guidelines”) paragraph 1.11 which calls for governments to avoid recharacterization of intercompany transactions merely because such transactions are not observed between independent parties.

3. Paragraph 148 seems to intermix concepts of operating income and cash flows. These concepts should be separated and the points outlined with more clarity.

4. On the matter of aggregating transactions, Paragraph 11 leaves much ambiguity for the taxpayer in determining how to ensure that all intangibles contributing to measured value are accounted for, and that no material item has been excluded. This paragraph should be revised.

5. Specific examples on distribution activities seem to oversimplify issues and ignore pertinent factors that should influence the pricing of a transaction. These examples also raise issues that could cause additional uncertainty for multinational enterprises (“MNE”). These examples should be modified.

6. The conclusion in Example 12 that the tax authorities can ignore an exclusivity term or territory restriction if it is not enforced historically is hasty. Strict application of this guidance could lead to non arm’s-length results. The example should be revised.
7. Certain examples within the Discussion Draft seem to use the Acquisition Price Method; however, this method is not a specified method in the OECD Guidelines. Such examples should be clearer about circumstances in which application of such a method may or may not be reliable. The Discussion Draft should also clearly state that the APM is not a specified method in the OECD Guidelines.

8. Paragraph 155 seems to imply that differences between projections used in a transfer pricing analysis and those used for another business purpose reduces the reliability of the transfer pricing analysis. The mere presence of a difference between projections used in the transfer pricing analysis relative to projections used for other business purposes does not automatically indicate that the projections used for the transfer pricing analysis are unreliable.

Further comments addressing these points follow.

**Emphasis on Functions**

When discussing the identification of parties entitled to intangible-related returns (Section B), the Discussion Draft seems to potentially overemphasize reliance on functions and potentially underemphasize returns that might, at arm’s length, be attributable to investment in intangible development. Paragraph 40’s language is particularly strong, as the expectation that “… the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles” could be interpreted as a requirement. The draft deals with contractual terms, functions and risks separately, but should in each section continue to remind readers that what is really important is the interaction of all three together.

As written, the definition of “intangible related returns” seems to incorporate returns to both the performance of intangible development functions and the returns to investment in intangibles development. Paragraph 28 states:

“As used in Chapter VI, the intangible related return attributable to a particular intangible is the economic return from business operations involving use of that intangible after deducting (i) the costs and expenses related to the relevant business operations; and (ii)
returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments. In a particular circumstance, intangible related returns with respect to an intangible may be positive, negative, or zero.”

Understandably, intangible related returns appear to include returns associated with both the performance of intangible development functions and returns associated with investment in intangibles development activity. This, in combination with the language in paragraph 40 may lead readers to conclude that mere investment in intangibles development (without the performance of “important functions”) cannot attract meaningful returns.

This ignores the fact that many circumstances exist at arm’s length in which third parties that finance intangibles development are provided with substantial returns if those efforts are successful.

Some relevant examples of such third-party structures are as follows:

1. In the electronic consumer and industrial products industries, many electronics manufacturing services companies offer design services and run the majority of the design effort for an OEM but do not receive the majority of profits from related intangibles.
2. In the software industry, it is not uncommon for software development to be outsourced for a service fee. OEMs continue to earn intangible-related returns in these situations.
3. Venture capitalist firms provide financial capital to high-risk businesses (essentially investing in their potential intangibles and management) in return for the ability to profit from those businesses’ value through an ownership stake or other mechanism often without performing the related activities or controlling key decisions.

The Discussion Draft language compromises MNE’s ability to allocate intangible investment and arm’s length returns associated with such investment where they choose. We recommend that the language be revised to unambiguously account for financing risk to be rewarded and ensure that all facts and circumstances are taken into account. One way to accomplish this would be to clarify that parties that provide mere financing are entitled to an expected return that is appropriate given the risks associated with the investment that they have made (leaving any expected returns in excess of
this expected return for financing with the party that is performing the “important functions” outlined in paragraph 40).

**Reasonable Efforts to Prevent Ex-Post Adjustments and Inappropriate Recharacterizations**

The Discussion Draft should be modified to provide more clarity on what constitutes reasonable efforts to prevent an ex-post adjustment or avoid recharacterization risks. Two specific examples follow:

1. On the matter of projections, much space is devoted to talking about how difficult it is to make long-term projections of income and expense. Paragraphs 144, 149 and 154-158 contain examples of such statements. While creating reliable financial projections is indeed difficult, it is also true that sometimes this is the best information that independent parties would have available to them. It is common for third parties to use such information to price deals, and to let profit differences associated with differences between actual results and these projections accrue to a single party (generally the purchasing party). As long as taxpayers are able to demonstrate that they used the best information available at the time a transaction was executed to price that transaction, tax authorities should not be permitted to make adjustments to transaction prices based on the difference between ex-ante projections and ex-post results. The existing language needs to be modified to make this point clear.

2. The first few sentences of Paragraph 40 state that it is “not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees.” It then seems to support this statement with the next sentence that notes that third parties sometimes outsource some of these functions. This seems to imply that the way third parties structure their transactions is relevant for how transactions can be structured on an intercompany basis. Such language seems to contradict with the OECD Guidelines’ paragraph 1.11, which confirms that

“...associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent
The mere fact that a transaction may not be found between independent parties does not of itself mean that it is not arm’s length.”

Therefore, the first few sentences of Paragraph 40 add ambiguity for the reader, and should be modified to clearly state that MNEs are permitted to structure their transactions as they see fit.

**Paragraph 148**
The language in paragraph 148 that describes the use of valuation approaches seems to use income and cash flow concepts interchangeably. Use of cash flow-based methods (rather than income-based methods) leads to fundamental differences that are unclear in the existing language. For instance, if one is using a discounted cash flow method (rather than a discounted operating income method), one should not make deductions for returns attributable to “business activities and/or assets other than the intangibles.” This is because in a cash-flow based method, the returns to such activity are captured through the discounting process (so long as the investments associated with such activities are appropriately captured in cash flows).

This issue could most directly be addressed by changing the language in paragraph 148 as follows:

“Valuation approaches that estimate the discounted value of projected future cash flows income attributable to the transferred intangible or intangibles can be particularly useful analytical tools. There are many variations of valuation techniques based on the discounted value of projected future cash flows income. In general terms, such valuation techniques begin by projecting the revenue anticipated to be produced in a given business over the useful life of the intangibles being valued. They then deduct, from those projected revenues, estimates of projected cost of sales and operating expenses to yield an estimated projection of operating income over the anticipated useful life of the intangible. Estimates of cash flows operating income attributable to business activities and/or assets other than the intangible being valued may be deducted from the projections of operating income. Depending on the specific facts, these deducted cash flows income streams can include projected routine functional returns as well as projected income attributable to other activities, attributes and other intangibles. The resulting residual stream of projected cash flows operating income attributable to the intangible being valued is discounted to calculate the present value of the stream of intangible related cash flows income. The
discount rate or rates used in calculating present values of the stream of projected cash flows income reflects both the time value of money and the risk that future cash flows may not materialise.”

Alternatively, the Discussion Draft could preserve the ability to use either operating income or cash-flow based methods, but this approach would require more meaningful guidance so that the methodological distinctions between income and cash-flow based methods are clear.

**Aggregation of Transactions**

Paragraph 11 states:

>“While it may be appropriate to aggregate intangibles for purposes of determining arm’s length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified economically significant intangibles in the MNE’s global business, should support the determination of arm’s length conditions.”

In this example, taxpayers should have more guidance on how one would get comfortable, in cases of aggregation, that all of the specified intangibles are contributing to the measured value, and that nothing else that is not listed is contributing to that value.

**Distribution Activities**

Specific examples on distribution activities seem to oversimplify issues and ignore pertinent factors that should influence the pricing of a transaction. These examples also raise issues that could cause additional uncertainty for MNEs.

1. The Discussion Draft should better clarify how to measure and compare levels of marketing expenditures when discussing these in Example 5. It should be noted that this is not an easy objective to measure because it requires comparables under similar circumstances and these (even in the same industry) may not be available.

2. Examples 2, 5 and 7 raise issues that may cause additional uncertainty for MNEs. In these examples, if a distributor is found to have invested more than could be reasonably expected
of the party after careful analysis, a question may be posed as to whether the appropriate response should be correct the historical investment profile (i.e., (i) adjust historical results to effectively reimburse historical above-normal investments) or (ii) adjust pricing of product or royalties such that it earns a reasonable share of the expected future profits). Examples 2 and 5 seem to imply that both adjustment options might be possible and correct. Example 2 (Paragraph 186) and Example 5 (Paragraph 200) provide for ambiguous adjustment possibilities based on the same historical factors whereas Example 7 (Paragraph 208) does not provide the same adjustment options. Ideally for reduced uncertainty it is preferable that the facts point to a single appropriate type of adjustment rather than leave the type of adjustment open. At least, the circumstances where each of these should be applied needs to be clarified to reduce uncertainty and the risk of double taxation. Important in this determination would be the contractual arrangements and actual conduct of the parties, which should set out which party has taken on the economic risk of the investment on a consistent ex-ante basis. However, one off transgressions from otherwise consistent behavior should not lead to a change in characterization, rather correction of the transgressions from consistency.

**Ignoring Terms When Not Enforced**

The conclusion in Example 12 that the tax authorities can ignore an exclusivity term or territory restriction if it is not enforced historically is hasty. Strict application of this guidance could lead to non arm’s-length results.

Companies may tolerate “excursions” from rights or not enforce them where it benefits them from doing so, but may restrict and enforce those rights at a later date. In Example 12, the use of distributors that do not respect the territory may not adversely affect Primarni’s business in those non-authorized markets. It may not have a direct presence in those markets and it may enjoy the benefits of additional product revenues or royalties from their indirect exploitation. The legal restriction might be enforced, however, if Primarni decided to enter the market or the pricing in those markets was damaging the brand. In these cases, the company might enforce the territory restrictions and any investments by the distributors would be lost with no recourse. The example should be changed.
Issues Concerning Implied Use of Acquisition Price Method

Examples 15 and 18 seem to use the Acquisition Price Method; however, this method is not a specified method in the OECD Guidelines. Also, given that this method can lend itself to estimation errors in certain situations, such examples should be clearer about circumstances in which application of such a method may or may not be reliable.

Specifically, the APM uses a “reductionist” approach to intangible valuation, i.e., adjusting the price of something larger than the intangible to determine the intangible value. Such an approach needs to be performed with a high degree of caution because it has a tendency to compound estimation errors and subjectivity inherent in the adjustments onto the residual value of the intangible. This compounded valuation variance or error can be less significant in a more direct valuation approach.

For example, if a “bottom-up” approach is taken and each element of the valuation has a 5~10% error factor, when combined the valuation will have a similar 5~10% error factor in the valuation of the whole. Even if one element has a higher error quotient, the other valuation may well still be acceptably accurate. In contrast, if the APM is applied and significant adjustments are required to the target transaction price, then the errors in each of the adjustments (and any missed adjustments) compound onto the value of the remainder, which is often a much larger proportion of the intangible value. For this reason it is important to be careful that all adjustments are made and each adjustment is reliable when applying this method, or its reliability could be significantly impaired in comparison to a bottom-up approach.

Examples 15 and 18 should therefore note that caution must be used when using such a method and remind the reader that the APM is not a specified method in the OECD Guidelines.

Differences Between Projections

Paragraph 155 states, “It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.”

This language seems to imply that differences between projections used in a transfer pricing analysis and those used for another business purpose reduces the reliability of the transfer pricing analysis. The mere presence of a difference between projections used in the transfer pricing analysis...
analysis relative to projections used for other business purposes does not automatically indicate that the projections used for the transfer pricing analysis were unreliable. For example, projections generated by the business for certain purposes might be “best case” or optimistic scenarios rather than best estimates of expected values given all available information. In such circumstances, projections used for transfer pricing purposes may appropriately be different than such business projections, and tax authorities should consider the context of inconsistent projections in evaluating the reliability of projections used by the taxpayer.

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The authors hope that these suggestions are of assistance in this important project. Please let us know if we can be of further assistance.

Sincerely,

Mark Bronson
Michelle Johnson
Simon Webber
Ref. BUSINESSEUROPE TAX POLICY GROUP
Contact: Mr. Krister Andersson, Chairman

September 13, 2012

To:
Joseph L. Andrus
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France

Dear Joe,


BUSINESSEUROPE is pleased to provide comments on the OECD Discussion Draft entitled “Revision of the Special Considerations for Intangibles in Chapters VI of the OECD Transfer Pricing Guidelines and Related Provisions” (hereafter referred to as the “Draft”).

The treatment of intangible property within global businesses is a very important topic that raises many difficult tax issues from a transfer pricing perspective. BUSINESSEUROPE acknowledges the complexity and sensitivity of the topic and supports and compliments the OECD for its efforts to reach a common and better understanding on how to recognise and treat intangibles for transfer pricing purposes.

To promote growth in our economies companies need predictability and further guidance in this complicated area. Consequently, the need for consensus and equal application of transfer pricing rules in relation to intangible property in the Member States and beyond are of utmost importance. In this respect, BUSINESSEUROPE would like to emphasize the need for designing guidelines that stand a chance of gaining widespread acceptance without changing the fundamental building blocks on which the arm’s length principle has rested on with respect to Intangible property in the past. Furthermore, BUSINESSEUROPE would also like to highlight the importance of appropriately considering any EU-law implications within the project.

General comments on the Draft

The Draft addresses a number of issues that are as important as they are sensitive and delicate. The OECD has clearly tried to develop language and guidance in this area which are rooted in principles and guidance already found in the guidelines. However, the Draft also introduces a number of new concepts and definitions, some of which give rise to concern from a business perspective. The principles provided and definitions used in various cases are not properly aligned with other Chapters of the OECD.
Transfer Pricing Guidelines (TPG) and do not accord to well recognized international practises in dealing with intangibles. We fear that this could lead to increased controversy between tax administrations and tax payers. As an example we refer to paragraphs 135 and 136 in the Draft which strongly recommend the CUP and profit split method for determining the arm’s length price for the transfer of an intangible. This is not consistent with the revised Chapters I-III, in which the hierarchy of methods have been removed and the concept of the most appropriate method has been introduced.

Another example where the proposed language in the Draft is not aligned with other Chapters in TPG can be found in paragraph 81 where it is stated that “A one sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use of transfer of intangibles.” However, other parts of the TPG, e.g. 2.59 and 3.22, conclude that there may be cases with circumstances where a one sided comparability analysis would be sufficient.

Intangible property is no doubt one of the most important assets for many multinational enterprises, as they often represent significant value. Considering the values at stake, the tax treatment of intangible property within global businesses is, quite obviously, of importance not only to businesses but also to tax administrations. Unfortunately, the Draft seems to be based on the notion that there are significant hidden values in multinational enterprises which are being developed, used, and transferred without proper compensation or adequate taxation.

Thus, the Draft seems to respond not only to a more general need for better guidance, but also to a growing interest from tax administrations for what is considered to be core value drivers in enterprises of today. The latter is reflected throughout the Draft, not least when it comes to difficult and illusive topics such as whether e.g. “workforce in place” or “market specific characteristics” could constitute intangible assets for transfer pricing purposes or provocative IP management structures where a few people in a low tax jurisdiction are managing substantial intangible assets that have been developed elsewhere.

It is important that the guidance to be developed in this area is balanced, general in nature and focused on resolving the typical rather than the atypical and extreme situations. Although it is important and relevant to address tax evasion in this context it needs to be acknowledged that the guidance should first and foremost be aimed at providing the general principles and guidance to be followed when dealing with intangibles from a transfer pricing perspective.

Many multinational enterprises have spent a significant number of years developing structures where ownership of an IP, the product of R&D performed internally within the group as well as externally, in line with the principles of the current guidelines is centralized to one location for sound administrative and business reasons. Many have also devoted significant resources to ensure that all parties involved are being remunerated on an arm’s length basis on the basis of functions performed, assets used and risks assumed. With the exception for times of major restructurings, this structure has so far most likely caused them limited controversy. Further on, where there has been controversy it has probably not very often been over whether there is in fact an intangible asset. Nor is it likely that there has been much controversy as to who has the
right to any returns coming out of those assets. From this perspective and with reference to some of the new principles being introduced, many enterprises may question whether the new guidelines will achieve its objective of bringing less controversy and double taxation rather than the opposite.

In order to provide predictability, avoid ambiguity and prevent double taxation BUSINESSEUROPE believes it is important that the Draft provides for:

- A clear definition which seeks to mimic how intangible assets are identified and recognised on arm’s length terms between independent entities.
- Principles for establishing the ownership of an intangible. Ownership should require that the entity can claim legal protection of the intangible, perform functions and incur costs in relation to the intangible. The ownership concept, however, should not be mixed with the determination of what is an appropriate return for expenses incurred or functions performed by other entities within the group.
- A method to assess the value of the intangible asset.

A. Identifying Intangibles

General comments

BUSINESSEUROPE firmly believes that finding a clear and well accepted definition is at the heart of this project. Without such a definition, the risk of inconsistent interpretation and application of the arm’s length principle is evident, with double taxation as the ultimate consequence. The arm’s length principle as set out in Article 9 of the OECD Model Tax Convention (MTC) and the OECD Transfer Pricing Guidelines (TPG) is a natural starting point for identifying a suitable definition.

The arm’s length principle seeks to mimic terms and conditions between independent parties. This suggests that any definition should try to capture value driving intangibles that constitute assets in the meaning that two independent parties would agree to transfer the ownership and control of them. A definition that does not evolve around the concept of an asset would deviate from what can be observed in the open market and would thus not be coherent with the arm’s length principle.

On this basis, a definition of intangible assets that are to be recognized for TP-purposes ought to include three typical characteristics: ownership, control, and transferability. Although business attributes or notions such as goodwill, on-going concern value, synergies, location savings, workforce in place etc. may affect the valuation of a transaction, such attributes or notions are not themselves assets which can be owned, controlled or transferred separately. Consequently, they should not be included in the definition. This also seems to be in line with the current wording in the TPG.

It should be noted that such a definition would not be limited to intangible assets which can be registered or otherwise protected through a similar procedure (such as trademarks, patents, etc.) It also covers intangible assets where these characteristics
can be manifested and upheld in a contractual arrangement between two parties (dependent or independent).

As stated above, business notions are not intangible assets themselves and should not be recognized for TP-purposes on a stand-alone basis. This does not mean that they could not be of relevance in a transfer pricing analysis. Instead they could very well be elements connected to the valuation (and comparability) of such assets and may accordingly affect the transfer price of an intangible asset. Thus, unless it is possible to identify a transfer of a tangible or intangible asset (either by way of a realization of such an asset or the right to use such an asset), goodwill and similar value elements cannot trigger a taxable event by themselves.

**Detailed comments**

**Paragraph 5**

*5. In these Guidelines, the word “intangible” is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.*

Although, this definition provides some further clarity relative to the current guidelines it is still not clear enough to provide sufficient legal certainty for business. Although we fully support that an intangible should be capable of being owned or controlled for use in commercial activities, the word “something” is very vague and from a legal and accounting perspective not an acceptable concept to determine what should constitute an intangible. Consequently, and in line with our previous comments, BUSINESSEUROPE suggests that the word “something” be replaced with “an asset”.

Furthermore, a key characteristic of an asset in dealings between independent persons is that it can be separately transferred from one party to the other, thus excluding various business notions such as e.g. goodwill, on-going concern value etc. from the definition. We therefore suggest adding the words “and also is separately transferable” after “commercial activities”.

We are also of the opinion that legal and accounting principles constitute a useful starting point for any effort to determine whether or not an intangible asset exists and therefore suggest that the second sentence is amended accordingly.

**Paragraph 7**

*7. The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be*
transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.

Between independent parties, an asset does not trigger a taxable event unless it can be and is transferred. Thus, to be recognised for transfer pricing purposes, an intangible asset should also be separately transferable. Consequently, and in line with our comments under paragraph 5, we suggest that the last sentence be deleted.

**Paragraph 16**

(ii) Know-how and trade secrets

16. Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret. The confidential nature of know-how and trade secrets may be protected to some degree (i) under unfair competition or similar laws, (ii) under employment contracts, and (iii) by economic and technological barriers to competition. Know-how and trade secrets are intangibles within the meaning of section A.1.

Albeit we agree to the general conclusions in this section, we would like the guidelines to recognise that know-how should typically be unique or non-routine to create a valuable intangible that need to be recognised for TP-purposes. Know-how that is common knowledge, trade practice, off-the-shelf solutions etc. should typically fall outside the scope of what is considered an intangible asset for the purpose of these guidelines. We suggest the last sentence to read as follows:

“Know-how and trade secrets could constitute intangible assets within the meaning of section A.1 provided that they are unique and of a non-routine character which allows for them to be characterized as assets that are possible to transfer and value.”

**Paragraph 22**

(v) Goodwill and Ongoing Concern Value

22. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes. It is important to recognize, however, that the terms goodwill and ongoing concern value are often used to describe an important and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm’s length price. Similarly, when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark or other licence that reputational value should be taken into account in determining an appropriate royalty. To assure that
such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as intangibles within the meaning of section A.1. Such treatment in no way implies, however, that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily appropriate measures of the price that would be paid for the transferred business or license rights, together with their associated goodwill and ongoing concern value, by independent parties. In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis.

As stated in our general comments above, business notions such as e.g. goodwill and on-going concern value may affect the valuation of a transfer of an intangible asset but do not by themselves qualify as such since they are not separately transferrable. We suggest that the sentence starting with “To assure that such values are taken into account….” be changed into the following two sentences.

“To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value should be taken into account in a comparability analysis. Since goodwill and ongoing concern value cannot be segregated or transferred from other business assets they are not intangibles within the meaning of section A.1.”

Within the context of paragraphs 20-22 of the Draft, it might be appropriate to define in detail the influence of a goodwill element on a transfer pricing analysis. Example 13 of the Discussion Draft evidences how goodwill may increase the value of the transfer of a right on an intangible, in connection with the transfer of a business.

Paragraphs 23 and 24

(vi) Group synergies

23. In some circumstances group synergies contribute to the level of income earned by an MNE group. Such group synergies can take many different forms including streamlined management, elimination of costly duplication of effort, integrated systems, purchasing power, etc. Such features may have an effect on the determination of arm’s length conditions of controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by a single enterprise, they are not intangibles within the meaning of section A.1.

(vii) Market specific characteristics

24. Specific characteristics of a given market may affect the arm’s length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labor costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics may not, however, be owned, controlled and transferred by an individual enterprise. Such items are not intangibles within the meaning of section A.1., and should be taken into account in a transfer pricing analysis through the required comparability analysis. See TPG Chapter III and paragraphs 9.148 – 9.153.
BUSINESSEUROPE fully endorses the position that factors like group synergies and market specific characteristics are not intangible assets on the grounds that they cannot be owned, controlled or transferred. As correctly pointed out, such factors should rather be viewed as comparability factors which may have an effect on the arm’s length value of a controlled transaction. In this context, we would however like the Guidelines to further recognize that in practice, the tools available to make comparability analyses are rather blunt and that factors like group synergies and market specific characteristics are very difficult to identify and benchmark on an individual basis. If a taxpayer has made a good effort to value a transfer of an intangible asset with the valuation tools currently available, Member States should accept this and recognize that it is often not possible to dissect such an analysis and show the value of these factors individually. This equally applies to the discussion in paragraph 90 and onwards.

**Paragraphs 25 and 26**

**(viii) Assembled workforce**

25. Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.

26. Additionally, it should be recognized that:
   - Contractual rights and obligations may be intangibles within the meaning of section A.1. so that a long term contractual commitment to make available the services of a particular group of uniquely qualified employees may constitute an intangible in a particular circumstance;
   - The transfer of an existing assembled workforce may provide a benefit to the transferee by saving it the expense and difficulty of hiring and training a new workforce, and may affect the compensation required in connection with the transaction;
   - While the transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of an intangible, as a factual matter such a transfer may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm’s length dealings. In each case, the specific facts, as reflected in a detailed functional analysis, should control the transfer pricing outcome.

BUSINESSEUROPE strongly oppose having an assembled workforce be treated as an intangible. It is difficult to see how any personnel can be owned, controlled or transferred. With the possible exception for athletes, it is equally uncommon to see that a shift of personnel in isolation would be remunerated between unrelated parties. Naturally, and as for any service rendered, if a group of employees is providing services for another company appropriate compensation should be paid. Equally if a business is transferred between independent parties including workforce providing valuable services, this may give rise to a higher value of the business as such (i.e. the assembled workforce is a comparability factor that may or may not add a value). It should be pointed out, however, that an independent acquirer normally is careful to put
a high value and/or applies a high risk premium to such a factor for the very reason that workforce cannot be owned or controlled.

In addition, the wording in these paragraphs is very vague, theoretical and complex and provides little guidance. How shall business apply this in practice and be able to identify and draw the line between when a workforce will create an intangible and when it will not? This wording is likely to lead to numerous disputes with revenue authorities with double taxation as a consequence.

Consequently, we suggest that paragraph 25 be changed to clearly state that an assembled workforce should not be treated as an intangible within the meaning of Section A.1.

Furthermore, we propose that the third bullet point in paragraph 26 be deleted and that the first bullet point in paragraph 26 be redrafted as follows:

“A long term contractual commitment to make available the services of a particular group of uniquely qualified employees does not constitute an intangible. However, it may be taken into account in a transfer pricing analysis through the required comparability analysis.”

B. Identification of Parties Entitled to Intangible Related Returns

General comments

The concept of ownership aims at determining the allocation of intangible assets together with its expenses and expected returns for TP-purposes between two or more related parties. The owner should typically receive the economic benefits of the intangible assets as well as assume the risks related to the assets in question. We acknowledge and agree to the concept of intangible returns instead of dividing between legal and economic ownership. We also believe that legal ownership in terms of the contractual arrangement between the parties, including allocation of rights and obligations, appears to be a sound starting point for the ownership analysis as this illustrates the intention of the parties with respect to the ownership allocation.

With respect to intangible assets that can be registered or otherwise protected, such as patents and trademarks, the legal ownership as expressed in the contractual arrangement between the parties and the ownership as manifested in such registers typically coincides.

However, occasionally this is not the case. This may have many reasons. Within a wholly owned group, the protection granted through registers and similar measures seeks to create legal protection vis à vis third parties rather than between the members of the group. Therefore, within a group it is of less interest which legal entity is the registered owner, than it is between independent parties. As a consequence, the registration as a manifest for the legal ownership is not necessarily as strong within a group as between independent parties. In the rare cases where the contractual agreement between the parties and the registration (or similar) do not coincide, the former shall prevail.
Administrations should be very careful when deciding to forego and disregard what the taxpayer has clearly set out to accomplish. The legal ownership as defined above should be respected unless it clearly deviates from the economic substance of a transaction and the conduct of the parties. In line with Chapter IX of the TPG, such action from administrations should be allowed only in exceptional cases. Reasonable efforts to centralize IP-rights must not be disregarded by administrations without there being substantial and significant factors to indicate that this would in fact be incompatible with how business is actually performed.

Nevertheless, in cases where the intention of the parties cannot be determined and/or when the conduct of the parties clearly deviates from such an arrangement and the arm’s length principle, the objective should be to determine what would be a reasonable allocation between independent parties given the facts and circumstances of the case.

In this respect, we believe that the current Draft erroneously focuses too much on the physical performance of the actual development, maintenance and protection of an intangible asset for the purpose of determining ownership. It is frequently observed between independent entities that some or even all of these activities are being outsourced or subcontracted with a clear agreement that any intangibles being developed as a cause of these activities are owned by the principal. Not recognizing this with respect to related parties would be incompliant with the arm’s length principle and create a significant risk for tax controversy and double taxation.

Instead, we believe that ownership of intangible assets shall be based on the principles already developed in Chapter IX of the TPG regarding the notions of risk, control and financial capacity. In an arm’s length situation, it is indeed reasonable to assume that the person taking the risk for a R&D-activity, and performs the necessary control activities to assume this risk, will retain the ownership of the intangibles being developed.

In this context, some caution should be taken when adopting the notion of control in relation to activities creating intangible assets. By way of example, outsourcing of R&D activities (e.g. by way of contract R&D) between independent parties is sometimes done because the principal does not have the resources or competence to perform these functions. This party might therefore not have the ability to control and/or manage the process in any detail but only in a high level management sense. Hence, the meaning of control is crucial. Any requirement in this context ought to be fully in line with the guidance currently found in Chapter IX, such as the right to “hire and fire”, participation in and ultimate authority over budgets, key strategic decisions etc. The fact that the contractor/service provider is using its particular competence to decide how to reach the objectives outlined, should not influence the allocation of the intangibles for TP-purposes and the attribution of intangible returns. Whilst such competence may be a comparability factor and influence the arm’s length price between the IP owner and the contractor/service provider it does not result in a situation where the contractor is entitled to intangible returns.

Furthermore, the notion of funding (i.e. which of the parties has funded the IP-development) equally is a useful guide in determining ownership. It is indeed
reasonable to assume that among independent parties the one that has funded the development-activities, whether the actual development work has been conducted by this party or not, will have a rightful claim to the benefits (and risks) related to the IP so created.

**Detailed comments**

**Paragraphs 40 and 41**

40. It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm’s length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, these functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

41. Moreover, where associated enterprises are retained to perform functions related to the development, enhancement, maintenance or protection of intangibles, it is expected that, in a situation where contractual entitlements and functions are in alignment, the party or parties claiming contractual entitlement to intangible related returns will exercise control over the performance of those functions and the associated risks, will bear the necessary costs required to support the performance of the function, and will provide arm’s length compensation to any associated enterprise physically performing a relevant function. In assessing whether the member of the MNE group claiming entitlement to intangible related returns in fact controls the performance of the relevant functions, principles analogous to those of paragraphs 9.23 through 9.28 should be applied.

Paragraph 40 states that where functions are in alignment with contracts and registrations it is expected that the party claiming entitlement to intangible related returns is physically performing through its own employees the important functions related to development, enhancement, maintenance and protection of the intangibles.

As noted above, we believe that the draft implies too much focus on the physical performance of the actual development, maintenance and protection of an intangible asset for the purpose of determining ownership. We do not believe this to be in line with the arm’s length principle as it does not reflect the behavior observed in the market.
place between independent parties. As it currently stands, paragraph 40 may in fact be seen as contradictory to the existing guidance found in Chapter IX in the TPG.

In addition, it is unclear how “own employees” shall be interpreted (e.g. by way of payroll or organizational reporting) considering the fact that control and decision bodies may be centralized, but include employees with employment with several legal entities.

The wording also seems to indicate that all these functions (development, enhancement, maintenance and protection of the intangibles) always are equally important for the entitlement to intangible related returns. Functions that potentially could be considered relevant and important in this context would probably not be same for all types of intangibles and would certainly not be the same for development activities as for maintenance activities.

The concept outlined above should be in line with example 1, where the development and strengthening of intangibles are activities that entitle to benefit from economic returns attributable to the intangible, while a simple administrative activity to protect the trademark would merely allow an arm’s length remuneration.

The assumption of risk together with the financial capacity to bear the risk is a key factor when determining entitlement to intangible related returns. This issue is adequately addressed in the TPG (9.10-9.46). Intangible related returns should naturally be allocated in accordance with the economic reality underlying the arrangement as addressed in the current Guidelines.

On this basis, BUSINESSEUROPE recommends deleting the current paragraph 40 of the Draft and redrafting paragraph 41 which deals with the relationship between risk, financial capacity to assume the risk and entitlement to intangible related return to better align with the principles outlined in Chapter IX of the current TPG.

**Paragraph 54**

54. In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance:

- Perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis;
- Bear and control the risks and costs related to developing and enhancing the intangible; and,
- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

Where a party is allocated intangible related returns under contracts and registrations, but fails to perform and control important functions, fails to control other related functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.
The first bullet point in paragraph 54 seems to suggest that a member of an MNE should perform all important functions to development, enhancement, maintenance and protection of the intangibles and control other related functions outsourced to other parties. This would mean that only few or minor functions can be outsourced which clearly neither would be compatible with the current wording of Chapter IX in the TPG, nor a reasonable application of the arm’s length principle. As previously stated in our comments to paragraph 40 we believe that the relationship between risk, financial capacity to assume the risk and entitlement to intangible related return is appropriately addressed in Chapter IX and recommend deleting the first bullet point of paragraph 54. The wording regarding functions in paragraph 54 is not only directly contradictory to for e.g. paragraphs 9.25-9.26 in Chapter IX, but also show a lack of understanding of how MNEs are organised and structured from a business point of view. In addition, the wording implies that the concept of significant people functions developed for attribution of profits to permanent establishment and hence day-to-day decision making rather than strategic decision and relevant control should also be applied between legal entities in an article 9 context. We find this to be highly inappropriate.

**Paragraph 55**

55. Where relevant functions, risks, and costs are in alignment with legal registrations and the terms of relevant contracts, the contractual allocation of entitlement to intangible related returns should generally be respected by tax authorities and transfer pricing determinations should be made on the basis of that contractual allocation of intangible related returns. Where such risks, functions, and costs are not in alignment with contractual allocations, part or all of the intangible related returns may be allocated to parties performing such functions and bearing such risks, and transfer pricing adjustments may be appropriate to assure that each member of the group is properly rewarded for its risks, functions and costs.

Since there may be occasions when no legal registration is possible and also where the external legal registration and internal allocations does not match, we recommend changing the first sentence to “…in alignment with legal registrations and/or the terms of relevant contracts…” The internal allocation of entitlement to intangible related returns shall be respected if it is arm’s length.

**D. Determining Arm’s Length Conditions in Cases Involving Intangibles**

**Detailed comments**

**Paragraph 81**

81. In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles.
Although the intention of this paragraph is clear, it should be noted that typically there is only one party in a group (i.e. the group) and under global operational models it is sometimes difficult to fully synthesize two different “sides” related to two legal entities within a group. From this perspective, the statement that one sided comparability analyses are not sufficient seems a bit strong.

**Paragraph 83**

83. It will often be the case that a price for a transaction can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations, at least on an after tax basis. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34 – 9.38 or 9.122 should be applied, or whether the conditions of the transaction should otherwise be adjusted. This discussion highlights the importance of taking all relevant facts and circumstances into account in the comparability analysis.

The first sentence can no doubt be questioned. As for the second sentence and onwards, we fear that this will lead to tax authorities rejection transactions actually conducted based on the argument that independent parties should not have made such a transaction.

It needs to be acknowledged that there are probably transactions taking place within a group that you would rarely find between independent parties. This does not mean that these transactions cannot be priced in accordance with the arm’s length principle. It does however mean that these transactions will be more difficult to analyze. Paragraph 1.69 of the TPG states "...The fact that independent enterprises do not structure their transactions in a particular fashion might be reason to examine the economic logic of the structure more closely, but it would not be determinative....". Consequently, tax administrations are advised to show great cautiousness in dealing with such transactions and to respect the transactions actually undertaken to the extent it is possible. Transactions should not be disregarded or substituted with other transactions simply because it is difficult to find comparable transactions between independent parties.

If there is an overlap of the range of acceptable prices for the seller and for the buyer and if the price falls within this range, the price should be accepted by the tax authorities. The tax authorities should not ask for the median or a specific point in the range. When looking at the realistically available options of a company, a company should not be compelled to elect for the most favorable one since it should take into account its belonging to a group and so the interest of other members. As indicated in paragraph 9.60 of the TPG, as long as the choice is not clearly less attractive than another one it should be accepted.

"9.60 ………….However, alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under..."
comparable circumstances. If a more profitable structure could have been adopted, but the economic substance of the taxpayer’s structure does not differ from its form and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, the transaction is not disregarded. However, the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is clearly more attractive.”

**Paragraph 95**

**(d) Useful life**

95. Many intangibles have a limited useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, as noted above. The useful life of some intangibles can also be affected by the rate of technological change in an industry and by the development of new and potentially improved products. It may also be the case that the useful life of particular intangibles can be extended.

The useful lifetime of an intangible is an important factor in many valuations but there is great uncertainty and divergent opinions on how to determine it. In our opinion, the definition of useful life in paragraph 95 does not provide accurate or sufficient guidance. In particular, the paragraph should better reflect the fact that in today’s fast changing environment, very few, (if any) intangibles will hold a value indefinitely unless supported. Thus the paragraph should in our view take the position that intangibles with indefinite lifetime only holds true in exceptional cases. BUSINESSEUROPE suggest the paragraph be worded as follows:

“Other than in exceptional cases, intangibles have a limited useful life. The useful life of an intangible is the time period over which the intangible, without additional support, can be expected to generate above-normal or above-routine returns. However, the useful life is not necessarily the time period over which the intangible can be used or continues to work. The market value of certain types of intangible tends to decline over time if the value is not enhanced through R&D investment. The rate at which the value declines depends on the speed of technological progress in the industry, the intensity of competition, and the role that intangible property plays in the overall production process.”

**Paragraph 108**

108. In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify other factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should
appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions.

We find that the paragraph appears to place too much emphasis on the profit split method. Under certain circumstances it may be reasonable to give a routine return to one entity and have the residual profit going to the other entity.

Paragraph 110

110. While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. In particular, it is important to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes be biased in favour of conservative estimates of the value of assets reflected in a company’s balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to valuation approaches that are not necessarily consistent with the arm’s length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm’s length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.

Accounting and business valuation measures are frequently used in practice and can be an important reference for transfer pricing purposes. They are not preclusive but can provide useful indications and thus should be taken into account in a transfer pricing analysis. Consequently, we do not agree with the general call for caution in using these kinds of valuation methods. Since these methods are frequently used in transactions involving intangibles between independent persons, they should arguably be equally applicable on transactions between related parties. Furthermore, unless the guidelines provide a general recognition of these valuation techniques, it needs to provide significantly further guidance as how to value intangibles for TP-purposes.

Paragraph 116

(vi) Application of rules of thumb

116. In cases involving the use or transfer of intangibles or rights in intangibles, it is sometimes suggested that certain rules of thumb may apply to determine a correct transfer price or to allocate intangible related returns between a transferor and transferee of rights in intangibles. The application of a general rule of thumb does not provide an adequate substitute for a complete comparability analysis conducted under the principles of Chapters I through III. Accordingly, application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee is discouraged.

It is reasonable to assume that a rule of thumb normally would be developed either because there are some experience on what is a reasonable interval when determining a correct transfer price or because the parties (including authorities) seem to accept a particular interval in a certain situation. Consequently, we feel that the language used
in the paragraph is unnecessarily negative when it comes to the application of a rule of thumb and recommend a less harsh language.

**Paragraph 136**

136. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances.

We do not agree that experience has shown that a CUP is most likely to prove useful in cases of transfer of intangibles. Given the unique nature of intangibles, in our experience, a CUP is rarely or never found in cases involving intangible assets.

Valuation techniques are often useful, given their widespread use in commercial markets and in current transfer pricing approaches. We suggest that this be more clearly reflected in the paragraph.

**Paragraph 155**

155. In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

It is not our experience that projections prepared for non-tax purposes are likely to be more reliable than projections prepared exclusively for tax purposes. Business forecasts often tend to be overly optimistic, resulting in too high values.

**Paragraph 166**

166. In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that nonroutine returns are attributable to such intangibles in perpetuity.

We do not agree with the last sentence in the paragraph. It should rather be stated that few if any intangibles have indefinite lifetime.
Paragraph 177

177. If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

Is it possible to determine if independent enterprises would have insisted on a price adjustment clause in comparable circumstances? Are there any typical situations where it clearly can be said that independent parties would have included such clauses? In our opinion it is virtually impossible to say what independent parties would have done in this respect. We are concerned that this will lead to numerous disputes and recommend that the paragraph is deleted.

Comments on the Examples Found in the Annex to the Discussion Draft

General comments

The existence of examples to illustrate the guidance provided is generally valuable. However, drafting the actual examples often proves to be a difficult and delicate task. Although some examples in the Draft seem reasonable, many of them need redrafting and several of them do not appear to be sufficiently aligned with the guidance in the actual Draft.

It is important to note that in reality tax professionals and businesses will have to deal with many grey areas in relation to intangibles transfer pricing. In particular, it can be extremely difficult to find good comparables. Unfortunately, this is not apparent from the examples.

BUSINESSEUROPE recommends limiting the number of examples to not more than 10 and providing each example with a heading that clearly indicates the issue at hand. Example 2 could e.g. be provided with the following heading;

Situations where the parties actual conduct deviates from the contractual arrangement.

A limited number of examples providing more of reasoning would be of more value than using multiple examples to illustrate consequences of changes in one or several requisites. Many of the current examples seem much too focused on dealing with extreme and/or evasive situations with the only purpose of allowing for a clear-cut solution. Such examples will unfortunately seldom provide any guidance in practice.

As it stands, examples 21 and 22 illustrate this concern as both examples stipulate clearly what kind of contracts you supposedly would find between independent parties. In reality you would probably in most cases find different kinds of contracts reflecting different types of risk appetite which makes it very difficult to clearly say that it would or would not be an arm’s length behavior to have or to not have an adjustment or
renegotiation clause between dependent parties. From a guidance perspective it would be much better if the examples could be aimed more towards indicating the kind of factors that you would need to consider when performing the analysis.

In conclusion, BUSINESSEUROPE cannot support including all the examples as currently drafted in an annex to Chapter VI of the Transfer Pricing Guidelines.

**Detailed comments**

With reference to example 1 of the Discussion Draft, the development and strengthening of intangibles are considered as activities that entitle to benefit from economic returns attributable to the intangible, while conversely, a simple administrative activity to protect the trademark would merely allow an arm’s length remuneration. In section B of the Discussion Draft, functions that create an entitlement to profits attributable to intangibles are not clearly identified. It should be useful to clarify which functions grant the right to enjoy economic returns involving intangibles.

With reference to example 4 of the Discussion Draft, it would be appropriate to explain how the remuneration related to the intangibles would be allocated between the parties involved in the transaction.

Example 5 of the Discussion Draft gives emphasis to the level of expenditure related to the intangible in order to identify the parties that are entitled to benefit from economic returns attributable to the intangible. Example 5 could be redrafted focusing the attention on which party has the decisional control on the most important and strategic functions (and on consequent risks), rather than on the costs incurred to develop, enhance, maintain and protect intangibles.

Example 6 is reasonable in theory but it would be very difficult to apply in practice, and as such, it becomes unworkable. In particular, a taxpayer will not be able to find out the length of a comparable contract and the chance of that contracted being renewed. The example only works if the contract is for a fixed period and will definitely not get renewed.

Example 7 is too aggressive and could be misused. A tax authority cannot make an adjustment just because a local operating company made a loss and paid a royalty in the same year. Further, a taxpayer should not be discouraged from structuring their business in a particular way just because there are no available comparables. This example potentially goes against the 5 factors of comparable analysis, such as business environment. The example should clarify the characterisation of the distributor (i.e. does it undertake significant risk and autonomous marketing functions) so it is clear whether or not it is exposed to downside potential. Currently, this example is potentially also inconsistent with example 4, where it is suggested (in paragraph 195) that in some circumstances it is reasonable for a fully-fledged marketing company to make a loss.

Example 14 appears to be one sided. There could be a genuine business reason for this series of transactions. The example needs to be clearer as to what behaviour this
is trying to guard against. Is it that the transactions are occurring so close together? On a narrow reading of facts we agree with this example, but a slight change of facts will significantly change the TP analysis i.e. it would be useful if there was another example where the facts led to Company S being entitled to a return to goodwill with respect to Product Y.

We recommend that example 19 is deleted altogether as it appears incorrect and more importantly better suited to be in Chapter IX.

EU and other aspects

BUSINESSEUROPE would like to emphasize the importance of appropriately considering and analysing any EU-law implications within the project. Exit taxes, for one, are a concern and relevant since as many as 21 of the OECD members also are members of the EU. As concluded by the European Commission, although an unconditional deferral may resolve the immediate difference in tax treatment, double taxation or unintended taxation may still arise due to mismatches between different national rules. This can be the case e.g. where Member States apply different valuation methods.

A key objective of this project must be to eliminate international double taxation in a timely manner. Consequently, the need for consensus and equal application of transfer pricing rules in relation to intangible property in the Member States and beyond are of utmost importance. Given the severe budgetary situation in many countries, temptations to impose burdensome rules or interpretations of what constitutes appropriate prices for the transfer of intangible property must be resisted.

Furthermore, considering the complexity of this area, it is important to strike a balance between what can be perceived as a theoretically “correct” solution and what is a workable approach in practice. Again, the objective is to find a model which allocates profits and losses relating to intangible property in a reasonable way without leaving a large space for domestic interpretation, divergences and thus risk of double taxation.

BUSINESSEUROPE is happy to continue a constructive dialogue with the OECD on this topic.

On behalf of the BUSINESSEUROPE Tax Policy Group

September 13, 2012

Krister Andersson
Chairman
The CBI welcomes the opportunity to comment on the OECD Draft “Revision to the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions” published on 6 June 2012 (hereafter referred to as “the Draft”).

The issue of intangibles has been an area raising some of the most complex issues in transfer pricing. Although further work is required to reach the consensus on the different issues relating to transfer pricing for intangibles, an early publication of the Discussion Draft is a welcome step. The CBI appreciates the opportunity to comment and contribute to the current thinking of the OECD and is interested in debating these issues further in the appropriate collective forum or on a more individual basis.

As the UK’s leading business organisation, the CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

KEY MESSAGES

The CBI is broadly in agreement with Section A of the Draft subject to the amendments discussed in “Comments on different sections of the Draft” below.

Greater emphasis should be placed on legal concepts. Something can only attract a price if it can be “sold”, and it can only be sold if it is capable of being owned.

Elements, such as know-how, which are susceptible to legal protection can also be intangible assets.

It is unclear how things can be intangibles by virtue of being “controlled” but not “owned”.

In addition to the creation of brand recognition and the consistent delivery of the “brand promise”, proper weight should be given to the first step of design, which may well be the most important factor in creating a valuable asset.

Goodwill and the benefit of any long term contractual commitments in respect of an “assembled workforce” can be intangibles, although the former contributes to the value of licensed rights, while the latter does not exist purely because a workforce has been assembled.
“Group synergies” are not intangibles, but the know-how of how to achieve them can be.

The principle of entitlement should be rooted in Article 9 of the OECD Model Tax Convention and should primarily refer to comparison with comparable uncontrolled arrangements. Assumptions about how parties behave should be replaced with comparisons with uncontrolled arrangements.

The definition of intangible related return set out in the Draft is confusing and unnecessary.

The apparent emphasis on physical performance of functions seems to impose non-arm’s length arrangements on related party transactions. The requirement is also over burdensome for a tax payer to meet.

The concepts in Section B are focussed on the development of technology intangibles. They apply less clearly to the creation of marketing intangibles. They also do not work for straightforward licensing arrangements. Section B.3 and the examples do not always support the principle of entitlement, and unhelpfully introduce different concepts, particularly focussing on the amount of expenditure.

The principles of identifying and characterising transactions involving intangibles should primarily refer to comparison with comparable uncontrolled transactions. In considering the nature of transactions involving intangibles, taxpayers and tax authorities should look to what does (or would) happen in commercial transactions. Consistency should be maintained with Chapters I to III and IX of the OECD Transfer Pricing Guidelines (TPG) so that Chapter VI plays its intended role of elaborating how those principles apply for intangibles, rather than modifying them.

The CBI believes that the Draft, in particular Section D, gives considerably more scope for tax authorities to disregard or recharacterise transactions undertaken by the related parties than the guidance in Chapters I and IX. The Draft should clarify that all consideration of recharacterisation is limited by the approach and criteria laid out in these chapters.

The benefit of separately defining the Section D.1.(vi) intangible is not immediately evident. The CBI suggests that the Draft simply refers to “intangibles that affect the reliability of comparisons between the controlled transaction and otherwise comparable uncontrolled transactions.

The discussion of price adjustment clauses is disturbing as it appears to assume that unrelated third parties frequently insert price adjustment clauses into contracts where future outcomes are uncertain. However, uncontrolled parties often enter into agreements where there is great uncertainty but make no price adjustment provision. Where contingent terms are agreed, they generally do not involve any renegotiation based on information developed after the agreement has been negotiated. Instead, the contingencies are explicitly identified and valued.

COMMENTS ON DIFERENT SECTIONS OF THE DRAFT

Section A: Identifying intangibles (paragraphs 5-26)

The CBI considers that the significance of legal concepts is currently under-emphasised in the draft. The core of the definitional exercise should be that the applicable governing law, and the agreed contractual arrangements (assuming they reflect reality), provide the framework to determine whether there is an intangible and whether there would be an existing and sufficient (legal) interest in that intangible to generate a return in an arm’s length scenario.

The CBI queries whether the use of a “control” factor is useful in the opening definition of an “intangible” in paragraph 5 of the Draft. In transfer pricing, the task is to arrive at a price which would be agreed upon between independent parties for a particular transaction. For something to be capable of attracting a price, it must be capable of being “sold”. This includes legal forms of exploitation other than outright sale of ownership, e.g. licensing. Furthermore, for something to

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1 Which could include informal/unwritten licensing as in example 12 of the Draft.
be capable of being “sold”, it must be capable of being owned by the “seller”, i.e. a potential purchaser at arm’s length will not pay for something which has no legal existence. Certain classes of intangibles may have a fragile “form of ownership”, such that the intangible may be dissipated due to extraneous circumstances. An example is know-how which loses any dimension of exclusiveness once the relevant information becomes known by a third party. Nonetheless, know-how is susceptible to certain forms of legal protection, e.g. confidentiality obligations imposed by contract. Therefore, the paragraph 5 definition might usefully be extended to include items which are “susceptible to legal protection”, as well as assets which are more conventionally capable of being owned. However, the CBI does not readily see what classes of intangibles could fall within the scope of transfer pricing analysis (in circumstances where not “owned”) by virtue of being “controlled”.

21 Given the fundamental definitional importance of paragraph 5 of the Draft, the CBI believes that the second sentence of the paragraph unhelpfully blends two separate concepts. The phrase “rather than focusing on accounting or legal definitions” does indeed go to the definitional task, but may be taken as rejecting or diminishing the potential significance of the accounting treatment or legal concepts. On the contrary, the CBI regards the legal concepts as being of central importance since parties at arm’s length will only pay for something which is capable of legal protection. On the other hand, the CBI does not regard the accounting definitions as being of compelling importance at the definition stage (although these definitions are often usefully taken into account in determining the economic value and thus, the existence of legal rights of some sort). The second part of the second sentence in paragraph 5, however, whilst unobjectionable in content, concerns pricing and not the identification of relevant intangibles, and therefore could belong more appropriately in Section D of the Draft.

22 Brands are increasingly important in modern commercial operations and thus it is important to accurately represent what a brand is. The CBI agrees with the core comment of paragraph 19 of the Draft that a brand represents a combination of intangibles. This is a normal position rather than an exception. However, the wording of paragraph 19 might be read as suggesting that the normal position is that either the sole, or most significant aspect, of a brand is its visible representation in the form of a trademark or trade name. The section heading “Trademarks, trade names and brands” itself might give this impression. Furthermore, the listing of component intangibles excludes a reference to know-how, whereas know-how is often the most significant component of a brand.

23 The CBI notes that the creation of a successful brand comprises three key components:

a  the first component is the design of something (e.g. a product or a standardised business format) which is capable of creating a sense of attachment in a particular segment of the market. This might be because it fits in with how the people concerned view themselves; or how they want to be viewed; or simply because it fits in with what they enjoy. The level of analysis, market understanding, design capability and other know-how involved in this design phase should not be underestimated, in particular, where what has to be produced is complex and requires consistency between all components of the product or service in order to be effective. A single incongruous aspect can destroy the effectiveness of the brand design, for example, if it conflicts with the luxury good positioning of a product;

b  the second component is the creation of brand recognition via advertising, and the association of the brand concept in ‘a’ above, with particular trade names and trademarks; and

c  the third component is a consistent delivery on the ‘brand promise’ (i.e. the things designed in step ‘a’ above which create the attachment). This will often include not just delivery of what is initially created, but also the need for regular update and modification in order to keep delivering as technology or fashions change (particularly if part of the promise is to deliver a sense of being at the forefront of new technology, e.g. Apple).
24 Notwithstanding the ‘combination’ wording included in paragraph 19, the Draft and examples, e.g. example 3, convey a picture of a brand as just comprising the component ‘b’ above. The CBI believes that the emphasis of paragraph 19 should be amended to correct this, including an indication that the interchangeable use with ‘trademark’ and ‘trade name’ is generally inaccurate. It is the CBI’s view that brands should be captured under a separate heading rather than sub-sectioned within the trade names and trademarks section.

25 The CBI agrees that in principle goodwill should be regarded as an intangible, although it may be difficult or even impossible to transfer goodwill in isolation from the assets and undertaking of a business. Nonetheless, goodwill may be transferred as part of a bundle of assets, and its value is clearly capable of attracting a higher price for that bundle of assets from an arm’s length purchaser. Goodwill may also be susceptible to legal protection, for example, by way of an action in tort for passing off. On the other hand, in circumstances where goodwill itself is not a subject of a sale or a transfer, but may nonetheless influence the value of other intangible rights that are the subject of a transaction (as in the trademark licence example given above), the CBI believes that the identification of goodwill as a relevant intangible should not form part of the analytical process. While goodwill may contribute to the value of licensed rights, this is relevant to the pricing of the licensing transaction and not to the identification of the relevant intangible (in the trademark example, the trademark rights).

26 The CBI agrees that “group synergies” should not be regarded as an intangible within the meaning of Section A of the Draft. However, as noted above, the CBI doubts the utility of the “control” concept in the last sentence of paragraph 23 of the Draft.

27 Regarding “assembled workforce”, the CBI considers that the mere fact of a particular group of “uniquely qualified or experienced” employees should not by itself be regarded as an intangible. However, it should be noted that contractual rights are entirely capable of being intangibles within the meaning of Section A of the Draft. Thus, the benefit of a long term contractual commitment by a person to make available the services of a group of employees may constitute an intangible in the hands of the beneficiary of that commitment. If particular provisions in the service contracts of employees contain, or come to contain, net value, that may demonstrate that the contractual rights in question represent an intangible which is capable of forming the subject of a transaction which could be subject to transfer pricing analysis. For example, star footballers’ contracts may represent significantly valuable assets for their employer. The existence of intangibles, based upon legal rights and obligations, should not, however, be confused with valuation questions and pricing.

Section B: Identification of Parties Entitled to Intangible Related Returns (paragraphs 27-56)

28 The CBI believes that the principle adopted for determining entitlement to intangible related returns is critically important. The Draft includes the following statement:

“Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.”

29 The CBI agrees with the first sentence. However, the second sentence suggests that in order to determine “assets used” in keeping with the first sentence, some consideration needs to be paid to ownership; to determine “risks assumed” in keeping with the first sentence, some consideration needs to be paid to financial risk. It is an uncontroversial observation of arm’s length arrangements that a party which is the legal owner and makes investment is likely to have some interest in the benefits or returns arising. The key is whether there can be functions performed, assets used, and risks assumed by parties other than the investor and legal owner which would, in comparable arm’s length situations, give rise to a benefit or return with respect to the intangibles. The CBI believes that this point should be clarified in the Draft. The CBI’s suggestions below may help in providing clearer guidance.
Section B could be improved by adding guidance that the transfer pricing analysis should be started by reference to a comparison with comparable uncontrolled arrangements. The CBI believes that the principle of entitlement should be rooted in Article 9 of the OECD Model Tax Convention and should refer to comparison with third party arrangements. Such an approach would be similar to that adopted in Chapter IX (some of the principles of which have been incorporated into the Draft) when considering risk allocation. Chapter IX requires comparison with third party agreements. Only in cases where the third party comparables are inconclusive, it is a requirement to consider which party controls risk (see 9.18 of TPG). In the Draft, the principle of entitlement gives primacy to control of risks, functions and costs. This can cause uncertainty because the required level of control and decision-making is not well understood and there is no guidance on how it can be monitored and documented. In addition, large MNEs can have transnational committees exercising control. In these cases the control cannot be easily mapped to legal entities, as the Draft requires.

The CBI suggests that the principle should be:

a. Is there evidence of similar entitlement to intangible related costs and return in comparable uncontrolled transactions? If so, these comparables should be sufficient to assess the consistency of the entitlement with the arm’s length principle.

b. If no reliable comparables can be found to support the determination of entitlement, further analysis is required to determine whether the entitlement is one that might have been expected to have been agreed between independent parties in similar circumstances.

c. The further analysis focuses on which parties perform functions, bear costs and control risks, and applies similar standards to those in Chapter IX in evaluating control over risks and decision making.

The above decision tree deals with a situation which the Draft finds challenging, i.e. how to deal with a party which bears costs. If the entitlement meets the comparability requirements in step 1, that should be the primary test. If no reliable comparisons can be found, the decision tree moves to consider the performance of functions and control of risks. Even if the party outsources functions relating to the development and enhancement of the intangible, it will participate in the intangible related returns if it performs the control functions set out in 9.23 of the TPG. If it does not satisfy this requirement, the draft should make clear the consequences. Presumably it should then be entitled to a finance-type return taking into account the risk of the investment. Subsequently, that cost should be taken into account in computing the remaining intangible related return.

In paragraph 28 of the Draft, the CBI believes that the definition of intangible related returns could be improved. As drafted, the definition describes the process of performing a residual profit split. It confuses the principle of identifying the party entitled to the return with measurement of that return. It is unclear as to how a simple licensing arrangement would fit with this definition. In addition, the definition assumes that all profit is either intangible profit or routine profit. However, the Draft elsewhere points out that there are other sources of excess profits arising from features which fall short of intangibles (e.g. paragraph 124 of the Draft). As such, there is a need for a detailed definition of intangible related return as the current draft only deals with which party should receive any return to the intangible, whether that return is positive, negative, or zero.

In paragraph 29 of the Draft, the CBI believes that there are several conceptual points which are not adequately signposted. Firstly, the determination should refer to arrangements in comparable uncontrolled transactions since this is a basic premise of any transfer pricing analysis. Secondly, the paragraph bundles together the concepts of “developing, enhancing, maintaining, and protecting” intangibles as if these activities always go together and have equal importance. These activities are not discussed in detail in the Draft, but the Draft would benefit from a greater separation of these activities. Thirdly, when considering costs incurred, the concept of “past, present, and future” needs to be considered. At present it is not clear as to how the party responsible for past and future costs would be rewarded in the analysis.
35 In paragraph 36 of the Draft, the CBI is unclear as to what is meant by “document”. Is this just saying a contract should be in place, or is it also suggesting that the rationale for the decision should also be documented? If the former, it is often not possible to complete the formal contracts before the transaction takes place. If the latter, then the requirement is likely to be onerous, and greater clarity will be required. It is unclear how rights can be allocated before the intangible has been developed.

36 In paragraphs 38 and 40 of the Draft presumptions are made about conduct of parties. These presumptions appear to have no evidence. There is no reference as to how parties behave in uncontrolled situations, and this absence is curious. By requiring physical performance of functions, the Draft may be forcing non-arm’s length behaviour in related party transactions.

37 In addition, the CBI believes that paragraph 40 of the Draft introduces uncertainty over which functions are important. An apparently extensive view of which functions are required may place restrictions on outsourcing, contrary to the third party behaviour.

38 With regards to paragraph 43, the CBI notes that some of the risks cannot be “controlled”. As such, “control” cannot be used to assist in determining which party is entitled to the return without further clarification. In addition, if the list is extended to brands, often external factors can affect the perception of a brand. As such, if “control” continues to be used, it needs to recognize that some of the risks cannot be directly controlled. This concept is similar to that in 9.23 of TPG and refers to the capacity to make decisions to take on risk and whether and how one manages the risks.

39 The CBI believes that Section B.3 could be improved. In particular, the CBI notes that the conclusions reached in paragraphs 54 and 55 of the Draft are not consistent with the principles developed in Section B.3 (see comment 22 above setting out the decision tree starting with comparisons with uncontrolled arrangements as the primary test). It is CBI’s view that the principles in Section B should determine whether a party has an entitlement to the intangible related return. Those principles should focus on legal agreements, performance of functions, and control of functions and risks. The amount of expenditure is not a factor which creates entitlement.

40 Similarly, the CBI believes that the conclusion in paragraph 51 of the Draft is incorrect. As noted above, under the principles of Section B, the expenditure is not the determining factor which creates entitlement. It is the control of the functions and risk that are. The example confuses quantum of the reward with the principle of entitlement.

41 The CBI considers that paragraph 53 of the Draft is not a true reflection of 1.64-69 of TPG. Recharacterisation in Chapter I deals with discrepancies between form and substance and with non-commercial arrangements. In paragraph 53, the form and substance are stated to be aligned, but the tax authorities can still disregard the arrangements. The paragraph introduces scope for recharacterisation not authorised by Chapter I.

Examples 1-11

42 Example 1: This example is helpful. However, it points to a problem with the definitional concepts in Section B. The example works because intangible development and enhancement are seen as the functions giving rise to intangible related returns, whereas protection does not. However, as noted above, in Section B there is no distinction between development, enhancement, maintenance and protection.

43 Example 2: This example may reach the right conclusion, but it does not illustrate the conceptual steps in Section B that are required to test entitlement. The example should explain what rights Company S has been granted under the contract, how that contract compares to uncontrolled arrangements, which party has performed development and enhancement functions, and which party controls those functions and related risks.
Example 3: The conclusion to this example in paragraph 192 of the Draft needs to relate back to the principles of Section B, i.e. the contract is comparable to uncontrolled arrangements, Primair bears costs and controls functions.

Example 4: This example does not demonstrate how the principles of Section B would allocate an intangible related reward to Primair. It should be entitled to something. In paragraph 196 of the Draft the reference to the level of Company S’s marketing expenses is introduced, but the level of expenses has no place in the conceptual entitlement to return in Section B.

Examples 5, 6 and 7: These examples illustrate no principle previously defined. In fact, the level of expenditure is now used to override the principles previously explained based on functions and control.

Example 8: Despite Company S meeting the entitlement principles in Section B, the example concludes that it should be compensated by the parent. This conclusion cannot be reconciled with Section B.

Example 9: This is a helpful example. It would be even more interesting if the “Shuyona R&D centre” were not a legal entity, but a function across legal entities.

Example 10: This is a helpful example, particularly since the “general policy direction” in paragraph 218 of the Draft is not seen as exerting control.

Example 11: This example could potentially be useful. There is a general concern that the example should not be seen as making any comment on bona fide CCAs. In addition, the disqualification of Company T comes down to having no capacity to “conduct or supervise” the research activities (paragraph 223 of the Draft). However, the wording of the example does not seem to be right since the principles of Section B make it clear that Company T does not have to perform the activities. Under 9.23 and 9.24 of TPG, on which Section B relies, the issue is whether Company T has the capacity to make decisions to take on risk and whether and how to manage the risk, and whether it can assess the outcomes of the R&D activities outsourced.

CBI Examples

51 The CBI has set out below several examples illustrating a suggested process for determining and supporting entitlement to intangible related returns, focusing on marketing intangibles. The core principle the examples seek to highlight is that if a taxpayer can identify evidence of similar entitlement to intangible related costs and returns, the comparable should be sufficient to assess the consistency of the entitlement with the arm’s length principle. It is only when the taxpayer is unable to find suitable comparables that a more detailed approach is required.

52 Otaki Limited (“OL”) is a global entertainment group composed of three divisions: cinemas; music concerts; and sporting events. OL customers can purchase tickets to films either online or at their local cinema. All tickets for the music concerts and sporting events divisions are sold online. The leadership of the Cinema division, based in country A, enter into an arrangement for a third-party company to develop and maintain a smart-phone application (“App”) which enables Otaki’s customers to purchase cinema tickets using mobile phones. In exchange for development and day-to-day maintenance of the Cinema App, the third-party retains 10% of the ticket revenue processed by the App. The Cinema App is very popular and quickly becomes a key sales channel for OL.

Example 1 – Internal comparable, no further support required

53 Based on the success of the Cinema App, OL decides to develop a similar App for its music concert division. OL is concerned about the level of payments it is making to the third-party company which developed and maintains the Cinema App, so it creates its own App subsidiary (“App Co”) in country B to develop and maintain the Music App. After a functional analysis, Otaki Group determines that App Co’s functions, risks and assets are sufficiently similar to the third party company used for the Cinema App and it is therefore entitled to the same 10% of revenue return.
As OL has identified a similar transaction which sets out the entitlement to intangible related costs and return, being the potential Comparable Uncontrolled Price (“CUP”), it has a basis for supporting the transaction and no further analysis may be required.

**Example 2 – External comparables, no further support required**

54 After a failed trial of an App for its sporting events division, OL undertakes a global customer survey and discovers that many of its customers would prefer to purchase their sporting event tickets in person at a local ticket office. OL group establishes a world-wide network of small ticket booths in malls and other high foot traffic locations to sell tickets. The ticket booths have local staff that use OL’s existing internet site to book the customer tickets, and print the tickets out in-store for the customer. OL commission a benchmarking study to determine the appropriate return for the ticket booth operations. OL identifies local ticket booth competitors and concludes that these comparables have similar functions, risks and assets to the local ticket booth operations. Accordingly, it uses the returns of these competitors to support the arm’s length nature of the ticket booth operations. As with Example 1, no further support is required to demonstrate compliance with the arm’s length principle.

**Example 3 – External comparables, no further support required**

55 In country Z, a key market for OL, ticket booth sales are sluggish. Country Z management decide to increase local marketing spend. OL reviews the functions, risk, and assets of the country Z subsidiary and concludes that the change in policy has not resulted in the creation of local marketing intangibles, and that the existing benchmarking results, from Example 2, are still appropriate. Accordingly, the country Z subsidiary is not entitled to any additional intangible related returns.

**Example 4 – No external comparables, further support required**

56 Despite the additional advertising spend, ticket sales at the ticket booths in country Z continue to be below expectations. Local management suggests that the brand does not resonate with the local market and that it needs to be changed and a significant re-launch needs to be undertaken. OL authorises country Z to engage a local marketing agency to develop a new brand, marketing strategy and advertising campaign. Country Z bears the cost of the marketing initiative, including a substantial television advertising buy. Country Z also takes steps to protect the new brand from infringement. The local ticket booths are authorised to start selling tickets for third parties and are paid bonuses if they successfully establish new third-party relationships. As a result of these activities, country Z’s ticket booths substantially increase both revenue and profits.

57 After analysis, OL determines that country Z now performs and controls functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. Accordingly, the existing benchmarking support for country Z’s operations is no longer appropriate. Furthermore, OL is unable to identify any other support for the new arrangements. As such, OL applies the principles set out in the TPG to determine the functions, risks and assets employed by country Z as compared to those contributed by OL. The intercompany arrangements between OL and country Z are amended to reflect the conclusions of the detailed analysis which included considering guidance set out in Chapter IX of the TPG.

**Section C: Transactions involving the use or transfer of intangibles (paragraphs 57- 76)**

58 The CBI agrees that the characterisation of a transaction as requiring an “intangible related return” for transfer pricing purposes does not mean that that return should be treated as a royalty for the purposes of Article 12 of the OECD Model Tax Convention.

59 The CBI also agrees that the comparability analysis of service transactions or sales of goods needs to evaluate and take into account what intangibles are used in connection with such sales of goods or services.
60 The CBI agrees that in certain circumstances combinations of intangibles may be more valuable than the sum of the individual intangibles. In the example given in paragraph 68 of the Draft it is suggested that transfer pricing analysis will necessarily require a detailed analysis of the intangibles and their contribution to value creation. The preliminary issue however is one of identification of comparables. Only if a reliable comparable for the combination does not exist would it be necessary to undertake further analysis of the intangibles (including risks, functions etc.) to determine whether the intangible return of the combination would be greater than that of its constituent parts, and how that should be taken into account in determining an entitlement to an intangible related return.

61 In addition, the CBI notes that the statement in paragraph 68 of the Draft that “interactions between each of these classes of intangibles, as well as which parties incurred the risks and costs associated with securing the intangibles, are therefore very important in performing a transfer pricing analysis” appears at odds with the statement in paragraph 47 of the Draft that the bearing of costs relating to intangibles does not of itself create an entitlement to an intangible related return.

62 The CBI recognizes that a more detailed analysis may be required where intangibles which have a combination or ‘marriage’ value can be, and are, separated with a view to reducing an aggregate value. Even here, however, the first reference point should be to seek appropriate comparables for the separate parts, as appropriate comparables normally reflect the prospect of realising a marriage. The CBI agrees that it is important to identify situations where taxpayers or tax authorities seek to artificially separate intangibles that, as a matter of substance, cannot be separated.

63 With regard to the transfers of intangibles in combination with other business transactions, the description of “business franchising” in paragraph 73 of the Draft refers to a combination of services and intangibles being made available for a single fee. In practice between third parties, this is not usually the case. Separately identifiable service fees and royalties are normally charged since royalties (or single fees covering both service and intangible provision) are typically subject to withholding taxes and services fees are generally not.

64 Nevertheless, in certain circumstances, a combined supply of intangibles and services may be put in place not least to simplify charging structures between related parties. As noted above in relation to combinations of intangibles, these combinations may sometimes be more valuable than the sum of the parts. For example, this may arise because there is an additional know-how component concerning how to effectively combine the component pieces, or because of pricing benefits of more efficient procurement.

65 It is important to note that where franchising of a business format is concerned, the knowledge concerning how the various components best fit together to create an enhanced value is itself a valuable intangible (i.e. know-how).

Examples 12-17

66 Example 12: the assessment of the conduct of the parties in the determination of the amount of the intangible related return is consistent with the principles outlined in 1.53 of TPG.

67 Example 13: in accordance with the comments above in respect of goodwill, the CBI agrees that the intangible value of goodwill attributable to the branch business needs to be taken into account in considering what an uncontrolled price would be for the transfer of that branch business to Company S. The CBI notes, however, that this example raises difficult questions concerning how much of that goodwill is attributable to the branch and the head office. If the valuation is made by notionally considering the branch as a separate entity which enters into an arm’s length arrangement (assessed by reference to comparable uncontrolled transactions) with its head office for the licensing of Ilcha’s intangibles, then such a licence would often specify that goodwill in the trademark remains with the licensor. Irrespective of that contractual point, it also needs to be
recognized that, in the modern world, the value of the trademark and other brand intangibles in
country B may be influenced as much by what is done outside country B (but is known in country B)
as by what is done in country B. The goodwill attributable to the branch (e.g. arising from its local
conduct of the business and associated reputation) will therefore need to exclude components of
total goodwill which are attributable to the head office rights and activities.

68 Examples 14-17: the CBI has no substantive comments.

69 Examples 15: paragraph 238 of the Draft notes that given the proximity of the external and internal
transactions, the purchase price paid by Birincil for Company T is of direct relevance. However, the
definitions and valuations of the intangibles used for accounting purposes are not so relevant for
transfer pricing purposes. Nevertheless, an awareness of inputs into and method of calculation of
the accounting valuations could be used in assessing the transfer pricing aspects of the post-
acquisition restructuring.

70 In Example 15, the CBI believes that it would be helpful to give more commentary as to the
rationale for Company T’s entitlement to a return in respect of the part of the purchase price
allocated to goodwill that is retained in Company T. If the workforce retained in Company T
provides services which Company S or external parties are either not capable of performing or
performs them not as efficiently as Company T, this should be taken into account as a
comparability factor (as outlined in paragraph 25 of the Draft) in the transfer pricing assessment of
the services provided by Company T to Company S. As Company T presumably has little or no
tangible assets, it should be considered whether the value retained by Company T represents an
intangible asset such as goodwill or is a comparability factor to be taken into account when pricing
the services provided by Company T.

71 Example 16: the CBI concurs that Company S has both received services from Zhu’s employees and
benefited from the use of Zhu’s software. This needs to be taken into account in considering the
total price to be paid by Company S to Zhu. However, the extent to which Company S was required
to tailor the software to apply it to Bank B should also be taken into account in determining the
intangible return paid to Zhu.

Section D: Determining Arm’s Length Conditions in Cases involving Intangibles (paragraphs 77-181)

72 The CBI believes that the Draft, in particular Section D, gives considerably more scope for tax
authorities to disregard or recharacterise transactions undertaken by the related parties than the
guidance in Chapters I and IX. The Draft should clarify that all consideration of recharacterisation is
limited by the approach and criteria laid out in these chapters.

73 The concept of “realistic alternatives” is defined very broadly in section D.1.(i) of the Draft. This is
likely to invite disputes not just between taxpayers and a tax authority, but among different tax
authorities. The original discussion of the concept of options realistically available in paragraph 1.34
of the TPG envisioned a more general use of “options realistically available”, i.e. as one factor
relevant to the comparability analysis. The CBI believes that the concept of realistic alternatives
should be retained as a comparability criterion but not as a way to test the validity of the
transaction.

74 The CBI suggests revising paragraph 81 of the Draft since there are often circumstances where a
one-sided comparability analysis may be appropriate, for example, when routine functions are
involved and the residual profit split methodology of the TPG is utilized.

75 Throughout the Section D.2., the Draft goes out of its way to state that certain valuations (such as
those done for purchase price accounting) have “no” relevance for transfer pricing. However, it
should be noted that the valuation techniques used in financial statement analyses are not
different in substance from valuation approaches used in economics and business generally. The
Draft therefore should provide explicit direction that the “most appropriate” method should be
used. In addition, it should specify that the approaches used in valuation/purchase price accounting
may or may not be the most appropriate method, based on the specific facts and circumstances of the intangible transfer at issue.

76 With regards to paragraphs 95 and 166 of the Draft, the CBI suggests that there are several examples where it is reasonable for an intangible to have an indefinite life, particularly when an appropriate on-going development and investment is made. Often a commercial valuation of an intangible asset (between independent parties) utilizes the concept of terminal value, which is often based on a capitalization formula that assumes cash flows into perpetuity. The consequence of retaining the current wording could be to misalign well-established commercial practices with a transfer pricing study and hence could lead to controversy between tax administrations and tax payers.

77 In paragraph 105, the Draft introduces a specific type of intangible – the “Section D.1.(vi) intangible.” The benefit of separately defining the Section D.1.(vi) intangible is not immediately evident. The CBI suggests that the Draft simply refers to “intangibles that affect the reliability of comparisons between the controlled transaction and otherwise comparable uncontrolled transactions.”

78 Paragraph 108 of the Draft appears to place too much emphasis on cautioning away from the use of the profit split method. Under certain circumstances it may be reasonable to allocate a routine return to one entity or entities and have the residual profit going to the counter party or parties.

79 While the CBI empathizes with paragraph 116 of the Draft that a general “rule of thumb” does not provide an adequate substitute for a complete comparability analysis, the CBI considers that general rules of thumb should be recognized for intangibles. An application of rules of thumb is acceptable in certain instances and often has commercial and empirical evidence to support its reasonableness in a transfer pricing context.

80 With regards to paragraph 136 of Draft, the CBI suggests that valuation techniques can often be more than useful but rather most appropriate in certain circumstances given their widespread use in commercial markets and by tax administrations and tax payers in current transfer pricing practices.

81 In Section D.4.(vi), the Draft suggests that when the valuation of an intangible is highly uncertain at the time of the transaction, tax authorities might reasonably impute price adjustment clauses. This discussion is disturbing as it appears to assume that unrelated third parties frequently insert price adjustment clauses into contracts where future outcomes are uncertain. However, uncontrolled parties often enter into agreements where there is great uncertainty but make no price adjustment provision. Where contingent terms are agreed, they generally do not involve any renegotiation based on information developed after the agreement has been negotiated. Instead, the contingencies are explicitly identified and valued. Any price adjustment needs to take into account the valuation of the entire deal at the time of the contract, and not just the price going forward.

Examples 18-22

82 Example 19: the CBI suggests that Example 19 of the Draft is removed. The CBI considers that such an example is more suitable in Chapter IX of the TPG. Also, the narrative of the example is difficult to follow and reconcile the conclusions thereof.

83 As a general observation with regards to the examples, the CBI believes that they should clearly demonstrate the principles of Section D of the Draft while having regard to the commercial realities of how multinationals operate by not being overly theoretical, as currently written.
Dear Mr. Andrus,

“Transfer Pricing Centre” Association (“TPCA”) is newly established non-profit organization aimed at promoting transfer pricing knowledge in Poland. The association was founded by specialists working for capital groups in Poland, mainly in energy and industry sector.

TPCA welcomes the opportunity to provide comments on the Public Discussion Draft “Revision of the special considerations for intangibles in chapter VI of the OECD Transfer Pricing Guidelines and related provisions” (the “Discussion Draft” or “DD”). We appreciate the Discussion Draft provided by the OECD and the economic principle of determination of returns attributable to intangibles as well as examples illustrating the application of the provisions resulting from Chapter VI of the Transfer Pricing Guidelines (“TPG” or “Guidelines”). On forthcoming pages, we present the summary of our comments on selected issues from the Discussion Draft, followed by detailed comments on our remarks and concerns.

We wish to thank the Transfer Pricing Unit and the Working Party No 6 of the OECD for the opportunity to express our views on the considerations for intangibles and for the work pursued to clarify the related valuation aspects. We are at your disposal to discuss any aspect of our comments. We look forward to developments and further discussions on the considerations for intangibles.

Yours faithfully,

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Summary of the most important comments presented in TPCA opinion

A. Comments on Section B of Discussion Draft: Determination of returns attributable to intangibles based on relevant functions, assets and risks – Comments to the question posed by the Working Party No 6

- The concept of “intangible related returns” and “economic return” may raise some interpretation difficulties. TPCA would welcome more guidance on the manner in which intangible related returns should be translated into the arm’s length remuneration and when the calculation of intangible related return is required.

- We agree with the general principle intangible related returns should be determined on the basis of relevant functions, assets and risks. We observe, however, that the Discussion Draft deals with functions, risks and costs, while comments on assets are missing. In TPCA opinion, costs can be regarded as derivative to functions, assets and risks, therefore complete analysis should also involve assets employed.

- TPCA presents some concerns related to the concept of an MNE member having certain functions performed by associated enterprise in return for arm’s length remuneration where that MNE member still maintains the right to the intangible related returns. We propose to develop commentary on key / important and control functions that are critical for MNE member to maintain the right to intangible related returns. We suggest to revise the draft with regard to outsourcing of functions as an almost standard option – particularly with respect to development and enhancement of intangibles. We believe that outsourcing should be treated with caution and analysed on case by case basis. In our opinion, there are cases in which a subcontractor might be entitled to acquire certain rights to intangible related returns for functions performed, which solution should be treated as a parallel to the arm’s length remuneration.

- Attribution of intangible related returns based on functions, risks and costs related to development, enhancement, maintenance or protection of intangibles might constitute simplistic approach and may lead to results that would not have been agreed between independent parties. We would appreciate supplementing Guidelines with more examples of functions related to development, enhancement, maintenance and protection of intangibles that could be used for various categories of intangibles and their impact on the right to intangible related returns.

B. Other comments

- We agree that in the case of “non-unique” intangibles comparability analysis might be feasible and defendable in certain circumstances. We fear, however, that in the case of “unique intangibles” – identification of comparable transactions seems hardly possible, while adjustments seem to carry a risk of significant error. TPCA would welcome more guidance with regard to comparability of transactions involving the use or transfer of intangibles and adjusting comparable date for those transactions.
TPCA sees need for more guidance on the issue when valuation techniques may be used for transfer pricing purposes and whether they are apt to estimate arm’s length results. We would recommend stating the status of valuation techniques for the purposes of transfer pricing analysis in relation to the OECD approved methods.

In our opinion, the purpose of valuation is not a sufficient determinant for acceptance or rejection of valuation results for transfer pricing purposes. We recognise the assumptions adopted in valuations as a critical factor affecting the reliability of valuations. The assumptions underlying valuations should be verified from transfer pricing and business perspective.

We believe that the 25% rule or other statistical rules should not be discouraged in cases involving intangibles since in many situations they give the only rational solution for determining distribution of profits. They are based on observations concerning actual data and therefore may be treated as representation of what would possibly be agreed between independent parties and thus follow the main transfer pricing concept.

Distinction between the terms “the use of intangible” and “transfer of intangible” might cause a lot of problems related to (i) the legal classification of licence transactions as “use of intangibles” and (ii) TPG classification as “transfer of intangibles”.

TPCA would appreciate clarification of some new wording presented in the DD and collateral changes to the TPG Glossary section.

Below please find the detailed comments on the Discussion Draft.
A. Determination of returns attributable to intangibles based on relevant functions, assets and risks – Question posed by the Working Party No 6

In the Discussion Draft business was requested to comment as to whether the formulation contained in section B. successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks.

1. Economic principles of “returns that are attributable to intangibles within an MNE group”; Analysis of assets; Identification of Parties Entitled to Intangible Related Returns

DD intends to provide guidance on the attribution of returns to intangibles, i.e. identification of parties entitled to intangible related returns. However, the concept of intangible related returns as presented in the DD (paragraph 28) may raise some interpretation difficulties. The concept relates to “economic return from business operations involving the use of [...] intangible after deducting (i) costs and expenses related to relevant business operations; and (ii) returns to business functions, assets other than the particular intangible in question, and risk [...]”.

The term “economic return” is a very new term in the meaning of TPG. We suppose it is a “loss” or “profit” “attributable to a particular intangible”, but it is not precised in which meaning the word “economic” was used in this case. It is equally important “what we deduct” and from what basis – from “profit/loss” or maybe “cash flow”.

The definition relates only to the use of intangibles and not to their transfer. We wonder whether such wording was intentional, as according to section C.1 and C.2:

- use of intangible applies in situations where there is no transfer of intangible or rights in the intangible (DD paragraph 59);
- transfer of intangible may encompass all the rights (e.g. sale) or only limited rights (e.g. licence) (DD paragraph 62).

We believe that attribution of intangible related returns should refer to transactions involving both the use and transfer of intangibles.

When explaining the concept of “intangible related returns” the Working Party expresses that returns should follow the contributions to the value of intangibles (page 12, in the box with statement of the Working Party). In our opinion, contributions to the value of a transaction subject should be followed and not “contributions to the value of intangible”, since the Chapter VI of the Guidelines should be consistent with other sections of the Guidelines and should not depart from the principles of Article 9 of the Model Tax Convention.

We observe that many transactions (also with independent parties) may influence “the economic return” from business operations involving the use or transfer of intangibles. In the definition of the intangible related return in DD paragraph 28, we notice that a new approach is proposed that does not refer to establishing arm’s length result of a transaction. It is proposed that intangible related returns should be defined but we see little guidance on the manner in which those intangible related returns should be translated into the arm’s length remuneration in a transaction involving the use or transfer of intangibles and in which situations the calculation of intangible related return is required.
TPCA agrees with the general principle that returns attributable to intangibles within an MNE group should be determined and allocated on the basis of relevant functions, assets and risks (“F-A-R”) of both (or more) parties to the transaction involving the use or transfer of intangibles – this principle corresponds to the general approach provided for in the Guidelines. We observe, however, that the Discussion Draft deals with functions, risks and costs (“F-R-C”) and not assets (e.g. DD paragraph 37, section B.2).

Therefore, we would like to pose the question whether in the case of transactions involving the use or transfer of intangibles the analysis should be focused on F-R-C or F-A-R. This is a fundamental question and if the F-R-C analysis reflects the OECD approach for transactions involving the use or transfer of intangibles, more justification should be given for resigning from the typical functional analysis relating also to assets employed by the parties to a transaction.

We strongly agree with the notion expressed in DD paragraph 46 stating that bearing the costs related to the development, enhancement, maintenance and protection of intangibles does not create an entitlement to intangible related returns. In our opinion, costs can be regarded as a derivative dependent on the way we employ assets, perform functions and bear/insure the risks. Therefore, analysis of assets is also crucial in cases involving intangibles.

We would like to underline that in the DD the concept of F-R-C relates only to development, enhancement, maintenance and protection of intangibles. We notice that DD treats F-R-C related only to development, enhancement, maintenance and protection of intangibles as decisive factors in terms of the entitlement to intangible related returns. We see a risk that such approach might be too narrow and might lead to not arm’s length results. When we take an example of a license agreement involving intangible where the licensor performs and controls F-R-C related to development, enhancement, maintenance and protection of that intangible (which is very popular in unrelated transactions), we might conclude based on the DD that the intangible related return be attributed to the licensor. However, DD paragraph 35 states that the licensee will be entitled to intangible related returns attributable to its licensed rights, subject to its obligation to provide arm’s length compensation for the grant of the license. Based on this very simple example we can see that F-R-C analysis limited only to development, enhancement, maintenance and protection of intangibles can lead to a result which would not be accepted by independent parties.

We are also concerned by the new notion introduced in DD paragraph 54 under which in order to be entitled to intangible related returns a member of an MNE group should in particular bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns. We would welcome more information on what kind of costs or risks are to be covered by this statement and to revise whether they are really decisive in the process of defining entitlement to intangible related returns.

Therefore, we would like to ask for more guidance on how to attribute intangible related returns within an MNE group on the basis of relevant functions, assets and risks (not limited to those related to development, enhancement, maintenance and protection of intangibles).
2. Valuation of intangibles or valuation or transactions that involve the use or transfer of intangibles.

Based on the current wording of the Chapter VI we understand that its aim is to comment on the valuation (pricing) of transactions that involve the use or transfer of intangibles. In 2010 TPG paragraph 6.1. we read: “This Chapter discusses special considerations that arise in seeking to establish whether the conditions made or imposed in transactions between associated enterprises involving intangible property reflects the arm’s length dealings. [...] The chapter discusses the application of appropriate methods under the arm’s length principle for establishing transfer pricing transactions involving intangible property used in commercial activities, including marketing activities.”

While for the purpose of determination of the transfer price for the use or transfer of an intangible, we find it fully reasonable to verify first the value of such intangible, we have the impression, however, that in several sections of the Discussion Draft the considerations focus on the value of an intangible itself or even MNE’s value without making a clear link to the pricing in the transaction that involves certain intangible (e.g. DD paragraph 9; the value of the intangible should be recognized as one of the factors involving the value of a transaction involving the use or transfer of intangibles). We believe that on introducing new version of Chapter VI it is advisable to avoid any unnecessary confusion. It would be worthwhile, therefore, to highlight the reason for analysing the role of intangibles in related party transactions and the aim of starting from this perspective before moving subsequently to the analysis of transactions involving the use or transfer of intangibles. Such introductory comments might be included at the beginning of section B (DD paragraphs 27-29), before moving to details presented in B.1, B.2, and so forth.

3. Registrations and contractual arrangements

It might be of benefit to underline the significance of written documentation also due to the reason that development and enhancement of intangibles and their value is very often a long-lasting process with uncertain outcome at its beginning. It is advisable, therefore, to have clear evidence of which party took the burden of developing the intangibles including the imbedded risk. As mentioned before, we observe that the value of intangibles may be affected by many transactions and / or operations. Therefore, documentation allowing to assess, which party and how contributed to the existence of particular intangible may help to eliminate unnecessary disputes and ex post analysis, which by definition do not involve the uncertainty present at design stage.

It should also be stressed that the circumstances of commencement the development of a certain intangible, as well as circumstances of newcomers joining a group developing the intangible or finally circumstances of transfer of such intangible (either completed or under development) vs. the moment in its lifecycle may have crucial impact on expected return from such intangible and thus the remuneration in a transaction. Therefore, the written form of arrangements seems to be of critical importance to avoid disputes and investigation on the substance of such arrangements. We would welcome more guidance on the content of such documentation.
4. Functions

The section devoted to functions related to intangibles (DD paragraphs 38-41) includes references to the situations, where functions are not performed by a given member of the MNE group claiming the right to intangible related returns, but are arranged by such a member to have them done under its control by independent or associated entities.

This option for “outsourcing” the functions is highlighted already in the introductory part of section B – where DD paragraph 29 stipulates:

“In determining which members of an MNE group are entitled to intangible related returns with respect to an intangible, the following factors should be considered: (i) the terms and conditions of legal arrangements including relevant registrations, licence agreements, and other relevant contracts; (ii) whether the functions performed, the assets used, the risks assumed, and the costs incurred by members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns in the relevant registrations and contracts; and (iii) whether services rendered, in connection with developing, enhancing, maintaining and protecting intangibles, by other members of the MNE group to the member or members of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm’s length basis under the relevant circumstances.”

The abovementioned three-step approach is further consistently elaborated on in DD paragraphs 38-41. We generally agree with the above stages of analysis, we tend to feel, however, that situations where certain functions are not performed by an MNE member claiming rights to an intangible, but are performed by an associated enterprise, should be treated as a kind of variation from the general rule, and as such variation they should be cautiously analysed on case by case basis. We fear, in particular, that the third stage of the analysis, focused on simple verification, “whether the outsourced functions are compensated on an arm’s length basis under the relevant circumstances”, may lead to overlooking potential negative impact of outsourcing of functions on the legitimate right of a given MNE member to claim rights to an intangible related returns.

Furthermore, Section (i) Functions highlights a distinction of “important functions” and “control over the performance of functions” that should be vested by the MNE member claiming rights to an intangible related returns, even if a bunch of functions is outsourced to an associated enterprise. We believe that proper understanding of these two terms is critical for proper execution of rules presented in Chapter VI. These terms, however, seem easy to slip on, as it is difficult to precise the edge definition of “important functions” and “control”, while their daily meaning is more than vast. It is therefore of utmost importance to include more guidance as to how to understand those terms.
5. Risks

As already mentioned in section devoted to written documentation, development and enhancement of intangibles and their value is very often a long-lasting process with uncertain outcome at its beginning. The scope and level of risks incurred by the entity entitled to potential future or present intangible related returns changes also over time, depending on the lifecycle of the intangible or advancement of intangible development phase.

It is clear for instance that the risks related to development of intangible and uncertainty as to successful completion of research and development process is incomparably higher at the very beginning of the design stage than at the final stage of application tests. Consistently, an enterprise that decides to join the undertaking of intangible development at its design stage incurs much higher risks than the one that decides to join the same undertaking at its final testing stage. It clearly shows the significance of timing in determination of pricing of intangible.

It should further be stressed that this correlation function is not constant, it is neither a simple function of costs incurred. Therefore, taking into account the particularly important impact of risk factor in evaluation of intangibles, we believe that this complexity of correlations between timing and expected returns from intangible should be elaborated in a more detailed and appealing way.

6. Arm’s length compensation for functions performed by associated enterprises

DD paragraphs 48-52 deal with several examples aimed to illustrate selected arrangements concerning arm’s length compensation for functions performed by associated enterprises.

In intra-group relationships where global planning is often centralized, while operational and functional interrelations are complex and often unique, it is difficult to talk about claims of particular companies under the same terms as it would be used between independent entities. It is difficult, therefore, to state that certain associated enterprises “perform functions related to the development, enhancement, maintenance or protection of intangibles, but do not claim entitlement to intangible related returns” (DD paragraph 48). Within MNE groups – due to lack of impartial relationships that characterize independent entities, as well as lack of determination to strictly define economic ownership of certain intangibles aligned with previously mentioned “one-pocket approach” – claims concerning rights to intangibles are rare or even not present. We feel, therefore, that both identification and verification of parties entitled to certain intangible related returns should not be based on the MNE members’ representations concerning claimed rights to intangibles. Moreover, such claims to rights, similarly as the allocation of rights, should in our opinion be subject to verification. Hence, objective rules, how to determine entitlement to intangible related returns suggested by TPG are highly welcome.

As already mentioned in point 4 of our comments, we believe that in principle an MNE member claiming rights to an intangible related returns should perform all key functions related to development, enhancement, maintenance or protection of intangibles as well as bear related risks, employ assets and bear costs. A situation where such functions are performed by an unrelated party is by definition an arm’s length relationship, but a situation where such functions are performed by
an associated entity is vulnerable to potential internal abuses, even unintentional. MNEs often tend to group certain functions within designated entities. This is very often the case with intangibles that in addition require legal supervision – a process that is easier under control of one or few selected entities. We believe, therefore, that the issue may concern a wide group of addressees of TPG.

Due to the above, the Guidelines should propose an impartial template, how should a model look like, and what conclusions should be aligned with such model. To stress again, particular care should be taken when describing the outsourcing of functions by the MNE member claiming rights to an intangible related returns to other group members. As we discuss above, such cases should be treated rather as an exception and thus it seems unlikely that designing a role model for such non-routine cases is possible. Certainly, guidelines for such cases are of great assistance, we fear, however, that presenting any “if-then” ready-made solutions may result in automatic application of the approach based on establishing remuneration for each missing function instead of thorough functional analysis aimed to verify which party is the legitimate legal and economic owner of a given intangible. We would appreciate, therefore, certain reservations in the Guidelines concerning the applicability of the general rules mentioned and encouraging a case by case analysis, supported with several examples illustrating what the key, important or control functions may be about and what the critical assumptions should be made.

The value of any model functions or illustrative examples is particularly significant taking into account that finding a suitable reference to uncontrolled transactions involving intangibles is with higher probability more difficult than in the case of other types of transactions. For this reason also we fear that recommendation included in DD paragraph 48: “Reference should be made to both the level of activity and the compensation received by comparable uncontrolled entities performing similar functions in assessing whether the compensation provided is consistent with the arm’s length principle” – may be complicated to be implemented in practice. Therefore, assuming that a bunch of functions might be difficult to benchmark, TPCA would welcome any additional guidance, whether stripping functions into small elements (like registration services, potentially easy to be benchmarked with e.g. law offices) is the right way to choose. We further believe, that it is worthwhile to stress as well the unconditionality of the remuneration for the services and its independence of the result of the transaction involving intangibles.

Section B.3 refers also to examples of settlements for marketing functions related to enhancement of intangibles. As already mentioned, many transactions (also with independent parties) may influence the economic return from business operations involving the use or transfer of an intangible. In the given example presented in the DD one could have even a dilemma, whether the marketing functions discussed should be assessed in relation to any potentially involved intangibles or should they be analysed as independent and separate services, particularly, if the contracting parties would agree so, and while TPG encourages to follow the contractual arrangements if they align with actual functions (see paragraph 55).

On the other hand, in development, enhancement, maintenance or protection of intangibles, there are so many vital functions contributing to the mere existence of intangible and potentially giving rise to controversies as to, whether and which of them should be treated as crucial in legitimization for the intangible related returns. Due to potential difficulties of outsourcing such functions vs. allocating
the right to the intangible related return, TPCA would strongly recommend to develop more examples of such functions in the Guidelines in addition to those already presented.

7. Transfer pricing adjustments in cases involving entitlement to intangible related returns

DD paragraphs 54-55 include a summary of deliberations concerning functional analysis, which ends up with a conclusion presented in paragraph 54 and then repeated in paragraph 55. This conclusion provides an answer to a potential dilemma, one might have when reading about the outsourcing of functions and analysing potential consequences of a statement that for a given outsourced function an associated enterprise was not remunerated on the arm’s length basis.

DD paragraph 54 says: “(…) Where a party is allocated intangible related returns under contracts and registrations, but fails to perform and control important functions, fails to control other related functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.”

DD paragraph 55 says: “(…) Where such risks, functions, and costs are not in alignment with contractual allocations, part or all of the intangible related returns may be allocated to parties performing such functions and bearing such risks, and transfer pricing adjustments may be appropriate to assure that each member of the group is properly rewarded for its risks, functions and costs”.

Bearing in mind the significance of the conclusion contained in this section, TPCA would appreciate any comments that could give more guidance on the proper interpretation of OECD standpoint in this respect. The main concern is namely, whether any non-conformity with arm’s length remuneration for outsourced functions related to development, enhancement, maintenance or protection of intangibles, would result in (i) reallocation of intangible related returns or (ii) adjustment of remuneration for such functions or (iii) any other (and if so, what) transfer pricing adjustments appropriate to assure that each member of the group is properly rewarded for its risks, functions and assets. Since ex post adjustments are relatively easy to be assessed as regards their financial impact, the discretion of MNEs in choosing the form of transfer pricing adjustments to attain fair remuneration of the parties is of crucial significance, but potential controversies with the tax authorities should also be taken into account.

B. Other comments

1. Conducting a comparability analysis in a matter involving intangibles

Section D of the Discussion Draft includes a vital statement that “Intangibles may have a special character complicating the search for comparables, and in some cases making value difficult to determine at the time of the transaction.”

We strongly agree with this statement, and would long even for more impact thereof in the comments on comparability as well as determining arm’s length remuneration for intangibles.
We feel, however, that the presented comments too easily deal with the comparability of intangibles, treating them, as if they were very similar to goods or services.

Section A includes an overview of intangibles, their characteristics, prerequisites, categorization and types. Among those categorizations one can spot a reference to “routine and non-routine intangibles” (section A.3. paragraph 13), and among them to e.g. “non-unique know-how, where other comparable service providers have comparable know-how” (section A.1. paragraph 9) on one hand and to registered patents, trademarks and trade names as well as know-how and trade secrets understood as “undisclosed information of an industrial, commercial or scientific nature” (section A.4. paragraphs 15-16) on other hand.

We believe that the abovementioned categorization seems reasonable, although we also want to highlight another view, under which once something meets the definition of an intangible, it is always unique and thus incomparable. Assuming, however, that indeed certain intangibles may be regarded as more innovative than others, we believe that the abovementioned categorization mentioned in section A of the Discussion Draft could very well do as a guide through the comparability issues – where cases with potentially easily traceable comparables seem to be found mainly among “routine or standard intangibles” while cases where comparables are not likely to be identified seem to more often happen among “unique intangibles”.

To our regret, however, this categorization is not followed in the comments on comparability analysis, which treat intangibles as an analysis object very much similar to goods or services. We fear, therefore, that the unique characteristics of many intangibles might be underestimated and a simple comparability and adjustment criteria be excessively used to compare intangibles, even if such comparison is pointless.

In several points of the Discussion Draft one can find, however, some remarks calling for attention when performing comparability analysis of intangibles. Such references, appreciated by TPCA for underlining uniqueness of intangibles, include for instance:

- “If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration” (section C.2. paragraph 73);
- “Intangibles often have unique characteristics and, as a result, have the potential for generating returns and creating future benefits that differ widely. Moreover, grants of rights to use intangibles may have important limitations that have a direct and important bearing on the price that would be paid for such rights. In conducting a comparability analysis with regard to a transfer of intangibles or rights in intangibles, it is essential to consider the unique features of the intangibles and the specific terms of the transfers, including the nature of any limitations on the rights of the transferee to use the intangibles following the transfer” (section D.1. paragraph 90);
- “It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. (...) If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing
method that is less dependent on the identification of comparable intangibles or comparable transactions” (section D.1. paragraph 103).

The strength of uniqueness is particularly reflected in so called “section D.1 (vi) intangibles”, which as commented hereinafter remains a not very precisely defined concept, while the characteristics thereof seem to represent the features of a at least significant share of intangibles.

On the other hand, the Discussion Draft often comments that – in brief – a search for comparables should be performed, comparability analysis carried out and if necessary, relevant adjustments made. Such comments are included mainly in section D.1., paragraph 108 and further elaborated in paragraphs 119-124. We generally agree with them, but would welcome more guidance with regard to comparability of transactions involving intangibles. We are also afraid that in vast majority of cases adjustments may be hardly possible or may carry a significant risk of errors in intangible related evaluations.

2. Determining arm’s length prices for intangible related transactions

a) Valuations techniques for transfer pricing purposes

DD refers to five OECD approved methods described in Chapter II. It admits, however, that “Some valuation techniques drawn from financial valuation practice may have application both in cases involving the use of intangibles in connection with sales of goods or services, and in cases involving transfers of intangibles or rights in intangibles” (section D.2. paragraph 109).

The Discussion Draft further elaborates that “Depending on the circumstances, they may be used either as a part of one of the five OECD approved methods described in Chapter II (e.g. in determining how to split profits as part of a transactional profit split method), or as a tool that can be usefully applied in identifying an arm’s length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions” (section D.2. paragraph 109).

We must admit that the abovementioned excerpt is not entirely clear in its wording stating that “depending on circumstances” valuation techniques may be used “as a part of one of the five OECD approved methods”. We observe also that the general initial approval or welcoming of valuation techniques for transfer pricing analyses related to intangibles is followed with numerous reservations in the Discussion Draft (some of them seem contradictory). It would be advisable, therefore, to elaborate this statement, in order to explain in more detail the intention behind this comment.

More precise statement in this area is particularly important as admitting valuation techniques next to the approved OECD methods for transfer pricing purposes would certainly bring a fundamental change to the analysis of transactions involving intangibles.

We would like to point out that experts’ valuations are already generally accepted as an impartial reference in many cases. This is also a common practice of businesses to appoint an external evaluator to establish e.g. price for a share transfer transaction in order to avoid potential transfer
pricing disputes with tax authorities. Indeed, usually such external evaluation successfully helps to avoid such disputes. Moreover, independent parties also use experts’ valuations for the purposes of significant transactions.

A reserved approach to the valuation techniques seems to be adopted also in the Discussion Draft. The document moves, however, much further and undertakes a technical discussion with assumptions and rules that should be observed when determining those techniques. We welcome it with appreciation, as it seems that discussion on rationality and consistency of assumptions may constitute a common ground for discussion between business, transfer pricing specialists, evaluation experts and last but not least the tax authorities. Sound feeling, common sense, business experience and general economic rules seem to well appeal to the concept of arm’s length testing question – to what conditions would unrelated enterprises agree in given circumstances. The practice often shows that the answer to this fundamental question often requires sourcing to the common sense, business experience and generally accepted economic rules, so the verification mechanism is in fact very much the same.

To our satisfaction, the Discussion Draft includes a wide set of comments and recommendations concerning analysis of assumptions in valuation techniques. From the level of detail of those comments and recommendations concerning assumptions analysis we are close to the conclusion that the role of valuation techniques tends to be appreciated in the Discussion Draft (more detailed comments on assumptions are presented in the subsequent point).

In view of the above, seeing both potential concerns as well as firm and sound recommendations accompanying the idea of using valuation techniques, we believe it is needed to have a more clear conclusion on the status of valuation techniques for the purposes of transfer pricing analysis.

To illustrate some undefined standpoints that might suggest contradictory conclusions and therefore raise doubts, we cite several excerpts and highlight the questions they might reveal:

- “Some applications of valuation techniques can be characterized as application of a profit split method” (section D.4.(iii)(b) paragraph 142). – Does it mean that some valuation techniques are in fact a form of application of transfer pricing methods and should be referred to as such methods? Is it possible to distinguish valuation methods which conform with definition of respective transfer pricing methods?
- “Where valuation techniques are utilized in the transfer pricing analysis, it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the principles of these Guidelines” (section D.4.(iv) paragraph 146), and “where valuation techniques are applied in a manner that gives due regards to these Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate consideration of the validity of the assumptions underlying valuation and the consistency of those assumptions with the arm’s length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable controlled transactions are not available” (section D.4.(iv) paragraph 147). – If the principles and rules are followed, can a valuation technique be approved and applied for transfer pricing purposes or can it be only used if comparable transactions are not available?
- “Valuation approaches that estimate the discounted value of projected future cash flows attributable to the transferred intangible or intangibles can be particularly useful analytical
tools” (section D.4.(iv) paragraph 148). – What is the approach of the OECD to the application of discounted cash flows method – can it be regarded apt to establish an arm’s length price or must it be applied in conjunction with a recognized transfer pricing method?

• “In situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified, it may be possible to use valuation techniques to estimate the arm’s length price for intangibles transferred between associated enterprises” (section D.4.(iv) paragraph 145). - Would it be appropriate to accept the estimate based on valuation techniques as an arm’s length price?

• Section D.2.(iii) is entitled “Use of transfer pricing methods based on intangible development costs”, while it comments on applicability of valuation techniques based on intangible development costs. We agree with presented comments, but we find it confusing that the term “transfer pricing methods” is used in the title – is the valuation technique treated here as a transfer pricing method or its application?

• “In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on identification of reliable comparable uncontrolled transactions may be utilized to determine arm’s length conditions for the sale of goods or services where intangibles are used in connection with the transaction. The alternative selected should reflect the nature of the goods or services sold and the contribution of intangibles and other relevant factors to the creation of value” (section D.3.(ii)(c) paragraph 131). – The wording seems to allow for choosing between transfer pricing methods and valuation techniques, of course not freely, but with attention to circumstances. The word “alternative” also suggests equal treatment of both methodologies. As such approach is contradictory to other statements included in DD, a need for clarified opinion on valuation techniques approved by TPG arises.

In view of the above concerns we believe that in several points in the Discussion Draft rephrasing or elaboration of comments would be needed to eliminate potential confusion.

b) Underlying assumptions in valuation techniques and their impact on result accuracy. Standards set out for assumptions in valuation techniques as a tool to verify the applicability of those techniques for transfer pricing purposes.

In discussion concerning the usefulness of valuation techniques DD stresses the particular significance of underlying assumptions and their impact on accuracy of valuation and thus - its reliability. We agree with vast majority of assumptions-related remarks, the general idea that is expressed e.g. in the following excerpt: “The reliability of the intangible value produced using a valuation model is highly dependent on the reliability of the underlying assumptions and estimates on which it is based and on the due diligence and judgment in confirming assumptions and in estimating valuation parameters” (section D.4.(v) paragraph 150).

We agree also with more detailed comments including recommendations as to how to approach the verification of assumptions. They instruct in particular that “taxpayers and tax administrations making use of valuation techniques in determining arm’s length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters”(section D.4.(v) paragraph 151).

We appreciate also further comments presented in the Discussion Draft, which i.a.:
recommend performance of sensitivity analysis by testing alternative assumptions,
advise verification of internal consistency of assumptions concerning revenues and costs – particularly if general conditions are difficult to predict,
instruct on choosing right discounting rate and warn of double discounting for risk,
comment on useful life aspects and terminal value specifics,
point out at some highly probably mistaken assumptions to be avoided, e.g. concerning constant, steady performance rate, or pre-tax and after-tax results.

As already mentioned in point a) of our commentary, the level of detail of comments and their technical content seem to suggest that DD is quite positive as to potential applicability the usage of valuation techniques for transfer pricing purposes and appreciates their contribution to such analysis. Simultaneously, however, apparently due to some concerns – presumably about potential accuracy or results and/or the ability to verify them from transfer pricing perspectives – the DD expresses numerous reservations as to the applicability of valuation techniques for transfer pricing purposes.

A reader of the Discussion Draft may ask himself or herself the following question – isn’t it just a step before defining the conditions for applying valuation techniques for transfer pricing purposes?

The recommendations and remarks concerning valuation techniques, in particular regarding assumptions, seem to be drilling very deeply through the arcane details of valuation techniques, so that one could be tempted to move further. And thus, it could be considered and extend the commentary on other aspects of valuation techniques, which are or might be of importance for transfer pricing purposes.

The Discussion Draft indicates that “It is not the intention of these Guidelines to set out a comprehensive summary of valuation techniques utilized by valuation experts. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilized by valuation or accounting professionals or to describe in detail one or more specific valuation techniques or methods that may be especially suitable for use in a transfer pricing analysis” (section D.4.(v) paragraph 147).

Nevertheless, we believe that setting out more recommendations and conditions regarding aspects of valuation techniques, which might be of importance for transfer pricing purposes, would not contradict to the abovementioned statement and intention contained therein. We agree that it is not the objective of TPG to endorse or reject any particular valuation techniques, nor to constantly follow the development in valuation techniques methodology to update such list of endorsed or rejected methods. It might be worthwhile, however, to consider developing a list of vital elements, upon which valuation techniques should be checked, if they conform with the transfer pricing requirements. In our opinion, such list of conditions should allow to keep the independence of transfer pricing methodology and valuation techniques and to verify the applicability of valuation techniques on case by case basis.
c) Purpose of valuation and its impact on accuracy of results

While we agree with vast majority of comments presented in DD with respect to underlying assumptions of valuation techniques as well as discouraged application aspects thereof, we have certain objections to the comments regarding the impact of valuation purpose on the reliability of such evaluation. The majority of sections pertaining to this issue refers to valuation techniques which are based on discounted values of future cash flows (DCF) or to general good practices concerning valuation techniques.

And so, in section D.2.(iii), paragraphs 110-111 we read: “110. While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. In particular, it is important to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes be biased in favour of conservative estimate of the value of assets reflected in a company balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to valuation approaches that are not necessarily consistent with the arm’s length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm’s length prices or values for transfer pricing purposes without a thorough examination of underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.

111. It is essential to consider the purpose for which the valuation is conducted. Valuations conducted for business planning purposes may be either more or less relevant than valuations conducted purely for tax purposes, depending on the circumstances”.

Based on the analysis of the abovementioned excerpt, which opens the deliberations on reliability of the valuations performed for other than transfer pricing purposes, we share a doubt that the reservations and comments presented therein might be even separately justified, but when put together and in a sequence, they do not necessarily form a consistent message.

The recommendation to approach with caution (i) valuation techniques conducted for different purposes, (ii) valuation results adopted different purposes and (iii) valuation assumptions made for different purposes – conveys a different message in each of those three cases. And thus, we agree that DCF valuation assumptions depending on the purpose of valuation may be highly speculative, and by manipulating with assumptions the interested party may attain desired valuation outcome. Therefore indeed, we agree that one should be cautious, but not in applying respective valuation techniques, but in using the results of valuations – performed for whatever purpose “without a thorough examination of underlying assumptions” as it is stated in DD paragraph 110 quoted above.

We believe that the mere purpose of valuation is not decisive for the acceptance or rejection of an evaluation results. In each case, even if the evaluation was performed for transfer pricing purposes, it is advisable to examine the underlying assumptions. This is not only advisable for the sake of being cautious, but also due to the fact that assumptions should always be assessed from perspective of specified interested party. This is due, in particular, to the fact that:
- the assumptions, particularly regarding discounted future cash flows, are both unknown and unknowable and may be affected by subjective predicted activities taken into account by certain entities while not valid for the others (see DD, section D.4.(v)(a) paragraph 154),
- the discounting rate may depend on specific risks for a given entity (see DD, section D.4.(v)(c) paragraphs 160-163),
- the assumptions may vary to certain extent and due to various reasons between parties to the transaction (see DD section D.4.(iv) paragraph 148),
- the assumptions can be defined not in a punctual manner but in form of a range of potential values, which can also be used, and even recommended to be used, for sensitivity analysis (see DD, section D.4.(v) paragraph 151).

Consequently, as it is stated in DD: “Depending on the facts and circumstances of the individual case, the calculation of the discounted present value of the streams of cash flows attributable to the intangible from the perspective of both parties to the transaction will generally be necessary. In these cases the arm’s length price will fall somewhere within the range of both present values (...)” (section D.4.(iv) paragraph 148). This statement confirms, also that it is justified to analyse a range of valuation results and not to target for a single number.

From the above one more conclusion may be derived – if two alternative evaluations give different results, but the difference between them can be justified by the differences in assumptions, it should generally be discouraged to reject one of the valuations.

To summarise the above comments, we strongly believe that valuation techniques should be regarded as unbiased models that are tailored to produce results according to defined mechanisms. The results, however, of a valuation technique of any kind depend on the assumptions made in its application. In our opinion, therefore, the purpose of valuation is not a sufficient determinant for the acceptance or rejection of valuation results for transfer pricing purposes. Due to the key role of assumptions in creation of the valuation outcome, potential decision as to the approval or non-approval of valuation results for transfer pricing analysis should always be based on examination of underlying assumptions.

Therefore we fully agree with the statement contained in section D.4.(v) paragraph 152 of the Discussion Draft: “It may be relevant in assessing the reliability of valuation model to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. (See paragraph 111). It would be reasonable for a tax administration to request an explanation for any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes”.

d) Purpose of projections adopted as assumptions in DCF valuation vs. their accuracy

The Discussion Draft includes some remarks recommending to cautiously choose data to be adopted as assumptions in valuations, particularly based on DCF. While we generally agree with this general suggestion, we find some of the more detailed comments not necessarily always valid.

For instance, in DD it is noted: “In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial
projections for business planning purposes. It can be that such analysis are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than the projections prepared exclusively for tax purposes, or exclusively for purposes of transfer pricing analysis” (section D.4.(v)(a) paragraph 152).

It is difficult to agree with the statement that projections prepared for various business purposes are usually more reliable than projections prepared for tax purposes, or exclusively for transfer pricing purposes. Certainly, as regards data adopted as assumptions for valuations for the sake of taxes or transfer prices, it may be assumed that the taxpayer will strive to support with the valuation result the amounts declared for tax purposes. It cannot be automatically assumed, however, that the projections adopted for other purposes than tax or transfer pricing are more reliable. One can list many cases, where reliable valuation is of vital interest of an enterprise, for instance when applying for an investment loan or credit, when aiming for better rating for business purposes, or when setting high targets for the team.

We believe, therefore, that it should be a general recommendation and good practice to examine the consistency of assumptions and to verify the underlying sources, by use of any available means, including for example: (i) comparing assumptions adopted in different valuations – either made for different purposes (see already quoted section D.4.(v) paragraph 152) or performed in different timing, with obvious limitation in the latter (ii) verification of usual accuracy of predictions made by a given entity, based on statistical analysis of past projections and subsequent actual results, etc.

We agree therefore with the recommendation included in DD: “It would generally be expected that a reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products” (section D.4.(v)(b) paragraph 159).

In our opinion it would be of benefit to base the guidelines on the technical comments like the one stated above, while recommendations based on common opinions and behavioural assumptions not subject to transfer pricing verification, should be generally avoided.

e) CUP method and “rule of thumb”

DD includes the following statement: “Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances” (section D.4. paragraph 136).

We must admit that presenting CUP method as one of preferred methods for evaluation of intangibles raises our serious doubts commented beneath, as we believe that application of CUP method may lead to peculiar results. Let’s take a simple but practical example to illustrate our concerns. In our exemplary case, as a result of the commercial search in database only one comparable licensing deal has been identified. Comparability was verified based on complete analysis conducted under the principles of Chapters I through III. The level of royalties on the license transaction was highly suspect in relation to the realizable return on the market niche (e.g. royalties
1%, EBIT 35%). Even a simple financial analysis and marketing research indicated that the parties acting reasonably would have never concluded a transaction under these financial conditions. The tax authorities of one country have, however, their "fact" and can be very satisfied with the terms of the one identified transaction. The Company which prepares valuation would not dare to ignore this "comparable". In this situation the question arises what should be done in accordance with the TPG. One cannot reject the “comparable” transaction using the rational approach applied by unrelated entities and instead apply “hypothetical” process of negotiating licensing terms and statistically observed conditions, since DD contains the following statement D.2 (116):

“In cases involving the use or transfer of intangibles or rights in intangibles, it is sometimes suggested that certain rules of thumb may apply to determine a correct transfer price or to allocate intangible related returns between a transferor and transferee of rights in intangibles. The application of a general rule of thumb does not provide an adequate substitute for a complete comparability analysis conducted under the principles of Chapters I through III. Accordingly, application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee is discouraged.”

DD nor TPG do not include any definition of the terms: “general rule of thumb”, “certain rules of thumb” and as a result TPG rejects an application of any statistically observed rules in the area of dividing profits between a licensee and a licensor. It would be helpful to differentiate the “any rule of thumb” and “statistical rule” which in our opinion should be accepted for use in cases involving intangibles

On January 4, 2011, the United States Court of Appeals for the Federal Circuit published its decision on Uniloc U.S.A., Inc. v. Microsoft Corp. In this case, a legal expert prepared its valuation unprofessionally with lack of due diligence, therefore the Court rejected the application of the rule of thumb in a way that have been applied by the legal expert. As of this moment, we observe that criticizing the statistical approach in the valuation process gained many supporters.

The above cited paragraph of the DD aims to eliminate a statistical approach from transfer pricing analysis in the area of the behaviour of individual investors negotiating a license agreement. We would like to underline that such approach is both unscientific but also impractical and, as shown in our simple example, sometimes very dangerous.

We would recommend that rather than reject the statistically observed behaviour of investors as determined by real “profit split”, calling them "general rule of thumb" or “certain rules of thumb”, TPG should provide more tools to develop the statistical evaluation, associated with the multivariate analysis (based e.g. on the factors described in DD paragraphs 77-78). We suggest more precisely resolving this issue, because in many cases, the 25% rule or a statistical rule gives the only rational solution for determining the distribution of profits between the parties to the license transaction. This is also in line with DD paragraph 35 stating that a licensee would be entitled to intangible related returns but must provide arm’s length compensation for the grant of the licence.

In the real world, licensor and licensee begin negotiations on the distribution of future benefits, taking into account solutions observed in the market by each side and at the same time specific business area (for example, in a niche market). A key measure in this case is profitability, which can be obtained by the licensee, e.g. measured by the ratio of operating profit to revenue and share
in this indicator, that should be attributed to the licensor, expressed in the form of license fee in relation to this revenue. As a result of the subsequent arguments used by the negotiating parties positions are adjusted taking into account many factors, including the scope of their functions, the necessary assets and the risk incurred (incurred costs are only a consequence of other factors, treated as obligations of the parties).

So if a key TPG’s principle is to replicate the way unrelated parties negotiate the hypothetical market transaction, consequently the 25% rule or other statistical rule should not be excluded from this process or even should be the starting point for such considerations.

We believe that, if TPG would not discourage from applying a 25% rule or other statistical rule, the market will provide information on real transactions based on standardised statistical analysis which will identify statistically significant relationships in distribution of the profits realized in licensing transactions signed between licensors and licensees in different industries.

3. Global perspective

We are also concerned by the fact that the Discussion Draft in several points relates to the global/group perspective (e.g. DD paragraphs 3, 11, 29, 34). Although we understand the concept of such expressions, we see a risk that transactional approach is rejected. We would appreciate more guidance on how from a local perspective handle the need to establish the costs incurred by members of MNE group in developing, enhancing, maintaining and protecting intangibles on a global level.

4. Distinction between the use and the transfer of intangibles

The Discussion Draft addresses transactions that involve the use or transfer of intangibles. The distinction between the use or transfer is presented in section C.1 and C.2. Under those sections:

- use of intangible applies in situations where there is no transfer of intangible or rights in the intangible (DD paragraph 59);
- transfer of intangible may encompass all the rights (e.g. sale) or only limited rights (e.g. licence) (DD paragraph 62).

In our opinion, this distinction is very artificial since in the general and even legal meaning use of an intangible is covered by licence (and not by transfer). We are concerned by this distinction and in our opinion there will be a lot of confusion relating to various licences that would be understood in the meaning of the DD as transfers of intangibles.

Moreover, we would appreciate the clarification whether the transfer encompassing all the rights in intangibles should be considered as alienation of intangibles in the meaning of article 13 of the OECD Model Tax Convention.

5. Collateral changes to the Guidelines

We understand that the Working Party still intends to address the following topics not currently addressed in the Discussion Draft and introduce modifications to Chapters I – III and Chapter VII of the Guidelines required as a result of the changes to Chapter VI.
We observe that the collateral changes should also be introduced in Glossary provided for in the Guidelines. In particular, we would welcome following changes:

- Definition of “commercial intangible” – definition is not related to the proposed wording of the DD,
- Definition of “marketing intangible” – definition is not related to the proposed wording of the DD,
- Definition of “trade intangible” – definition is not related to the proposed wording of the DD,
- Concept of “commercial activities” (DD paragraphs 5, 16) – concept might be understood too narrowly when interpreted together with the definition of commercial intangible – in our opinion, in DD paragraph 5 business activities should be recognized (and not only commercial activities),
- Definition of “section D.1 (vi) intangibles” – the Working Party might consider to introduce the definition in the glossary, moreover we would appreciate more guidance whether section D.1 (vi) intangibles are unique intangibles as the term is used in the Guidelines.

6. New wording in the Discussion Draft

There is some new wording introduced in the Discussion Draft which is not present in the current edition of the Guidelines. The new wording in our opinion include mainly:

- A premium return (DD paragraph 9),
- Economic return (DD paragraph 28)
- Income producing functions, risks and assets (DD paragraph 130) – we would like to underline that income is only one of the factors that should influence the establishment of the value,
- Nonroutine return (DD paragraph 166),
- Terminal value (DD paragraph 167).

We would appreciate uniform wording that is used throughout the Guidelines.

7. Cross-references in the Discussion Draft

As a final remark, we would like to draw your attention to the fact that the DD uses a lot of cross-references to both (i) other chapters of TPG and (ii) other paragraphs in the DD. We find it very difficult to analyse the DD taking into account the number of such cross-references. We would kindly suggest reducing the number of cross-references where possible to enable better understanding of the approach of the OECD as regards special considerations for intangibles.

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Warsaw, September 14th, 2012
Opinion Statement of the CFE on the OECD Discussion Draft

“Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions”

Prepared by the CFE Fiscal Committee

Submitted to OECD Centre for Tax Policy and Administration

in September 2012
CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 32 professional organisations from 24 European countries (21 EU member states) with 180,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe. CFE is registered in the EU Transparency Register (no. 3543183647-05).

Mr. Joseph L. Andrus
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Transfer Pricing is undoubtedly an international tax issue of topical interest to multinational enterprises. As global trade increases, uncertainty in the tax treatment of inter-company transactions as well as double taxation may also expand. Transfer pricing relates not only to the setting of prices for goods and services supplied to related parties, but also to the structuring of transactions and financial relationships.

As stated in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter, OECD Transfer Pricing Guidelines), the concept of transfer pricing should not be confused with that of tax fraud or tax avoidance, although transfer pricing transactions might in some cases be carried out for such purposes. Referring to transfer pricing as “income-shifting” might hinder effecting an accurate and thorough analysis of the subject matter. In addition, most of the issues that enterprises are currently facing do not involve low-tax jurisdictions but countries which have a similar level of taxes and where there is no particular tax reason to shift profits.

An examination of any transfer pricing issue should necessarily include an analysis of the arm’s length principle, as a concept generally accepted as the best possible means to set prices in intercompany transactions and avoid double taxation on international business. The arm’s length principle is outlined in Article 9 of the OECD Model Tax Convention.

The spiraling increase in cross-border flows of intangible property has become a most important international taxation issue, and arguably the main issue facing Tax Authorities, multinational enterprises and tax practitioners worldwide. The latter in particular have acknowledged that some of the most difficult transfer pricing issues have always involved the area of intangibles. Transactions pertaining to intellectual property in the ever-expanding global economy are playing an increasingly significant role, whilst a few complexities regarding the identification, valuation and transfer of intangibles lead to a careful review of existing transfer pricing methodologies and techniques. In substance, the tax treatment of intangible assets should warrant a particular attention in the transfer pricing context.
The arm's length principle requires that multinational enterprises apply transfer prices in their controlled transactions that are in compliance with the prices that would have been applied to the same uncontrolled transaction between unrelated, independent enterprises under the same circumstances. The transfer pricing method adopted by a multinational enterprise constitutes a pivotal component in determining the arm's length consideration in a transaction involving the intercompany transfer of intangible property.

As identical transactions between unrelated enterprises are not common, transfer pricing methodologies tend to focus on comparable rather than identical transactions. However, where intangible assets are concerned, critical issues may arise even in determining a comparative analysis. In this context, a consequent shifting focus to non-traditional methodologies, especially profit-split methodologies, could occur. These latter methodologies tend to rely in whole or in part on internal data rather than on data derived from comparable uncontrolled transactions.

Different methods may be selected under different circumstances. All variables should be assessed in determining the correct methodology for a particular transaction, bearing in mind that those variables may change over time, leading to a reconsideration of the methodology to be applied.

The Confédération Fiscale Européenne is pleased to provide inputs on the contents of the Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions” (hereinafter, Discussion Draft), released by the OECD on 6 June 2012, as part of the project on intangibles launched in 2010.

The Confédération Fiscale Européenne strongly supports the arm’s length principle as well as guidance provided on the subject matter by the OECD Transfer Pricing Guidelines and deems that the project on intangibles should be conducted within a framework which:

- guarantees legal and regulatory certainty;
- complies with the internationally accepted arm’s length principle;
- aims at avoiding double taxation; and
- takes into consideration all complexities relating to the identification, valuation and transfer of intangible property.

The Confédération Fiscale Européenne’s comments on the Discussion Draft are outlined below.

In commenting on the Discussion Draft, the Confédération Fiscale Européenne has been influenced by the proposed timeline. As a result, our comments are not a comprehensive list of all issues and areas of uncertainty, but a focus on the most significant issues which we believe can be addressed within the said timeline. This does not preclude the discussion of other issues if it might be convenient to include these within the project.

We will be pleased to answer any questions you may have concerning the Confédération Fiscale Européenne’s comments, outlined below.

Sincerely yours,

Confédération Fiscale Européenne
Comments to Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”

1. Introduction

On 6 June 2012, the OECD published the Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”, (hereinafter, the Discussion Draft) containing two principal elements:

- a proposed revision of the provisions under Chapter VI of the Transfer Pricing Guidelines;
- a proposed revision of the Annex to Chapter VI of the Transfer Pricing Guidelines, containing examples illustrating the application of the provisions of the revised text of Chapter VI.

The Confédération Fiscale Européenne appreciates the OECD work, which intends to provide businesses and Tax Administrations with a clear framework on the intangibles for transfer pricing purposes.

2. Definitional aspects of intangibles

The definition of intangibles, and the consequent identification, has long been a key issue in transfer pricing disputes.

The Discussion Draft provides a definition based on the concept of control, stating that an intangible is “not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”.

By adopting the above approach, the Discussion Draft distinguishes intangibles from other items that cannot be owned, controlled or transferred by a single enterprise, such as group synergies and market characteristics, which, for this reason, cannot be considered intangibles for transfer pricing purposes.

Furthermore, the OECD focuses its definition of intangibles on what unrelated parties would have agreed rather than taking into consideration the accounting and legal definitions.

The Confédération Fiscale Européenne welcomes the notion of “control”, but at the same time believes that the definition of what an intangible is should be clearly identified to ensure legal certainty for Governments and businesses.

The definition of intangibles should comply with both accounting and legal principles.

For example, with reference to goodwill, the Confédération Fiscale Européenne believes that the broad definition provided by the Discussion Draft does not eliminate the uncertainty.
In the Confédération Fiscale Européenne’s view, goodwill needs to be defined more in detail for transfer pricing purposes, taking into account the relevance of accounting and business valuation.

The Confédération Fiscale Européenne believes that it is necessary to have a clear framework to identify whether a particular item can be classified as intangible, in order to ascertain the nature of the transaction and to determine the “most appropriate transfer pricing method to the circumstances of the cases”.

3. Identification of parties entitled to intangible related returns

Determining the relevant parties who are entitled to earn income attributable to intangible assets is one of the most controversial issues for transfer pricing purposes.

The Scoping Document, published by the OECD on 25 January 2011, considers a significant issue the “(r)ight of an enterprise to share in the return from an intangible that it does not own”, introducing the concept of “economic ownership”, by contrast to its “legal ownership”.

Working Party No. 6 states that legal registration and contractual arrangements are the starting point for determining which members of the multinational group are entitled to intangible related returns.

However, the Discussion Draft focuses the attention on the alignment between legal form and the actual parties’ conduct.

The profits attributable to intangibles must be allocated to the parties performing the functions and bearing the risks as well as the costs that relate to development, enhancement, maintenance and protection of the intangibles.

The Discussion Draft stresses the notion of control over the principle of functions and risks: when a party passively bears costs related to intangibles but does not control the risks and the fundamental functions, such party cannot be considered entitled to intangible related returns: “Bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns”.

In the Confédération Fiscale Européenne’s view, it is necessary that each associated enterprise, involved in developing, maintaining and protecting the intangibles, obtains a remuneration based on functions performed, risk and costs borne, taking into account what independent parties would have agreed to in comparable circumstances.

The Confédération Fiscale Européenne notes that the Discussion Draft uses often the term legal ownership: it should also address the notion of economic ownership.

The Confédération Fiscale Européenne recommends that a strict legal approach should prevail and that the concept of “economic ownership” of intangibles should be abandoned since it could create some uncertainties. The same concern applies to local marketing intangibles.
4. **Transactions involving the use or transfer of intangibles**

The Discussion Draft provides guidance on identifying transactions involving the use or transfer of intangibles.

The Discussion Draft identifies two broad classes of transactions:

- transactions involving the use of intangibles in connection with sales of goods and services: in this case, intangibles are used by one or both parties in connection with sales of goods and services, but there is no transfer of intangibles;

- transactions involving transfers of intangibles: in this case there will be a sale of the intangible or the transfer of limited rights related to the intangible.

The *Confédération Fiscale Européenne* emphasizes the importance of a transfer pricing analysis to:

- understand the nature of the transaction;
- identify any intangibles involved in the transaction;
- identify the nature of such intangibles and related rights transferred between associated enterprises.

5. **Determination of arm’s length conditions in cases involving intangibles**

The Discussion Draft confirms the importance to conduct a comparability analysis considering the perspectives of both parties involved in the transaction.

During the said analysis, the Draft considers it necessary to take into account some specific features of intangibles (exclusivity, extent and duration of legal protection, geographic scope, useful life, stage of development, expectation of future benefit, rights to enhancements).

The *Confédération Fiscale Européenne* regards the comparability criteria listed above as rather stringent; generally, the comparables which can be identified in available public databases do not provide the information requested.

Furthermore, the *Confédération Fiscale Européenne* believes that some of these characteristics need to be defined more in detail. For example, the definition of useful lifetime, a key and controversial point in the evaluation of intangibles, is not sufficiently clear.

For the first time, the Discussion Draft states that evaluation techniques can be useful in a transfer pricing analysis.

However, at the same time, the OECD recommends caution in applying such techniques. In particular, it is important to consider the assumptions and other motivations supporting the application of evaluation techniques.
The Discussion Draft discourages the use of so-called “rules of thumb” (a formula-based apportionment of the profit attributable to an intangible between its owner and the user) and the use of cost-based methods.

The Confédération Fiscale Européenne deems that exclusion of a cost-based evaluation approach is too stern, since it can be a useful method at least for services with low added value.

Furthermore, it seems that the OECD is in favour of the application of the transaction profit split method in many circumstances.

It is worth noting that the Discussion Draft illustrates the reasons why some methods are not applicable in some circumstances and explains the difficulties in applying them.

The Confédération Fiscale Européenne believes that it is necessary to provide guidance explaining which methods are applicable under what circumstances.
19 September 2012

Joseph L. Andrus,
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Dear Mr Andrus

Discussion drafts on Transfer Pricing

We refer to the two discussion drafts and a press release issued by the OECD on transfer pricing aspects of intangibles, safe harbours for transfer pricing and certain transfer pricing timing issues in June. We set out below some comments on these.

Discussion draft on the Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions

There are some sensible and helpful developments in the guidance which should help and guide taxpayers and tax authorities. We particularly welcome the clarification in paragraphs 138 and 155 as we are aware that both of these have been challenged by tax authorities (the CUP by challenging the related parties 'would never have licensed') and the fact that forecasts have been used for other business decisions at the same or similar times have been largely ignored and replaced with hindsight.

However, we raise some points in four key areas:

- the definition of intangibles;
- there needs to be more focus upfront on 'what third parties would do' in that industry;
- there should be a reduced reliance on moving to a profit split after the event; and
- improve focus on factual aspects and reduce reliance and importance of theoretical ones to reduce potential for dispute.

Definition of intangibles

The definition of intangibles, and the consequent identification, has long been a key issue in transfer pricing disputes.

The Discussion Draft provides a definition based on the concept of control, stating that intangible is 'not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be
the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.'

Whilst we welcome the notion of 'control', the definition of what an intangible is should be clearly identified to ensure legal certainty for Governments and businesses. We suggest that, in fact, the definition should, as far as possible, be in accordance with prevailing legal and accounting principles.

Notwithstanding that it suggests that there should not be undue focus on accounting and legal definitions, it appears to us that the Discussion Draft definition is very close to that used for intangibles under IFRS, where the key concept is that the asset is identifiable; by which it is either separable from other assets or arises from a specific legal right (or both).

We think it would be helpful to either indicate that an intangible recognised or recognisable under IFRS is an intangible for the purposes of the guidelines, or explain why this is not the case.

'Recognised or recognisable' is important - as the guidelines note, an internally created intangible may not be recognised on a balance sheet. However it will usually be recognisable, as if the asset was sold, the buyer would show it on their balance sheet.

**Focus on 'what third parties would do' in that industry**

As an essential, we suggest that it would help if the guidance stated that fundamentally a taxpayer group should have the right to sell, licence, etc IP within its group, provided always, that the price and terms of such a licence would be considered to be arm's length.

Similarly, it would be helpful if the guidance recognised that for many IP dependent businesses, there may be established approaches for valuing different types of IP transactions in third party situations and use of the same approach for internal transactions should be highly persuasive.

Thirdly it would help if the guidelines recognised that while they are specifying certain functions, costs, risks, etc that should be undertaken and born to earn IP returns, this needs to be tempered with some analysis of whether third parties in that industry do always do this. If outsourcing a function, for example, is common in an industry, outsourcing it to a related party should not earn an IP return.

**Reduced reliance on profit split**

We are generally supportive of the approach that for intangible benefits to arise to an entity there needs to be appropriate substance to the transaction. However, we are concerned that the only entities that will cleanly fit the ideal view of functions, risks, costs and ownership in a single entity, will either be ones very focussed on tax planning who have moved jobs into low tax countries, or very simple entities.

For many groups that have evolved over time via mergers and acquisitions, IP ownership is highly likely to be in a number of entities driven by historic structures and the prohibitive cost of transferring IP. A group may however wish to drive efficiencies by centralising activities to be performed by one centre of excellence.

The current approach will leave most groups with a complex and subjective profit split approach between entities bearing cost and risk and owning assets and other entities performing functions, and it is difficult to envisage this will not lead to large numbers of highly subjective disputes around the value of functions over risks etc.
A preferred approach might be for this to be the approach only where the entity cannot demonstrate the functions concerned are, and can be, performed by third parties within their industry. If a function is, in the market, outsourced to third parties within an industry it seems a reasonable arms-length approach to treat a related party as an outsource provider gaining a service provider return. If a function simply cannot be or is never outsourced in an industry, it seems reasonable to share IP returns.

For example, the draft guidance cites R&D program design and management as a key function that an entity must perform, but in many industries specialist providers will perform a full function of designing and managing a development program. Similarly, there can be many providers of strategic marketing advice and an agency might well in some industries develop a full proposed strategy for a new product.

Cost and profit split can occur between third parties but are complex and rare and imposing this later, can under value risks parties might have adopted initially.

While a profit split approach can be appropriate, this needs to be used with caution, limited to circumstances where the value added from each party is too difficult to reward with other approaches and the functions, costs and risks borne do not have third party equivalents in that industry.

**Improved focus on factual aspects and reduced dependence on theoretical ones**

Some of the early provisions in the guidance, in particular where focus is put on the 'realistically available options of the parties to a transaction' and the perspectives of each of the parties', leaves open a frequent challenge of recharacterising transactions by a vague argument that 'x would never have done that'. Such arguments are highly subjective as in a multinational group there is a single group strategy and while subsidiaries will have objectives, they will not be at liberty to pursue or create their own strategy. Any discussion on the bearing theoretical strategies that subsidiaries could have been following moves discussions in an unhelpful theoretical direction, far removed from facts of the transaction and what third parties might do.

With intangibles for example, it is entirely rational in many situations for a large and profitable company to reduce risk by selling IP and moving development risk to another party and in a controlled situation the resources available to any subsidiary are to some degree controlled by the group in terms of dividend and capital policies. Similarly for risky but high potential intangibles for example, there can be plenty of evidence that small companies with limited resources for example can raise funds to develop and exploit these (eg biotechs).

Example 19 does help here as it focuses on forecasts rather than more theoretical concepts but, as noted below, it is rather simplistic.

We also have one specific comment regarding paragraph 102 regarding risks related to the infringement of the intangible rights. This is an area of enormous commercial sensitivity and while it is a valid factor in valuing IP, taxpayers will normally obtain such advice under legal professional privilege for commercial reasons which could be lost (with catastrophic impact on the value of the IP and the taxpayer’s business) if this is shared with tax authorities. The guidance needs to be sensitive to the fact that taxpayers might not be able to provide such evidence.

**Comments on examples**

Distributor examples 3-8. These are interesting and helpful. We suggest one further example should be considered. Many multinational groups do not reimburse marketing costs due to either the time and inconvenience of recovering indirect taxes charged on them, or such taxes being irrecoverable. It would be useful to add to the examples the scenario where de
the subsidiary is de-risked in the years of investment by lower prices which rise in later years giving a stable range of return.

Examples 9-11. These are also interesting and helpful but need to be supplemented with a further example similar to example 11 where the facts are similar but the subsidiary does manage the outsourced research: that it has qualified personnel to manage the outsourcing and does review, challenge and approve plans and budgets, etc but the functions are performed by a central R&D centre of excellence. This is in part covered by example 18 which does seem to contemplate that this would mean the IP return moves to the subsidiary but it would be clearer if this were also presented as an alternative scenario in this set of examples.

Example 11 also seems to totally ignore the fact that T has borne the risks even if it did not effectively manage them, so the example needs further expansion to explain how this should be played out in any analysis. For example, is the example saying that Shuyona would reimburse T if the product fails in development at arm-length? At arm’s length we do not believe this would happen. Should there in fact be some sort of profit split if it can be demonstrated that T does bear the risk of product failure, with Shuyona getting a return commensurate with the functions and skills it provides? Also, as is very common, what if, say, 75% of the work invoiced to T was actually outsourced to third parties and not performed by Shuyona’s own staff – would this change the balance, with say, Shuyona getting a return on the element which it functionally performed? We also have a concern with this example as there are third party situations where IP is out-sourced to diversify or reduce risk but R&D remains with the licensor (as they wish to maintain staff and skills in an R&D function). If third parties do this and share the IP reward why would related parties not be able to?

Example 19 is interesting but rather simplistic, as it assumes no other use of the manufacturing assets of Pervichnyi or S. It also ignores system and supply chain complexities of managing contract manufacture which perhaps need to be developed in terms of system or distribution cost and working capital cost and/or the advantages of asset consolidation programmes, etc. It also presumes there is no risk to the revenues projected that are assumed by the licensee and what the impact of not reducing the selling price to 950 might be.

Discussion draft on the revision of the Safe Harbours section of the Transfer Pricing Guidelines

We welcome the development of safe harbours as a means to improve both transfer pricing compliance and transfer pricing administration. Safe harbours should be available to all taxpayers at least for low value-added services and other routine functions. In particular, as transfer pricing requirements become more complicated and opportunities for overseas trade are increasingly explored by small companies, the compliance burden is increasingly becoming a barrier to trade. The adoption of safe harbours could be of particular help to SMEs, for which the relative burden of compliance is more significant.

A clear definition of safe harbours at OECD level, and guidance on their operation, would also reduce the risk of inconsistency in safe harbours between different jurisdictions, as well as taxpayers’ uncertainty.

The Discussion Draft notes some possible negative consequences deriving from the availability of safe harbours. However, we agree that these risks would be minimized if safe harbours are adopted on a bilateral or multilateral basis by means of competent authority agreements between countries.
Press release on certain transfer pricing timing issues

For intangibles, it is often critical to focus on an ex-ante basis, in particular where there remains significant development risk and there is a practical issue that hindsight can give you a very different perspective, as information and risks change. Tax authorities rarely challenge licence prices if a product fails but will focus on products that succeed (and perhaps do better than anticipated) but critically, an arm’s length price must be based on what you knew at the time and arm’s length conditions need to consider what third parties might do in that industry.

Yours sincerely

Ian Menzies-Conacher
Chairman, International Taxes Sub-Committee

The Chartered Institute of Taxation

The Chartered Institute of Taxation (CIOT) is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT’s primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

The CIOT’s comments and recommendations on tax issues are made solely in order to achieve its primary purpose: it is politically neutral in its work. The CIOT will seek to draw on its members’ experience in private practice, Government, commerce and industry and academia to argue and explain how public policy objectives (to the extent that these are clearly stated or can be discerned) can most effectively be achieved.

The CIOT’s 16,500 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’. 
September 14, 2012

Sent via email to: joe.andrus@oecd.org

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit,
Centre for Tax Policy and Administration
Organization for Economic Co-operation and Development

Dear Mr. Andrus:

Re: Comments on Discussion Draft – Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

The Canadian Institute of Chartered Business Valuators (CICBV) is pleased to provide our comments on your Discussion Draft – Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (“Guidelines”).

PROFILE OF THE CICBV

Established in 1971, the CICBV is the largest professional business valuation organization in Canada, with over 1,400 Members. The CICBV is a self-regulated organization that grants the Chartered Business Valuator (CBV) / expert en évaluation d’entreprises (EEE) designation to individuals who have successfully completed the CICBV’s extensive education program, a comprehensive entrance examination and who have attained significant business valuation experience. The CBV/EEE designation is recognized as the premier credential for professional business valuators in Canada. CICBV Members are bound by the CICBV’s strict Code of Ethics, are subject to its disciplinary process and have continuing education obligations that must be met. Over the years, the CICBV has developed extensive standards of practice that all Members must meet. The vast majority of our Members hold professional designations in addition to the CBV/EEE, such as Chartered Accountant and Chartered Financial Analyst. In addition to providing a broad range of business valuation services to Canada’s business, legal, investment, banking and government communities, our Members are also active in other areas, such as financial advisory services, transfer pricing advisory services, the quantification of economic damages, and business management.
Our Members are regularly involved in valuing intangible property in the context of the transfer of such types of property both within, and outside of, Canada and other jurisdictions. The high quality of our member’s work and the importance of the CICBV professional standards are recognized by the Government of Canada’s taxation authority – the Canada Revenue Agency (CRA) - and by Canadian securities regulators, and are often referenced by the courts, academic bodies, accounting bodies, and regulatory bodies.

The CICBV is a sponsoring member of the International Valuation Standards Council - an independent international valuation standard setting organization. The CICBV is also the co-founder, along with the ASA, of the International Institute of Business Valuation, which is an organization of valuation organizations from around the world which strives to promote consistent and high quality education related to valuation and development of valuation organizations using leading practices.

CICBV’s VIEWS and COMMENTS

The CICBV commends the work that the OECD has undertaken to date in relation to developing guidelines on the transfer pricing of intangibles, and offers its assistance to the OECD in support of its further efforts. We believe that that it is important for the transfer pricing, tax and valuation professions to collaborate on this project. The CICBV appreciates the opportunity to have addressed the WP6 in March and October 2011, and would welcome the opportunity to further invest in the process and further assist the WP6 by presenting or clarifying our views and comments on the Guidelines.

Our comments on the Guidelines are limited to those aspects that relate to valuation issues, our area of expertise.

Accordingly, the following represents a summary of our views and comments:

1. The valuation of an intangible is a complex exercise. The robust standards and body of knowledge of the valuation profession should serve as an explicit benchmark or point of reference in the OECD’s Guidelines, including such matters as the premise of value, definition of value, valuation methodologies, and principles. Valuation guidance itself should exist independent from the Guidelines, except for references to such independent guidance or references to the need for a valuation exercise. A similar approach can be found in accounting standards; whereby, the need for a valuation exercise contained in a standard refers to fair value standards found elsewhere;
2. We believe that the valuation profession, via taskforce or working party, should be commissioned by WP6 with a mandate for drafting appropriate valuation guidance on behalf of the OECD that is consistent with the objectives, criteria, and constraints set-out by WP6. Our experience and pre-existing body of knowledge could alleviate unnecessary incongruence between the valuation, tax, and transfer pricing professions;

3. The OECD should consider adopting or borrowing from valuation concepts, principles and methodologies as defined or addressed by valuation bodies such the CICBV, ASA or the IVSC. As an example, we believe that it would be appropriate to use as a standard of value for valuation exercises necessitated by the Guidelines, the “fair market value” definition set out below as it is consistent with and complementary to the arm's length principle and a taxation context. In theory, the underlying premise of the arm’s length principle implies that the OECD will be indifferent to a transfer/sale of an intangible between related parties if its terms are reflective of parties acting at arm’s length. In the view of the CICBV, the concept of fair market value shares this premise by definition. We would be pleased to provide further information and insights to the OECD in this regard.

An international glossary of business valuation terms, long adopted by the CICBV, defines fair market value as “the highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts”.

4. In lieu of directly adopting the standards of a recognized valuation body or commissioning the valuation profession to ratify valuation standards on the OECD's behalf, we would suggest that the Guidelines explicitly direct taxpayers to, and/or defer to, a valuation prepared in accordance with the body of knowledge set-out by the valuation profession (e.g., practice in accordance with the IVSC standards and/or in accordance with the standards of the respective governing valuation organizations) on such matters as disclosure and work standards, terms of reference, valuation principles and valuation methodologies.

5. We believe that the application of valuator judgement is paramount to the validity of a reasoned valuation conclusion. Accordingly, the Guidelines should avoid any reference to priority of valuation approaches, be it cost, market, or income approach. Instead, the Guidance should support the use of multiple valuation approaches, as appropriate, and reasonably supported.
6. While we agree with the majority of paragraph 22, we disagree with the last sentence in section 22 which states “In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis”. While the purpose and use of accounting fair values may not be consistent with a taxation premise in many instances, fair value may be a relevant consideration in the determination of identifiable intangible asset valuation and goodwill for the purposes of reconciling concluded values for intercompany transfers/sales. Likewise, we disagree with the last sentence of section 110 which states: “In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes”. Instead, we believe the accounting fair values determined with reference to a purchase price allocation may be relevant (but not necessarily so), based on the particular facts and circumstances underlying its determination. At a minimum, such fair values represent measures of value to be considered. Accordingly, we support the following statement:

111. It is essential to consider the purpose for which a valuation is conducted. Valuations conducted for business planning purposes may be either more or less relevant than valuations conducted purely for tax purposes, depending on the circumstances.

7. We believe that the intercompany transfer or sale of ‘something of value’ or an intangible begins with the measurement of total value transferred as a first step, and the classification, allocation, or delineation of that total value as a second step based on consideration of:

a. Required classifications, jurisprudence, or legalities of a particular tax jurisdiction;

b. Risks-return profile;

c. Ownerships and control;

d. Economic benefits; and,

e. Functional activities that support the intangible.

Accordingly, we do not support guidelines that prioritize and necessitate defining the intangible to be valued ahead of measuring the value transferred. In our view, such an approach would appear to prioritize form over substance in a particular intangible transfer/sale, and could contradict economic realities or not detect the transfer of economic benefits that flow from an ill-defined or yet-to-be defined intangible1. An approach which commences at the definitional level is further challenged by potentially divergent definitions of intangibles, legal and regulatory regimes, and unique facts and circumstances. We are

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1 Reference should be made to Richard Ginsberg’s presentations to WP6 which illuminate our suggested approach and related valuation matters.
concerned that an approach that cedes measuring the total value transferred as a second step, may inadvertently avoid capturing an ill-defined transfer of an intangible or something of value. In our view, the total value transferred to a related party and any value retained by the transferor, should reconcile to the total value assuming no transferred occurred. The prior classification/categorization of this transferred value is not a precondition for its measurement.

To summarize this point, as a general approach we recommend that it is important that there should be first a measurement of whether any value has been transferred, and then that value should be classified and allocated among various intangibles such as technology, brand, contracts, as well as goodwill, according to the particular requirements of various tax jurisdictions. In this regard, we highlight the following paragraphs in the Guidance which we believe supports this position and perspective:

5. In these Guidelines, the word “intangible” is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

6. Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless carry significant economic value and may need to be considered for transfer pricing purposes. Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterisation for accounting purposes, but will not be determined by such characterisation only. Furthermore, the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterisation for general tax purposes, as, for example, an expense or an amortisable asset.

22. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes. It is important to recognize, however, that the terms goodwill and ongoing concern value are often used to describe an important
and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm’s length price. Similarly, when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark or other licence that reputational value should be taken into account in determining an appropriate royalty. To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as intangibles within the meaning of section A.1. Such treatment in no way implies, however, that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily appropriate measures of the price that would be paid for the transferred business or license rights, together with their associated goodwill and ongoing concern value, by independent parties. In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis.

In our view, the above statements appear to be consistent with a prioritization of substance over form; of an economic determination of intangible value over a definitional approach. The CICBV supports an approach which supports a prioritization of substance over form.

We hope that our comments are helpful to you. It is our belief that input from members of the valuation profession will be an essential element of your considerations in this area. In this regard, we would be pleased to work with you further on this project.

If you have any questions regarding our comments, please do not hesitate to contact Robert H. Boulton, CA, CBV, our Director, Education and Standards (email: boultonb@cicbv.ca).

Yours truly,

Barbara Morton, CA, CBV
Chair, Professional Practice and Standards Committee
Richard Ginsberg, CA, CBV
Chair, Accreditation Committee
C/M/S/ Bureau Francis Lefebvre

**REPLY TO THE OECD’S REQUEST FOR COMMENTS ON THE “DISCUSSION DRAFT – REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TP GUIDELINES AND RELATED PROVISIONS – 6 JUNE TO 14 SEPTEMBER 2012”**

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Introduction

Intangibles are one of the most complex and challenging topics with regard to transfer pricing. They constitute valuable assets for companies, involve important investments, may generate important revenues and, consequently, significant taxable incomes. Having due regard to the amounts at stake, the presently discussed revision draft (hereafter “Discussion Draft”) was thus highly expected by companies, practitioners and administrations facing the specific difficulties raised by intangibles and the different approaches provided by domestic laws. Indeed, with regard to the increasing number of intra-group transactions and disputes relating thereto, the subject required to be more specifically addressed than it used to be.

In this context, we welcome the fact that the OECD invited us to comment on its Discussion Draft of Chapter VI on the transfer pricing aspects of intangibles.

Further to providing general comments with regard to the submitted Discussion Draft, we will debate issues that relate specifically to each one of the four sections of the draft document:

- Identifying Intangibles;
- Identification of Parties Entitled to Intangibles Related Returns;
- Transactions involving the use or transfer of intangibles; and
- Determining Arm’s Length Conditions in Cases Involving Intangibles.

Most of the comments we express below are applicable to several specific paragraphs of the Discussion Draft at once. Therefore, we have organized them under the general headings of the Discussion Draft. In few cases, however, where we illustrate a point with a practical example, we have referred to specific paragraphs, but this should be understood as a non-exhaustive, but merely illustrative approach.
I. General comments

By way of introduction, we noticed that an entire new language is proposed to replace the current provisions of Chapter VI providing taxpayers and administrations with more complete guidelines with regard to intangibles. We welcome these enhancements to the Guidelines.

However, as a preliminary remark, these comprehensive edits could be seen as diminishing the ability for taxpayers and practitioners to apply these Guidelines in a manner that complies with their spirit and key principles.

• First, we are of the view that, even when the subject is complex, it should be the objective of the Working Party No. 6 to provide clear definitions and recommendations. On several occasions in this Discussion Draft, it is stated that reaching a consensus is difficult, which cannot be disputed but does not really provide practical solutions to problems commonly faced by taxpayers, administrations and practitioners. The OCDE is generally expected to “explore the definitions of good practices” and “disseminate global standards and guidelines”.

Such absence of clear recommendation on certain key matters (such as definition of intangibles, consequence of legal ownership and costs bearing, applicable methods, comparability standards, etc.) may actually complicate an already complex situation rather than assist companies and tax administrations in finding an acceptable compromise between the various domestic laws and possible interpretations.

• Furthermore, the Discussion Draft contains numerous examples (mainly provided in appendix). The main corpus of the text is followed by 21 examples illustrating the OECD’s guidance on special considerations for intangible property: #1 to #11 provide examples of determination whether a party is entitled to intangible returns; #12 to #17 illustrate transactions involving the use or transfer of intangibles; and #18 to #21 illustrate cases of determination of an arm’s length price.

If, in theory, these should help clarify the reader’s understanding, in the case at hand, we believe that the OECD should rather formulate recommendations aiming at serving as reference to businesses and administrations. In order to encourage “a transparent and predictable fiscal environment [that] provides a positive business climate”, the OECD Guidelines should seek for a common understanding and largely applicable principles instead of providing numerous examples which are all too specific to be adapted to other actual and factual situations.

1 www.oecd.org/tax/globa relationsintaxation/workingintheinternationaltaxlandscape.htm
2 www.oecd.org/tax/globa relationsintaxation/workingintheinternationaltaxlandscape.htm
In other words, including into the main corpus of the text a standard set of reference principles that would be derived and generalized from said examples would be a highly welcome enhancement to the Discussion Draft.

- Also, the Discussion Draft appears to have raised to a higher standard the OECD requirements with regard to qualitative analysis of facts and circumstances. As is the case with other transfer pricing matters, the analysis of transactions involving intangibles necessitates the performance of a comparability and functional analysis. However, if these strict standards are adopted, the analysis pattern set by the revised Chapter VI could increase significantly taxpayers’ compliance burden and lead to more controversy.

For instance, when considering the extended information to be analysed to determine if an entity is entitled to intangibles related returns\(^3\), a tax administration may easily conclude that information provided in a taxpayer transfer pricing documentation is incomplete and/or irrelevant. Conversely, following an audit, a taxpayer may without difficulty, be in a position to establish that the reassessment is not sufficiently supported as per the OECD Guidelines’ standard.

We therefore believe that raising comparability and documentation requirements to an excessive level would increase uncertainties for taxpayers and administrations instead of providing a useful consensus basis for discussion.

While we fully agree that the OECD Guidelines should address abusive situations and attempt to restrain tax evasion schemes, we believe that the current anti-abuse environment too strongly oriented the draft document. In this respect, the Working Party No. 6 should pay attention not to consider every tax-payer as a potential tax-evader. When considering intragroup transactions relating to intangibles, it has to be reiterated that transfer (through sale, disposal, licensing etc.) routinely happens between independent enterprises and this is not an arbitrary concept invented for tax reasons. The general rule should be therefore addressed to the taxpayer while examples of what should not be done could be provided in appendix.

Hence, while we are aware of the complexities the OECD is facing in trying to harmonize definitions and offer guidelines, we consider that the revised chapter should ultimately provide more general principles that provide practical tools applicable to the greater possible situations and allow companies to provide reasonably reliable proofs of the proper application of such principles.

\(^3\) Discussion Draft, § 54 and 55.
II. Identifying intangibles

The draft under discussion aims at providing a specific definition of intangibles as regards transfer pricing, aside from legal, accounting or tax definitions. Intangibles are first defined broadly as assets that are not tangible, not financial, that are held or controlled for use in the context of commercial activities and that could be transferred separately or in combination with other business assets.

Although such definition tends to follow the economic reality of intangibles, it appears as increasing the current complexity characterizing the transfer pricing aspects of intangibles for the reasons detailed below.

- The proposed definition might be considered as not detailed enough and insufficient to address the conflicts between the various existing regulatory frameworks regarding definition and identification of intangible assets.

Problems with transfer pricing of intangibles frequently can be traced to a lack of understanding of what intangibles are and who owns them. Definitions of intangibles for accounting and/or tax purposes vary largely from one norm corpus to another. However, intangibles are also addressed, and therefore defined in the commercial or property law of almost every country, and the definitions provided by various domestic intellectual property laws are not that conflicting from one another.

It is therefore unfortunate that the current draft does not provide clear enough definitions or recommendations relating to the identification of intangibles. It would have been possible in our opinion to refer to typical intellectual property laws instead of submitting another, yet different framework of potential definitions, which are largely left to interpretation. Numerous real life examples between third parties show that using the existing legal framework is feasible even when the parties to a contract are located in different jurisdictions. In this respect, we would value the opportunity to share our suggested definition with the OECD.

Besides, the Discussion Draft does not address the practical issues regarding how the transfer of something that has no existence as per the domestic property law could be formalized in a contractual arrangement between the related parties involved in that transaction, as it is mandatory in many countries, or at least highly recommended by the OECD Guidelines themselves.

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4 Discussion Draft, § 36.
• The guidelines made limited attempt to categorize intangibles under labels, e.g. hard
versus soft intangibles. Still in practice, both tax authorities and taxpayers often
oppose routine to non-routine intangibles as a corner stone to method selection and
economic analysis.

This distinction may especially influence the determination of the relative contribution
of the parties to an intragroup transaction and therefore, the fixing of the arm’s length
price for this transaction.

We therefore believe that the OECD Guidelines should be completed to clarify the
concept of routine versus non-routine intangibles and to address the question of
whether an intangible should necessarily generate abnormal and excess profits.

• The Discussion Draft contains an illustrative list of typical intangibles. Some of these
intangibles call for specific comments.

As regard to goodwill and ongoing concern, viewed as intangibles in the context of the
discussed transfer pricing definition, they should be subject to separate and detailed
definitions. Goodwill in particular, as the same term may reflect different realities. The
definition provided in the Discussion Draft is too broad at this stage and as such,
encompasses the capacity to generate profit, which is not an intangible as such. We
believe that the OECD could have used existing financial definitions as well as
references to Chapter IX to avoid confusion between these different concepts.

On the one hand, we welcome the fact that the proposed draft recognised that certain
business elements contributing to the level of income earned by a multinational
company, such as group synergies and market specific characteristics, are not
intangibles.

On the other hand however, we regret that the document under review does not clearly
recognize that assembled workforce does not constitute an intangible. Assembled
workforce is listed in the Discussion Draft as an intangible for transfer pricing
purposes although it may not be owned nor controlled. It therefore does not appear to
us as an intangible with regard to transfer pricing purposes even if it is valued under
IFRS standards. Assembled workforce should only be taken into consideration to
determine arm’s length conditions of other controlled transactions.

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5 Discussion Draft, §13.
6 Discussion Draft, § 21 and 22.
7 Discussion Draft, § 25 and 26.
8 Discussion Draft, § 5.
We also believe that the OECD could do further work to determine if this list of typical intangibles should be extended to include fairly harmonized notions such as valuable contractual relationships (e.g. clients list/clientele, exploration/concession rights, long-term supplying agreements, etc).
III. Identification of Parties Entitled to Intangibles Related Returns

The second section of the revised Chapter VI, dealing with the identification of parties entitled to intangible related returns, calls for significant comments.

The Discussion Draft sets the effective facts and circumstances of the parties as main criteria to determine the parties’ entitlement to intangibles related returns while stressing that contracts, legal protection and bearing of costs, taken separately or together, are insufficient.

This approach seems to dismiss the principles previously instituted. The revised language may discredit the importance of legal ownership and the consequence of bearing the costs that relate to the development, enhancement, maintenance and protection of intangibles.

- In the current Discussion Draft, legal ownership and cost bearing are qualified as insufficient to determine the parties’ entitlement to intangibles related returns.

However, in many situations between independent parties, legal ownership provides valuable protection to the owner by preventing certain forms of abusive competition. The legal owner of a registered trademark for instance will be protected against a competitor using similar brand attributes. Quite advertised and notorious “battles” over patents ownership and/or infringement also have taken place in the recent years on the open market in several industries, and some are still currently unfolding, with very high impact on the value of some businesses or corporations, or very significant compensations being exchanged between unrelated parties. This illustrates that legal ownership in itself (or lack of) is oftentimes sufficient to increase (or reduce) business value by significant amounts.

Besides, bearing of costs are at the core of intangibles’ development, enhancement, maintenance and protection. Someone who bears the costs related to intangibles has necessarily taken some risks (at least financial risks) that need to be taken into consideration.

Although we agree that these elements may not solely suffice to conclude upon a party’s entitlement to returns related to intangibles, we believe these elements should be considered as interesting indicators.

- The document under review proposes to determine the parties entitled to intangibles related returns in view of a functional analysis with a particular focus on the performance of functions and on risks borne, as well as on the control thereof, as indicators of parties’ entitlement to intangibles related returns.

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9 Discussion Draft, §27.
Although we agree that a functional analysis should be conducted to confirm the business reality of inter-company agreement terms, we believe that the OECD should reconsider the depth it recommends to set to such an analysis, depending on the context at hand.

We note the fact that contracts governing the detention of intangibles, as well as legal protections, are maintained as starting points of the analysis in the Discussion Draft. In addition, we believe that if the costs related to the development and protection of such intangibles are – at least partly – directly borne by the previously identified legal owner, the functional analysis aiming at determining which party is entitled to intangibles related return would not have to be overly detailed.

It would be very helpful that the OECD recognizes that, only when legal ownership and direct bearing of costs are not attributes of the same entity within a group of companies, then a more detailed or cautious functional analysis should be performed to understand which entity is entitled to intangibles related returns.

- Furthermore, from a practical standpoint, the proposed order of importance of the elements that may be considered in determining a party’s entitlement to related returns increases the level of difficulties for a company to demonstrate the arm’s length nature of its transfer pricing policy. Indeed, the control and decision making processes over functions performed and risks borne may be quite challenging to fully understand and appropriately document as more than one entity may be involved in these processes at various levels of the development, enhancement, maintenance and protection of an intangible.

In many cases, the current wording of the Discussion Draft therefore sounds, to some extent, as if it had been designed to bar abusive schemes from being implemented, rather than to help good-faith taxpayers in implementing an appropriate, practical and efficient analysis and documentation based on a set of standards applicable to normal situations.

Therefore, and even if we agree with the OECD’s aim to prevent passive intangible holders from gathering all of intangibles related returns, we strongly believe that such objective should not increase all companies’ documentation burden and should not lead to require from full-of-substance intangibles owners or taxpayers using intangibles and complying with domestic laws and transfer pricing guidelines, to document their transactions involving intangibles with a much higher level of details than they currently do.
IV. Transactions involving the use or transfer of intangibles

The Discussion Draft distinguishes two categories of transactions involving intangibles.

- In the first category, i.e. use of intangibles in connection with sales of goods and services, we welcome the recognition of the fact that intangibles may be used by one or more entities within a MNE without being transferred. The examples set out in the Discussion Draft assist efficiently in providing a better understanding of the latter.

  The only comment to be made with regard to this section of the Discussion Draft is that the use of the word “transaction” might be confusing when no transfer actually happened. We believe that this part could be redrafted to present the OECD’s guidance on the subject in a clearer and more didactic manner. We suggest that the distinction made in this section of the revised guidelines may use a different wording, such as “situation” or “intragroup arrangement” instead of “transaction”.

- In the second category of transactions involving intangibles, i.e. transfers of intangibles, we welcome especially the recognition of the fact that intangibles may be transferred individually or in combination with other intangibles or with other business transactions.

  Actually, many aspects could contribute to value creation and it could sometimes become difficult to draw a line between the respective intangibles used in a business. In these specific situations, we agree that an aggregate value may be ascertained for a combination of intangibles.
V. Determining Arm’s Length Conditions in Cases Involving Intangibles

The inherent characteristics of intangible assets mean that determining an arm’s length price for transactions involving the sale or license of intangibles assets can be substantially more complex than determining an arm’s length price for transactions of goods or services. Working Party No. 6 has placed considerable attention to the question of determining arm’s length conditions in each case involving intangibles (i.e. the use of intangibles in connection with sales of goods or services and, the transfer of intangibles or rights in intangibles.).

The revised Chapter VI discusses the selection of the appropriate method in detail amongst the CUP method, valuation techniques and the Profit Split method. In our reading of the Discussion Draft, the proposed guidelines seem to set numerous restrictions and reservations to the use of the CUP method and of valuation techniques, thus leading to an intuitive conclusion that the profit Split Method might, by default, be identified as the most appropriate method in most situations. We believe that, if confirmed, such an approach is both misleading, as significantly departing from what, in our experience, forms the basis for discussions between unrelated parties in many cases, and problematic for many taxpayers, as practical situations are too complex to set, ex ante, an apparent preference for a given method over others. Instead, we would have welcomed an approach through which the various methods would have been discussed with practical recommendations regarding how to implement them or tools to determine which might be better suited to a specific situation, rather than putting too much emphasis on their many drawbacks or defects, which all of them inevitably display.

- Regarding the CUP method, the Discussion Draft first sets very high standards of quality and quantity of information requested in order to perform a comparability analysis. It is unfortunate that the guidelines seem to have raised again the standards required for comparability purposes and, as such, further disregarded the concept of reasonableness expressed in Chapter I of the OECD Guidelines.

The CUP method is broadly applied by multinationals in relation to intangibles (in order to define royalty rates, for instance) and is favoured, in theory, by the OECD guidelines. In our experience not only as transfer pricing experts and economists, but also as lawyers, it is even used in some situations by unrelated parties (based on publicly available information, albeit limited in many cases) as a practical tool for the negotiation of real-life transactions, at least at early stages. In our view, it would be problematic that companies and tax administrations would face increasing difficulties in applying this method in the case of inter-company transactions, if requirements for accurate public information are raised to such an “ideal” level as currently stated in the proposed guidelines.
As a (non exhaustive) illustration of this point, the Discussion Draft states “In conducting a comparability analysis, it will therefore be important to consider the expected useful life of the intangibles in question”\textsuperscript{10}. Expected useful life is most often a piece of information that is not available based on the reading of a license agreement between unrelated parties, nor from any other public source in most cases. Requiring such a comparison, would make the use of the CUP method based on publicly available agreements between unrelated parties virtually impossible in practice, while this is in our experience a very useful source for observing open market industry standards.

We do recognise that the current discussion of the various comparability factors included in the Discussion Draft provides useful comments, but our point is to stress out that, in absence of more robust recognition of the fact that the comparability analysis should in all cases be pragmatic in its approach, the wording of the Discussion Draft could make it quite easy for a tax administration to rule out any CUP analysis performed by a taxpayer (or vice-versa) on the ground that many of these factors are not taken into account in that analysis, thus making the CUP method impossible to use with a reasonable degree of robustness to justify a transfer pricing policy.

In conclusion, we would propose that the wording of the Discussion Draft be amended so as to keep enough flexibility to focus on the comparability factors that are available and material in the case at hand.

- In third parties situations, businesses often value the transfer of intangibles using valuation techniques such as the market, income or cost approaches (including amongst others the DCF, multiples, relief-from-royalty, premium profits, or excess earnings methods). Moreover, some tax administrations including the IRS and the French Tax Administration also propose or impose certain methods for valuing businesses and/or intangibles. We therefore welcome the works that have been done in order to provide guidance in this respect.

These financial valuation techniques involve a series of hypothesis to be considered. Each may have an important impact and involve a certain degree of subjectivity. Although we agree with the OECD’s prudence in relation to the endorsement or rejection of sets of valuation standards, there is a risk that, based on the current wording of the Discussion Draft, these valuation methods, although commonly used by independent parties, would be rejected by tax administrations when good-faith taxpayers use them, on the ground that they all involve a judgement call.

\textsuperscript{10} Discussion Draft, § 96.
In our opinion, this should not be sufficient enough a reason for disregarding them. Indeed, this is the case of any method, and transfer pricing analysis is not an exact science, as the OECD rightly points out in many cases.

We would rather propose that the OECD provide didactic guidelines to limit the risk of subjectivity of these methods and consequently to secure the valuation results, such as providing or discussing a non-exhaustive list of public sources that could be used to select various key parameters, or recommending running sensitivity analyses to test the effect of variations of given parameters and therefore demonstrate the reasonableness of the end results. Again we would value the opportunity of providing the OECD with our suggested didactic guidelines should our opinion be shared.

- The Discussion Draft confirms that the Profit Split method seems very attractive with regard to the determination of intangibles related returns. Though we agree that the profit split method can be used in certain cases, we believe however that the profit split method may raise lengthy debates between companies and administrations when comes the time of tax audits. The subjectivity necessarily involved in the implementation of such method (i.e. no reference to external data), often makes this method not necessarily more reliable than others (such as the CUP method or financial valuation methods), when defending it in such situations. Besides, in our experience, unrelated parties only rarely share any information regarding their profits, in transactions involving intangibles, thus making it perhaps less representative of pricing mechanisms on the open market. In consequence, we would recommend that the proposed guidelines would better balance the merits and drawbacks of said method compared to others.

- The Discussion Draft does not provide detailed comments on other methods (such as those discussed in Chapter II of the Guidelines – except as regards the CUP). We believe that it should not avoid the other methods, and especially the TNMM method, when it comes to discussing applicable methods for determining arm’s length conditions in cases involving the transfer of intangibles. As an illustration of this, it would have been useful that the Discussion Draft provide detailed guidance regarding whether and how the TNMM could be used, for instance as a one-sided approach to test the reasonableness of a royalty rate from the licensee’s standpoint, especially in situations where other methods would be found to be hardly applicable, or in conjunction with other methods.
Finally, we believe that the OECD should recommend selecting the most appropriate method in the same way as independent parties will do, taking into account, among other aspects, the reluctance of companies to communicate sensitive information about their vision of the future and their margin levels.

In situations where unrelated parties would need the use of a method to propose a specific pricing or support their position in a contemplated deal, the order through which they would review applicable methods may depend on the type of transactions, for instance whether the licence versus the sale of an intangible is contemplated. Unrelated parties may be more reluctant to share information on their vision of the future or on their profits, in case of a licence (by fear of the other party taking advantage of that to challenge the proposed pricing in its favour), but less reluctant to do so in case of a sale (where justification of the absolute value is more important).

Indeed, in case of a contemplated licence, companies wishing to enter into an agreement with a third party involving intangibles will often first try to identify comparable transactions, market references. The CUP method should in that case therefore be preferred as long as reasonably reliable information could be identified. If no market reference exists, then, in most cases, another one-sided method (e.g. equivalent to the TNMM) will be envisaged by the parties. Alternatively, or if this method is again inapplicable, the parties will then envisage sharing forecasted estimates and business plans to agree on the price to be paid (thus leading to a financial valuation method then converted in royalty flows).

Only on rare occasions will independent parties agree to split their profits among them (which involves sharing such an information).

In case OECD Working Party No. 6 would determine such reasoning to be a useful approach, it might be interesting that the final guidelines on Chapter VI further expands and develops it (along with necessary caution, so as not to turn it into a one-size-fits-all tool). In any case, as an utmost standard, we are of the opinion that the OECD should insist on the absence of predefined hierarchy and the necessity to select a reliable method as set forth in Chapter II.
Dear Mr. Andrus,

I am happy to have this opportunity to express my concerns regarding the transfer pricing aspects of intangibles and the intangibles-related aspects of arm’s length transfer pricing.

I believe that a dramatic simplification of the transfer pricing rules for transactions involving intangibles with due regard to the practical limitations faced by the taxpayers and the tax administrations would be the Working Party’s most valuable contribution to the development of the topic being discussed.

The recommendations currently provided by the Guidelines are too sophisticated in terms of defining the scope of the required analysis. Only in rare cases these recommendations may be implemented in a consistent, transparent and at the same time efficient and, I may say, reasonable way. The proposal to assess impact of each of the ubiquitous intangibles involved into a modern business transaction based on the residual profit analysis effectively places an unbearable burden both on the taxpayers and the tax administrations. The simple examples used for illustration purposes disguise the real multi-layer web of different effects of intangibles used by MNE groups across the world, the cross-effects and the positive and negative synergies created by combinations of such effects.

At the same time the generally accepted comparables-based approach to assessment of an arm’s length return on an intangible is unreasonably simplistic and basically ungrounded. The obvious fact that the arm’s length price for any given intangible depends entirely on its more or less unique possibility to improve the business performance of a particular user in that user’s particular circumstances seems to be forgotten. Use the data bases without a thorough comparability investigation involving specialized expertise (which is impossible to perform in most cases) leads to use of some arbitrary and formalistic methodology. Absence of the information required for a reliable comparability analysis in legally accessible domain adds to the overall practical impossibility to comply with the recommendations provided by the Guidelines.

The residual profit analysis hardly allows to distinguish the returns related to one intangible from the abnormal returns generated by any other outstanding feature of a company, potentially including location, bonus scheme applied, economies of scale exploited, use of advanced equipment, personal relationships of the company’s director or another intangible (visible or invisible to the researcher).

As regards to the proposed attribution of all above routine proceeds related to an intangible to the jurisdiction in which the ultimate management and control over the intangible is performed. I find it rather questionable, as in practice it is impossible to identify the one and only true place of the effective management and control over a particular intangible based on contracts and other internal documentation of an MNE group. In my opinion, the Guidelines excessively rely on the legal registrations and contracts which in case of intra-group transactions within an MNE group may not be treated as exhausting evidence of the true allocation of functions, risks, costs, etc.

The distribution of the actual decision making powers may be not documented (partially or at all) or such documentation may be intentionally flawed for avoidance purposes.
I would like to suggest that the Working Party members consider the following alternative approach to the intangibles as such.

The basic logic presented in the Guidelines proposes that intangibles may generate certain (positive or negative) return on top of some routine proceeds of a given company (if any). At the same time the Guidelines state that there might be some other factors affecting company’s performance which should not be considered as intangibles. This proposed segregation between the two groups of performance factors in my opinion is rather arbitrary and may be unjustified for the purposes of the Guidelines.

The blur distinction between a service and an intangible mentioned in the Discussion Draft is defined virtually only on the basis of presence (in case of an intangible) or absence (in case of a service) of some business function’s provider’s and requestor’s agreed common will to share the losses and profits generated by the requestor with the help of the function contributed by the provider. The risks associated with the intangibles in practice relate only to the retention of the comparative competitiveness of the significant people functions creating the value of such intangibles. For example, the risk of obsolescence is only applicable where the new product development function loses its competitive edge, and is practically attributable to product-specific assets, not the engineers developing the design or lawyers defending a patent. It’s only the combination of a function with a loss and profit-sharing (partnership-like) arrangement that makes intangibles different from a common function outsourcing, i.e. a service.

So in practical terms intangibles do not exist and may not create any return outside the body of some specific business function to which they relate. The examples of the intangibles provided in the Discussion Draft may be seen not as some unique possessions of a business but rather as indicators of some level of efficiency of a respective business function. Such approach effectively covers the successfully negotiated permissions, licenses to intangibles and/or other successfully negotiated contracts providing some other unique competitive advantages; successful organization of a business function as a whole (know-how, trade secret, etc.) or an algorithm allowing to improve its efficiency (software, patent, etc.); the distinctive accumulated efficiencies (or inefficiencies) of the marketing function (trade name, trade mark, brand, product’s design, their legal protection, etc.). This means that intangibles at an MNE group’s disposal may be treated not as individual objects creating some returns by themselves, but rather as indicators of above (below) the industry-average return on the respective consolidated business function of an MNE group.

In view of the above I suggest to assess the arm’s length return on an intangible as a combination of two components: the arm’s length return on a respective subscription-based service and the portion of loss or profit of the user of the service which corresponds to the share of significant people functions outsourced through such a service in the consolidated pool of significant business functions, risks and assets involved into the respective value chain.

The proposed approach may allow to avoid the traditional workload of arbitrary choosing some comparable intangibles and performing analysis without due regard to the undisclosed information on the specific features of the intangibles considered as comparable which by definition should lead to enormous scale of integral mistake. The example of multi-time difference between the values of major household brands of more or less similar soft drinks speaks for itself.

Under the proposed approach the practical task would be to define the arm’s length return on functions (services) and the profit (loss) sharing element of remuneration as parts of the known total return of a given business’ value chain based on the analysis of distribution of the significant people functions, tangible assets and risks within a single value chain.

Unfortunately, the practical ways to determine an arm’s length share of a value chain’s return attributable to a particular function are not addressed in the Guidelines. I believe that the said share may be more or less transparently and objectively measured based on the net income of the respective individuals performing the functions inside the MNE group and the arm’s length
costs of outsource to third parties. The objectivity feature is supported by arm’s length nature of personal remuneration and agreements with unrelated parties.

Another opportunity to provide a simple solution for the matter being discussed is to turn back to the ultimate purpose of the Guidelines, which is establishing a fair amount of taxes due from an MNE group to a particular tax administration.

In my opinion, the task of addressing this purpose has two main parts:

1. Make sure that a fair amount of taxes is paid to a jurisdiction where an intangible-related expense reduces the taxable profit.
2. Make sure that a fair amount of taxes is paid to a jurisdiction where an intangible-related income increases or should increase the taxable profit.

As regards to the first part, it is possible to make use of the positive example of taxation of rental income related to immovable property which has the very same problems with defining comparability and fair return. If the intangible-related income would be subject to tax in the same jurisdiction in which the deduction takes place (complemented by granting a respective tax credit at the income recipient’s side), no tax rate arbitrage would be possible, removing the opportunities for abuse of the intangibles as such.

As regards to the second part, the key problem is to identify if the taxable income was allocated to the jurisdiction(s) which have the taxing rights over such incomes based on the place of effective management concept. This issue, in my opinion, may be resolved based on the results of a comparable analysis of the levels of seniority and competence of the managers which may be seen as potential decision makers with respect to a particular intangible.

Again, I believe measuring the levels of seniority and competence in terms of the size of the net employment-related income earned by a respective manager to be the most transparent, objective and practical solution for identification of arm’s length distribution of returns on an intangible between the tax jurisdictions concerned.

Thank you for your attention.

Kind regards,

Sergey Popov,
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Comments on the OECD Intangibles Draft of June 6, 2012

Dear Mr. Andrus,

We are pleased for the opportunity to submit our comments on the Draft. It is a major enhancement in the analysis of all facets of transfer pricing principles related to intangible assets and its directions will prove very helpful guidance to managing tax controversies and double taxation issues. We will focus below on section B aspects where we believe that further consideration of the related impact and different perspectives should be given.

In particular, we refer to the paragraphs of Section B taking position on one of the most controversial issues, ie, the relevance of intangible funding vs management of functions and control of risks as drivers for the allocation of the intangible related return.

Example 1 under paragraphs 182-183 of the Draft illustrates the main concern, ie, the use of passive IP companies by MNEs as a profit shifting vehicle. Example 1 is an extreme case where the IP company claiming intangible related return has neither funded the intangible development nor paid an arm’s length price for its purchase, nor managed and controlled the related key functions other than merely administering patent registrations with the competent authorities.

Between such an extreme scenario and the straightforward one described under paragraphs 37 with a complete alignment of functions, risks and costs related to the intangibles, a range of different cases may be identified in the ordinary course of business within MNEs and between independent parties.

Section B acknowledges that capital is a significant asset for the purposes of investment return allocation. However, it requires internal performance of so-called important functions to be respected as beneficial owner of the intangible related return. In particular, paragraph 40 introduces a distinction between important and other functions related to intangibles by advocating that only non-core functions may be outsourced without losing entitlement to intangible related return.

Paragraph 40 and the related paragraph 54 seem to stretch the fund manager example under paragraph 9.25 of the TP Guidelines on risk control by somehow emphasizing the relevance of asset development and management per se for the purposes of the intangible return allocation. The
funding of the intangibles development and management is deemed immaterial to that end, as very clearly stated under paragraph 47 of the Draft. That is, it seems that the uniform view within WP6 is that capital is a secondary and ancillary asset for the purposes of intangible return allocation compared to internal performance of important functions. In other words, the risks related to the investment of capital in the intangible development are overshadowed compared to the carrying of the related important functions.

Indeed, Chapter IX on business restructurings identifies three key functions as the minimum threshold for allocation of return related to risks: decision to hire, decision of extent of authority and objectives, and decision of the amount of the investment. In our view, those three functions, as outlined by paragraph 9.25 in the so-called fund manager example, may equally apply to the area of intangibles. For example, a consumer product company may develop a new marketing campaign for the launch of a new product either entirely internally or by hiring an external advertising company, or through a combination thereof. Regardless of the internal or external performance of the related functions, purported to development of the intangible value in the market, the company will be entitled to the return achieved through the success of the marketing campaign by having taken the key decisions on the investment of capital to pursue the marketing campaign, and its way forward.

Similarly, we believe that, depending on the specific facts and circumstances, an IP company may be entitled to the intangible related return whether or not key function such as the development of the campaign for the launch of the new product is managed internally or externally, via third parties or intragroup, as long as an active decision-making control role is made by the IP company’s personnel and/or board of directors on the proposals and recommendations made by group companies acting as service providers.

Intangible development may be capital intensive, eg, R&D in the pharma industry, or even in any new frontiers of the technology sector, eg, tablet development as a recent example. Once an intangible is developed, maybe its market success may fund its further development by itself internally but, before reaching such a level of internal funding, high external financial resources may be necessary and banks may not be willing or allowed to take significant risks in the pursuit of intangible development projects that may take years before generating adequate cash flow streams.

The open market is full of areas of investments whereby the return on the business activity is essentially allocated to investors taking a control decision role in the management of the business rather than a direct performance one. Private equity, real estate investments, securitization vehicles, hedge funds are all investment and industry sectors whereby active management of the business is commonly made in a service capacity without risk-taking. Even public companies, indeed, are based on the dichotomy risks vs active management as the ultimate risk of loss is taken by the shareholders rather than the group management, which only bears risks related to their own role and compensation.

Transfer pricing should mirror open market and third party transactions by focusing on the interaction of functions, assets and risks by taking into account the way they are specifically conducted in each case. Functions can either be carried out at full risk or limited risk. Similarly, any asset, including capital, may be used in a business activity with different level of risks.
As a result, while we understand and essentially agree with the conclusions in Example 1 as an extreme case study, we would hope that further variations of IP asset companies are illustrated by addressing scenarios whereby the IP company has taken development and on-going risk by investing its capital based on decisions taken by its management exercising active control on the people and companies performing functions externally, including the important ones. In particular, it may be helpful if WP6 may wish to identify how allocating the intangible related return in a scenario whereby capital for investment on intangibles and active control of functions is made by an IP company hosting the key decision-making people as directors while all other functions are outsourced to one or more operational companies located in the same jurisdiction, and/or third party external advisors.

If anti-abuse concerns about use of asset company vehicles as IP owners were inspiring the Draft, indeed, we believe that those legitimate concerns may be counteracted by each Country through mechanisms other than transfer pricing. The level of taxation in any given Country should not impact on the application of transfer pricing principles by focusing on functional analysis.

IP tax incentive mechanisms such as Patent/IP Box regimes (indeed increasingly implemented by various Countries) and/or specific anti-abuse measures available such as CFC regimes, deemed residence tests, blacklist rules requiring an active business test for deduction purposes, business purpose doctrine, etc., may be more efficient and better tailored to tackle abuses than applying transfer pricing rules to force profit allocation by weighting people functions more than assets/capital ownership and risks assumption than can be seen in dealings between independent parties.

Absent incentives such as Patent Box regimes, tackling profit allocation by attributing higher weight to functions rather than assets ownership and risk-taking profile may even trigger the relocation of people functions in the low-tax jurisdictions where capital and assets are legally owned also not to give competitive advantages to companies established from the outset in such tax-efficient jurisdictions. In the dynamics of the globalization and open market forces, a defensive approach by high-tax Countries may have the detrimental and paradoxical effect of further increasing the level of delocalization of operational functions.

As a result, based on the above, for the sake of clarity and as a possible basis for consideration, we take the opportunity to submit to WP6 attention a revised version of paragraphs 40, 47 e 54 of the Draft as follows:

40. It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm’s length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will actively control physically perform, through its own management employees, the important functions related to the development,
enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, the control of functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

47. It is important to recognise, however, that bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns if not aligned with the corresponding assumption of risks and active control of functions.

54. In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance:

- Either perform internally and control important the functions related to the development, enhancement, maintenance and protection of the intangibles and or actively control other related the functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis;
- Bear and control the risks and costs related to developing and enhancing the intangible; and,
- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

Where a party is allocated intangible related returns under contracts and registrations, but fails to perform through its own employees and control important functions, fails to or actively control other related the functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and or controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.

* * *

The Draft is a major enhancement and has stimulated, and will stimulate, further discussion and analysis on the most crucial transfer pricing topics by eventually reaching full or most consensus. Thank you again for the opportunity to participate in the discussion on the subject matter.

Sincerely,

Gaetano Pizzitola
Head of Cross-Border Tax Services
Crowe Horwath Italy

Fabio Zampini
Cross-Border Tax Manager
Crowe Horwath Italy
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14 September 2012

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Dear Mr Andrus

Comments on Public Discussion Draft: Revision of the Special Considerations for Intangibles Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

It is with pleasure that we submit comments on the OECD’s public discussion draft: Revision of the Special Considerations for Intangibles Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (the “Discussion Draft”). We welcome the efforts of OECD Working Party No. 6 to request detailed business input with regard to the various provisions of this draft, and the efforts of the OECD Committee on Fiscal Affairs to provide further guidance relating to the transfer pricing aspects of intangibles.

1. Section A (Identifying Intangibles) of the Discussion Draft:

   a) Transferability of intangibles (proposed paragraph 7)

   Proposed paragraph 7 clarifies that separate transferability is not a necessary condition for an item to be classified as an intangible for transfer pricing purposes. We agree that this is consistent with the proposed definition of an intangible in proposed paragraph 5, as the definition does not insist on the existence of ownership and associated property law concepts.

   However, we note that the Discussion Draft is not consistent on the issue of whether transferability (separate or in aggregate) is required for something to be considered an intangible. The definition of an intangible in proposed paragraph
5 does not mention a requirement that an intangible would need to be capable of being “transferred” and merely uses the words “owned or controlled”. By contrast, proposed paragraphs 8 and 24 point out that intangibles need to be distinguished from items (i.e., market conditions or market specific characteristics) that are not capable of being “transferred” (in addition to ownership and control considerations). In this respect, proposed paragraph 8 uses the words “owned, controlled or transferred”, whereas proposed paragraph 24 uses the words “owned, controlled and transferred”. In these proposed paragraphs, transferability is included in the conclusion that the items in question (i.e., market conditions or market specific characteristics) should not be considered intangibles. This inclusion is inconsistent with the definition of an intangible in proposed paragraph 5. Accordingly, we propose that the OECD remove consideration of transferability in proposed paragraphs 8 and 24, or alter the definition in proposed paragraph 5.

We further propose that the OECD expand on the discussion of transferability in proposed paragraph 7, as transferability in aggregate (for example with other business assets) is also not required for an item to be consistent with the definition of an intangible in proposed paragraph 5. The definition of an intangible in proposed paragraph 5 merely requires an item, which is not a physical or financial asset, to be capable of being controlled for use in commercial activities. Controlling an item for use in commercial activities does not require any transferability at all, whether separate or in aggregate with other business assets or intangibles.

b) Description of know-how and trade secrets (proposed paragraph 16)

Proposed paragraph 16 includes the word ‘proprietary’ in the description of know-how and trade secrets. However, information or knowledge that assists or improves a commercial activity does not need to be ‘proprietary’ to be considered to fall within the term “know-how and trade secrets”. Consequently, we propose that the word ‘proprietary’ is deleted in proposed paragraph 16, line 1.

c) Group synergies as an illustration of items that are not considered intangibles within the meaning of section A.1. (proposed paragraph 23)

Proposed paragraph 23 asserts that group synergies are not considered intangibles within the meaning of section A.1., as they are not (owned or) controlled by a single enterprise. However, this statement is not consistent with commercial reality within many MNEs. While group synergies, such as streamlined management, integrated systems or purchasing power, cannot be
owned by a particular MNE entity, they can certainly be controlled by a single designated entity (or multiple entities) within the MNE firm.

In fact, without such controlling entities, the business operations of group entities may not benefit to the same extent, or at all, from any of such group synergies. Efforts have to be made, and control has to be exerted to ensure coordination amongst the MNE group entities to ensure group synergies are realized. Often, the stronger the coordination and control over the use of group synergies by the group entities, the more valuable group synergies become.

A common example is the acquisition of an independent local country loss-making manufacturing entity by an MNE group (think of a business involved in supplying products to industrial customers). In such a case, a designated related MNE entity (or multiple entities) may steer and control the implementation of group synergies for use in the acquired manufacturing entity.

Often the benefits of the bearing of such group synergies to the acquired entity far outweigh any possible contributions. Other intangibles (such as customer relationships, manufacturing know-how, product know-how and supplier relationships) may, or may not, also be contributed to the independent local country loss-making manufacturing entity. However, the contribution of any such other intangibles does not take away from the fact that group synergies are often, either on their own or separately, controlled for use by a designated entity (or multiple entities) in the MNE group.

In addition, the application of group synergies to any particular entity in the MNE group by a designated controlling entity (or multiple controlling entities) is often intertwined with the provisions of management services and may be inappropriately attributed to the provisions of such services. Alternatively, it may be the case that the competitive environment of the MNE group does not warrant any separate compensation for the value of group synergies to the designated controlling entity. In such a case, the competitive landscape may have limited or reduced the value of group synergies to a necessary condition to compete in the market without providing any further value to the MNE group. In this situation, developing and enhancing group synergies may be a minimum requirement for the performance of management functions of the controlling entity.

However, whether group synergies may be valuable or not in any particular circumstance and give rise to excess returns, is a distinct consideration from whether group synergies should be considered intangibles. So, while there is a need for some form of test for recognizing separate compensation for group synergies, which would be based on a factual analysis of the value drivers of the
MNE, we submit that group synergies should be considered intangibles within the meaning of section A.1, based on the fact that they may be controlled for use in commercial activities by a designated entity (or multiple entities) in the MNE group.

In addition, proposed paragraph 23 appears to imply that it is necessary for an item to be owned or controlled by a ‘single enterprise’ to be considered an intangible. Proposed paragraphs 8 and 24 contain similar references to a ‘single enterprise’. However, this focus on a ‘single enterprise’ is not consistent with the definition of an intangible in proposed paragraph 5. Furthermore, the Discussion Draft does not appear to provide any justification for such a requirement that an item should be owned or controlled by a ‘single enterprise’ as opposed to multiple entities within an MNE group. Accordingly, we propose that any references to ‘single enterprise’ in proposed paragraphs 8, 23 and 24 be substituted by references to one or more entities within the MNE group.

d) Assembled workforce as an illustration in section A.4. (proposed paragraphs 25 and 26)

Proposed paragraphs 25 and 26 do not provide a definitive answer as to whether assembled workforce is an intangible within the meaning of section A.1. We submit that the lack of a definitive answer only invites more controversy, with taxpayers/tax administrations potentially taking opposing views for the purposes of determining arm’s length conditions.

While it may be arguable that a workforce can be owned, it is much less arguable that a workforce can be controlled for use in commercial activities. In fact, many companies pride themselves on the quality and excellence of their workforce, and market the workforce as such to their customers (particularly in the service industry), as well as to current and prospective employees. Accordingly, such companies would expend considerable efforts to manage and enhance the quality of their workforce. We therefore submit that, based on the definition of an “intangible” in section A.1 and the commercial reality that companies control the quality of their workforce for use in commercial activities, that assembled workforce is considered an intangible within the meaning of paragraph 5.

e) Additional commentary on assembled workforce as an illustration in section A.4. (Proposed paragraph 26)

Proposed paragraph 26 provides some useful additional considerations specific to assembled workforce. In addition to the comments made, we submit that it may also be useful to recognize that an assembled workforce is an intangible that
is often specific to the business activities of the entity that houses the assembled workforce.

An assembled workforce is often more valuable in combination with these specific business activities, and consequently affects the value of these business activities (in a similar way as know-how may affect the value of business activities). An assembled workforce is also often more valuable in combination with specific business assets (e.g., manufacturing facility), or other intangibles (e.g., specific know-how or patented technology).

As a consequence, and in line with the comments made in proposed paragraph 9, an assembled workforce as an intangible would often not deserve separate compensation, or give rise to premium returns. In many cases, other comparable independent entities undertaking similar business activities (or exploiting similar business assets and/or other intangibles) may have a comparable assembled workforce, in which case it may be determined, depending on the facts and circumstances, that the assembled workforce does not justify allocating a premium return to the enterprise, over and above normal returns to the business activities it performs (or returns realized by other comparable entities exploiting similar business assets and/or other intangibles).

Moreover, the value of the assembled workforce considered on its own (in isolation of the business activities, business assets or other intangibles that houses the assembled workforce), may often be limited to the savings in expenses associated with hiring and training a new workforce.

f) Goodwill as an illustration of an item that is treated as an intangible within the meaning of section A.1. (proposed paragraphs 21 and 22)

Proposed paragraph 22 indicates that goodwill or ongoing concern value are treated as intangibles within the meaning of section A.1 in order to assure that these items are taken into account in appropriate situations (between associated enterprises), regardless of the precise definition of goodwill or ongoing concern value employed for transfer pricing purposes,. We support this treatment of goodwill and ongoing concern value as intangibles for purposes of determining arm’s length conditions. However, we submit that additional guidance needs to be provided for goodwill and ongoing concern value, based on complications arising from their specific characteristics.

These specific characteristics include the general recognition that goodwill or ongoing concern value cannot be segregated or transferred separately from other business assets (proposed paragraph 21). This lack of separate transferability poses complications from a practical perspective in analyzing situations where
the underlying business assets to which the goodwill is ascribed are subsequently broken up and transferred to multiple entities within an MNE.

Example 15 deals with this issue, and proposed paragraph 238 suggests that the full value of an acquired business should be reflected in either the value of the tangible and intangible assets retained in the acquired entity, or the value of tangible and intangible assets transferred to other entities within the MNE. Furthermore, proposed paragraph 238 asserts that it should generally be assumed that value does not disappear, nor is destroyed, as part of an internal business restructuring.

We disagree with the concept conveyed in paragraph 238 that the full value of goodwill of an acquired business should be reflected in the combined value of the broken up tangible and intangible assets. One of the main objectives of an internal business restructuring is generally to create value. To achieve this objective, various parts of the business of any particular entity may be disassembled, destroying value. The disassembled parts may then be discarded and/or subsequently reassembled in combination with tangible and intangible assets in other parts of the MNE with the objective of creating more value, either presently or in the future. As such, goodwill value associated with a combination of existing tangible or intangible assets (i.e., a prior complete business) may be destroyed, on the basis that combinations of these underlying business assets with business assets elsewhere in the business may result in a higher value of goodwill (or a higher value of one of the underlying business assets).

More generally, it would be difficult to accept the notion that goodwill associated with the operation of a particular business may be parsed in a sale of underlying business assets, and transferred in a parsed form in combination with the underlying business assets. It would be more useful to view goodwill as something that is inseparable from the full business (or going concern), which can only be destroyed or created in reference to changes in that particular business (such as through particular transactions of the entity with other entities, or through external events).

It may also be the case that the sale of a particular business asset is seen by a transferor to enhance the value of goodwill of the full business (by unlocking additional goodwill associated with the remaining portion of the business). As such, a perception of the amount of goodwill destroyed (or created) by transferring a particular business asset would be expected to affect the price at which the transferor would be willing to part from those business assets.
Similarly, a perception of the amount of goodwill that will potentially be created in the business of the transferee would affect the price that the transferee would be willing to purchase the business assets. However, it does not follow that the goodwill destroyed (or created) in the business of the transferor is indicative of the goodwill created in the business of the transferee (and as such goodwill can be said to have been transferred). Consequently, we do not support the concept that goodwill or going concern value as such is in fact transferred with underlying parts of the business.

g) Inclusion of contractual rights as an illustration of an item that is treated as an intangible within the meaning of section A.1.

Proposed paragraph 26 indicates that contractual rights may be intangibles within the meaning of section A.1. However, this point is merely made as part of a number of considerations regarding assembled workforce, and only made in the context of a long term contractual commitment to make available the services of a particular group of uniquely qualified employees. While we agree that inclusion of contractual rights as an intangible is consistent with the proposed definition of an intangible in proposed paragraph 5, as contractual rights are capable of being owned or controlled for use in commercial activities, we submit that this point warrants inclusion as an illustration of an intangible on its own, separately from the discussion on assembled workforce.

For example, the long term contractual commitment by an entity to sell products solely to one entity within a certain territory is commonly made, and such an item meets the definition of ‘intangible’ in proposed paragraph 5. Given the prevalence of contractual rights as intangibles in the commercial activities of MNEs, we propose that contractual rights are separately recognized as an illustration of an item that is treated as an intangible within the meaning of section A.1.

2. Section B (Identification of Parties Entitled to Intangible Related Returns) of the Discussion Draft:

a) Requirement for entity claiming entitlement to intangible related returns to physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles (proposed paragraph 40)

Proposed paragraph 40 indicates that it is expected that the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement,
maintenance and protection of the intangibles. Proposed paragraph 40 further elaborates that such important functions would include: design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

We submit that this requirement that an entity claiming intangible related returns on its own should perform certain important functions poses practical difficulty that in the business reality of many MNEs multiple entities are involved in performing what are dubbed in proposed paragraph 40 as important functions. We further submit that these practical difficulties are compounded by the subjectivity in such a “test” of identifying what exactly the important functions are in each set of facts and circumstances, and delineating the line between important and unimportant functions. This would lead to the unappealing transfer pricing outcome that intangible related returns are relatively arbitrarily spread out across multiple functions, with plenty of room for controversy on the relative importance of the functions performed by individuals or departments in any particular entity, and the resulting claim to intangible related returns by that entity.

Furthermore, in the stylized scenario of Example 11, this “test” leads to the seemingly contradictory result that an entity (Company T) with a fully functioning management team (running a manufacturing facility and supplying product to members of the MNE around the world), that bears the cost of ongoing R&D functions and legally owns any intangibles created through these R&D efforts, is not actually entitled to the intangible related returns from those ongoing R&D functions. While Example 11 does not venture into a sufficient level of detail in terms of assumed facts, it would appear unlikely that an entity with a fully functioning management team that funds ongoing R&D efforts and legally owns any intangibles created would not be capable of exercising control over the relevant functions and risks related to the development, enhancement, maintenance and protection of these intangibles. The relevant question here is whether the company (Company T) is in fact exercising such control, or whether this control is exercised elsewhere in the MNE group. Accordingly, we submit that principles analogous those of paragraphs 9.23 through 9.28 should instead be applied on an overall basis (and not just to the outsourced functions that are not included in the list of important functions). The threshold test here should be which entity exercises greater or greatest control over the relevant functions performed and risks incurred in developing, enhancing, maintaining and protecting the intangibles.
In this respect, we note that the example in paragraph 9.26 of the OECD Guidelines does not hinge on whether the company has technical personnel (capable of conducting or supervising the research activities). Instead, the principal in this example would need to be capable of making a decision on the type of research to be carried out by the contract researcher and objectives assigned to the research, and be capable of assessing the outcome of the research activities. These are higher level management functions as opposed to technical or supervisory functions. A distinction should be made in terms of an assessment from a management perspective of the outcome of the research function based on assigned objectives, and supervising the research activities themselves from a technical point of view.

We also submit that this threshold control test should generally be undertaken for each separately identifiable intangible, and that in cases where overriding control by one entity is less clear, a closer examination should be made as to whether rights in the intangible are in fact split between the entities. For example, a relevant variation of Example 11 is where Shuyona retains the legal ownership of the intangibles in Country X, where it exclusively operates, and shares the exercise of control over the R&D function with Company T, but presumably only to the extent that it benefits its own intangible rights in Country X. In such a situation, the compensation paid by Company T for the transferred intangibles, as well as the intercompany payments for the contract R&D services, would need to be adjusted to provide Shuyona with associated intangible related returns in Country X (and provide Company T with intangible related returns for the rest of the world).

b) Recognition of the actual transactions undertaken (as referenced in proposed paragraph 53) and the solutions of Examples 1, 7, 10, 11 and 16.

We submit that the solutions of Examples 1, 7, 10, 11 and 16 each include the disregard or re-characterization of the transactions actually undertaken as described in paragraphs 1.64-1.69 of the OECD Guidelines, and propose that this aspect of the solution is explicitly acknowledged, particularly since such practice is generally discouraged other than in exceptional circumstances.

Paragraphs 1.64 – 1.69 of the OECD Guidelines, which are referenced in proposed paragraph 53, indicate that a tax administration should not disregard the actual transactions actually undertaken, or substitute other transactions for them in other than exceptional cases. The basis for this guidance is that the restructuring of legitimate business transactions would be an arbitrary exercise, which would relatively easily lead to double taxation and differing views among tax administrations as to how the transaction should otherwise be structured. Paragraph 1.65 describes two particular circumstances, where it may be
legitimate and appropriate for tax administration to disregard the actual transactions undertaken or disregard the characterization of those transactions, but emphasizes the exceptionality of such circumstances.

One circumstance is where the economic substance of a transaction differs from its form. The other circumstance is where economic substance and form may be aligned, but the arrangements as viewed in their totality differ from those that would have been adopted by independent enterprises behaving in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate price.

Alternatively, it may be that the OECD does not believe that the solutions of Examples 1, 7, 10, 11 and 16 involve a disregard or re-characterization of the actual transactions undertaken, but instead that the contractual relationships as assumed in the examples do not reflect the true terms of the transaction or true legal form.

In this respect, paragraph 1.53 of the OECD Guidelines points out that where the conduct by associated enterprises indicates that the contractual terms have not been followed or are a sham, further analysis is required to determine the true terms of the transaction (i.e., the true contractual relationships between the parties, or alternatively stated the “true legal form”).

We propose that the solutions to Examples 1, 7, 10, 11 and 16 either provide a detailed explanation of the rationale for disregarding or re-characterizing the actual transactions undertaken by reference to the descriptions of the exceptional circumstances in paragraphs 1.64 – 1.69, or alternatively explicitly include the type of analysis that is referred to in paragraph 1.53 to determine the true terms of the transaction.

c) Inconsistency of alternative solution in Example 2 with proposed paragraph 42.

Proposed paragraph 186 indicates that an allocation of recall and product liability costs from Company S to Primero would remedy the mismatch between the asserted entitlement to intangible related returns and the bearing of costs. Proposed paragraph 186 further indicates that an appropriate alternative solution would be to adjust product pricing for all years to reflect that the relationship was not a limited risk relationship.

We submit that this alternative solution is inconsistent with the principle of proposed paragraph 42 as Company S would still bear an important risk (product liability and recall risks) and the associated costs, despite not having control over the risk. Adjusted product pricing to reflect the heightened risk of Company S
does not shift the full product recall risk to Primero, as Company S would still bear product liability risk for any amounts above and beyond its additional compensation through product pricing.

3. Section C (Transactions involving the use or transfer of intangibles) of the Discussion Draft:

a) Claim to a return on goodwill in Example 14 (proposed paragraph 235)

Example 14 appears to revolve around the question whether Company S has a claim to a return on goodwill with respect to a particular product (Product Y). We do not see the relevance of a discussion of goodwill in this example. Similar to Example 3, a more appropriate question is whether Company S has any claim to intangible related returns with respect to the Product Y trademark and if not, how it should be compensated by the intangible owner (Första) for its role in developing, enhancing, maintaining and developing the Product Y trademark.

However, even in considering these more appropriate questions, it is not clear, based on the assumed facts, that Company S should be compensated by Första as a marketing agent in a similar way as it was suggested in Example 3 (proposed paragraph 192) that Company S in that example should be compensated by reference to independent advertising and marketing agents. In Example 14, Company S is assumed to perform no functions with regard to advertising nor does it control any risk related to the marketing of products. Consequently, a reimbursement of advertising costs by Första through product pricing may be appropriate.

Notice that such a transfer pricing mechanism would not provide Company S with any business income, much less a return on goodwill. If Example 14 were to assume that Company S undertook marketing agent functions, it may have been argued that the mark-up by reference to independent advertising and marketing agents would include a return on goodwill associated with such a marketing/advertising agent business activity. However, such an implied return to goodwill based on the marketing/advertising business activity would not be appropriately characterized as a claim to intangible related returns associated with goodwill in respect of Product Y.

4. Section D (Determining Arm’s Length Conditions in Cases Involving Intangibles) of the Discussion Draft:

b) Concept of realistically available options to establish a floor price (proposed paragraph 81 and Example 19)
Proposed paragraph 81 indicates that options realistically available to the parties must be considered in evaluating a transaction involving the use or transfer of intangibles. We propose that the OECD provides additional guidance on the meaning and interpretation of the words “realistically available”.

In Example 19, the outsourcing of manufacturing to another entity (either Company S or an alternative supplier) is assumed as being a realistically available option to the transferor (Pervichny). This option allows the transferor to capture the present value of manufacturing the product in a lower cost environment (proposed paragraph 255). However, we note that this option assumes that the transferor would actually be equally successful in outsourcing this activity (and capture the hypothetical cost savings without actually having to carry out this activity), as it would be to continue with its current business (another realistically available option) or transfer the intangibles (actual transaction).

The commercial reality often is that successfully outsourcing to a lower cost environment represents significant business risks (such as outright success or failure of setting up the outsourcing arrangement, reliability of manufacturing operations, security of supply, and political stability) that may or may not turn out successful. In the face of such uncertainty, it is unclear how it can be demonstrated that such an option is realistically available.

This may be further illustrated by the hypothetical option of the transferor to outsource manufacturing of the product to an entity in an even lower cost environment than Country Y, where Company S is organized. The question is whether such an option would also be considered realistically available, and where the dividing line is between hypothetical options that are realistic or unrealistic.

Therefore, we submit that realistically available options (other than perhaps the option of continuing existing operations in the absence of a transfer) are only considered for transfer pricing purposes, if such options were indeed considered by management of the MNE group in sufficient detail with regard to the possibility of success based on an examination of the facts and circumstances. We further submit that, in such a case, the option should be appropriately qualified based on differentiated discount rates for the purposes of a reliable discounted cash flow valuation technique, whereby a higher discount is assigned to options which carry higher risk and uncertainty.

We trust that the above comments are of assistance to the OECD. We look forward to reviewing future developments on this issue.
Please do not hesitate to contact us, should you wish to discuss any aspect of our comments.

Yours faithfully

Steve Towers
Tax Partner

Roderik Vehmeijer
Transfer Pricing Director
Dear Mr Andrus

OECD Discussion Draft on Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

In order to streamline paperwork for the OECD we have collated material and input from several Member Firms of Deloitte Touche Tohmatsu Ltd, and therefore we have noted the contributors and countries who agree with the views set out below at the end of this letter.

Introduction and Overview

We thank the OECD for making available for comment an early discussion draft of its proposed revision of Chapter VI (Special Considerations for Intangibles) of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (‘the guidelines’).

We recognise that this document is an interim draft released for the purposes of obtaining timely input from the business community, that it is not at this time a consensus document and that it does not necessarily fully address all intended topics. We appreciate that by following this process there will be more work required to this draft than to material that has previously been released by the OECD for comment, and because of this our comments are considerable in number.

We fully endorse the need to update Chapter VI which, in its current brief form, does not provide sufficient assistance in the complex area of transfer pricing of intangibles. We consider there is need to expand the guidance rather than to change the underlying principles on which the transfer pricing of intangibles, and the current Chapter VI of the guidelines, are based. Chapter VI provides more detailed guidance on how to apply the transfer pricing concepts set out in Chapters I-III of the guidelines and we agree that the appropriate approach is to reinforce the principles of transfer pricing contained in those Chapters, and in
particular the arm’s length principle.

We believe that in its current form the discussion draft has three key areas where it does not achieve its aim of applying the arm’s length principle:

- The discussion draft appears to adopt an overall bias towards an econometric definition of intellectual property or intangible assets that is not seen in commercial transactions between unrelated parties. The more troubling aspect of the discussion draft is that, in our view, it does not follow the arm’s length principle. For example, the discussion draft states that goodwill is an intangible, but provides a very broad definition of the term, acknowledging that it can encompass a number of different concepts. This broad definition arguably eliminates the requirement that intangibles be identified with specificity, and is likely to result in increased controversy because multinational enterprises (MNEs) or tax authorities could assert that the existence of an unexplained cash flow or value is proof that an intangible exists. In respect of unrelated parties, if ‘property’ cannot be defined or identified, no rights (which are associated with ‘property’) can exist.

- In identifying parties entitled to intangible-related returns the approach the discussion draft adopts is not based on evidence from transactions between unrelated parties. While the draft cautions against making unsupported assertions the draft itself asserts, without providing support of that view, that it is ‘expected’ that to be entitled to intangible-related returns a party ‘will physically perform, through its own employees, the important functions related to development, enhancement, maintenance, and protection of the intangibles.’ The draft goes on to say that, ‘these functions would generally include, among others, the design and control of research and marketing programs, management and control of budgets, control over strategic decisions regarding intangible development programs, and important decisions with respect to defence and protection of intangibles and ongoing quality control.’ The draft proposes that although the costs incurred to perform those important functions regarding intangibles should be borne by the parties claiming entitlement to the intangible-related returns, the ‘bearing of the costs related to the development, enhancement, maintenance and protection of the intangibles does not, in and of itself, create an entitlement to intangible returns.’ In addition, the draft appears to authorise re-characterisation of transactions in circumstances when valuation is ‘highly uncertain’ at the time of the transaction. These are potentially significant departures from evidence-based applications of the arm’s length principle and in our view will lead to increased controversies and disputes, and potential double taxation.

- The draft recognises the role of reliable projections in the application of discounted cash flow valuation methods, but it might be taken to be giving undue importance to such methods at the expense of traditional methods that are based on evidence from transactions between unrelated parties.

We consider that the discussion in Chapter VI needs to be explicitly rooted in the arm’s length principle (as articulated in Article 9 of the OECD Model Tax Convention and elsewhere in the guidelines) with specific reference to transactions between independent enterprises. There is much data on intangible transactions between independent enterprises publicly available (including reports of decided cases between unrelated parties that find themselves in commercial dispute in various jurisdictions) on intangible transactions between independent enterprises. We urge the OECD to use this data as a guide rather than imagine what ought to happen or what might be expected to happen between independent enterprises, as a theoretical construct. Transfer pricing is a facts and circumstances based discipline and in our view must be grounded in empirical data.
The draft places too much emphasis and reliance upon a largely undefined ‘economic approach’ (focusing on ‘economic contributions’, ‘economic value’ and ‘economic substance’) at the expense of comparability with transactions between independent enterprises. As a result, the revised guidance as currently drafted does not sufficiently safeguard against MNEs or tax administrations departing from the arm’s length principle.

For instance, paragraph 2 of the draft, which is important as a foundation for the Chapter, states:

‘The purpose of this Chapter VI is to provide guidance specially tailored to determining arm’s length conditions for transactions that involve the use or transfer of intangibles. Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. The fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for purposes of Chapter VI, does not imply that the item or activity does not convey economic value or that it need not be considered in determining arm’s length prices and other conditions for controlled transactions.’

To more appropriately align the Chapter to the arm’s length principle, we suggest that the final two sentences should read as follows:

‘Consequently, the key consideration is whether the conditions of an associated enterprise transaction in respect of an item or activity accord with what would be expected in a transaction between independent enterprises in comparable circumstances, whether this involves tangible property, intangibles, services or other items or activities. The fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for purposes of Chapter VI, does not imply that the item or activity does not need to be taken into account in determining arm’s length prices and other conditions for controlled transactions, if independent enterprises would be expected to have taken it into account.’

Our key comments on specific Sections of the discussion draft are as follows:

Section A: Identifying Intangibles

- Chapter VI should use the term ‘intangible property’ rather than ‘intangible’, as this best accords with and facilitates application of the arm’s length principle;
- We recommend further consideration be given to taking account of the Commentary to Article 12 of the OECD Model Tax Convention in defining intangibles for Article 9 purposes.

Section B: Identification of parties entitled to intangible related returns

- We believe that it is necessary to start the discussion with a clear affirmation of the arm’s length principle such that the interpretation of Chapter VI by MNEs and tax administrations will remain true to the arm’s length principle, as set out in Paragraph 1 of Article 9 of the OECD Model Tax Convention. This might take the form of a statement that where data evidences a particular allocation of intangible related returns in comparable uncontrolled transactions then the same contractual allocation of intangible related returns between associated enterprises is regarded as arm’s length;
Absent such evidence, the arm’s length nature of the allocation of intangible related returns between associated enterprises is assessed by hypothesising the allocation that would be expected to have been agreed between independent parties in comparable circumstances; relevant (but not determinative) factors to consider in hypothesising this are which entity: (1) performs or outsources (under control) functions related to relevant intangible related activities, (2) bears the risks associated with the relevant intangible related activities, and (3) bears the cost (ie capital) related to the intangible.

Guidance in Chapter VI could be improved by stating explicitly that where data exists for comparable uncontrolled transactions showing the allocation of risk associated with intangible related activity, this is the best material that MNEs and tax authorities can provide to evidence compliance with the arm’s length principle. If such evidence is available, and comparability adequately assessed, then further examination of which party has functional ability to control risks, etc. is not needed;

In defining a functional control standard in respect of functions and risks for purposes of allocating intangible related returns, the guidance should reference the arm’s length principle by being based upon the general proposition that the level of functional control required is that which an independent party would be expected to have in comparable circumstances;

Based on the above, we conclude that the standalone assertion that legal ownership and contribution of capital cannot in any circumstances be determining factors in allocating intangible related returns without performance of, or control over, functions involved in intangible related activity does not accord with the arm’s length principle.

Section C: Transactions involving the use or transfer of intangibles

The guidance should explicitly state that when data is available to evidence that similar conditions exist in comparable uncontrolled transactions, then those same conditions between associated enterprises should be regarded as arm’s length;

The guidance should explicitly state that where the actual transaction is an intangible property license it should be tested by reference to intangible property licenses as they are entered into between unrelated parties; it would not be in accordance with the arm’s length principle to price an intangible property license as if it were, instead, the provision of a service.

Section D: Determining arm’s length conditions in cases involving intangibles

The guidance should in our view set out that any recognised financial valuation method can be useful in a transfer pricing analysis, depending upon the particular facts and circumstances. Valuations contained in purchase price allocations or cost-based valuations should not be prescriptively rejected as unreliable or irrelevant for transfer pricing purposes, though they might be rejected if it is shown that they have not been performed to a standard that would amount to evidence for transfer pricing purposes. Neither should purchase price allocation methods be viewed as prescriptively appropriate because transactions involving the use or transfer of an intangible post acquisition usually involve differing circumstances, which must be taken into account;

Using two or more valuation methods in conjunction accords with market practice between independent enterprises and should be endorsed for transfer pricing purposes provided it enhances the reliability of the analysis.

Timing
In our view, the guidance should set out that data that became available only after the date of the transaction, or circumstances that change after the date of the transaction and could not be foreseen, should not be taken into account in assessing the arm’s length nature of the transaction.

Each of these points is considered in more detail below.

Section A - Identifying Intangibles (Paragraphs 5 – 26)

Overview

We are generally supportive of the concepts described in Section A.

The discussion draft makes a fundamental change to the current Chapter VI by changing its title from ‘Special Considerations for Intangible Property’ to ‘Special Considerations for Intangibles’. The text of the current Chapter VI also uses the term ‘intangible property’ whereas the discussion draft refers to ‘intangible’. We do not consider that this change is appropriate, as the term ‘intangible property’ best accords with and facilitates application of the arm’s length principle. The definition of ‘intangible’ for transfer pricing purposes should reflect that the application of the arm’s length principle calls for an intangible to be recognised only when it would be between independent parties in comparable circumstances. In this regard, an independent party would not be expected to enter into a transaction to pay for the transfer or use of an intangible unless it thereby acquired property, in the sense of legal rights in respect of that intangible. The characteristics that the discussion draft requires for an item to qualify as an intangible, that is, it is capable of being owned, controlled or transferred, are all consistent with, if not dependent upon, the concept of property. Accordingly, the discussion draft’s implicit recognition that an intangible is property should be made explicit. This would more adequately safeguard against taxpayers and tax administrations inappropriately identifying items as ‘intangibles’, which experience has shown inevitably leads to controversy and potential double taxation.

It would be beneficial to include the additional criterion of ‘identifiable’ in the definition of intangibles, and the potential benefits of aligning to the greatest extent possible the identification of intangibles to the commentary on Article 12 in the OECD Model Tax Convention should be explored further and not dismissed.

Detail

Paragraph 5 introduces a broad definition of intangibles. While we agree with the two categories excluded (physical and financial assets) and that intangibles can be controlled or owned for use in commercial activities, we find it relevant for the definition to include the additional requirement ‘identifiable’. The purpose of adding the ‘identifiable’ criterion is to ensure that assets are specific, which will avoid futile discussions where the only evidence of an asset is circumstantial and supported only by economic results, i.e. that one party to a transaction incidentally has a ‘super profit’ or ‘super loss’. While we believe an explicit requirement of being identifiable would be a benefit we recognise that these issues are already partially dealt with in paragraph 11.

Paragraphs 6 to 8 contain a discussion on the convergence of intangibles definitions in accounting, legal and tax terms. We support the approach to initially reject any approach that is not linked to commercial recognition and treatment of intangibles and instead introduce the broad definition mentioned in paragraph 5. Nevertheless for the purpose of simplicity we consider that it would be useful if some of the
positive demarcation in Article 12 of the OECD Model Tax Convention could be considered equally relevant for identifying intangibles for transfer pricing purposes. Separating the task of identification of intangibles from the task of pricing the transfer or use of these intangibles under the arm’s length principle will, we believe, be beneficial in reducing potential disputes between MNEs and tax authorities.

Having consistency in definitions of intangibles that are based on the commercial recognition of intangibles would also provide increased certainty in the transfer pricing of intangibles.

Paragraph 7 states that separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Further clarification of the meaning of this statement would be desirable as it contradicts the criteria listed in paragraph 5 that to be considered intangible an item must be capable of being owned and controlled. ‘Owned and controlled’ is a concept of property and without property in the intangible an unrelated party cannot charge another for its use. In many countries, for example, goodwill connected to a customer base cannot be transferred without a simultaneous transfer of business. In these cases, however, there is no separate valuation or transaction in goodwill; the transaction to be considered would be the transfer of the business and goodwill is taken into account in valuing that transaction. We consider the conflict between paragraph 5 and paragraph 7 would be resolved by adopting a definition that includes ‘property’ (the definition in paragraph 5).

Paragraph 10 could be improved with simple guidance to state that the actual accounting or tax treatment of costs related to the creation of potential intangibles does not determine conclusively that an intangible exists.

Paragraph 13 sets out that the approach to determining an arm’s length price in cases involving an intangible does not turn on categorisation of intangibles. Examples of soft intangibles and hard intangibles are mentioned. We support strongly that there is no requirement to place an intangible into a category, and we suggest that the terms ‘soft’ and ‘hard’ intangibles should not feature at all in the guidance as they have no relevance to third party transactions.

Paragraph 14 states the illustrations provided in the discussion draft should be adapted to the specific legal and regulatory environment that prevails in each country. We disagree that this should be the case and propose that this sentence be omitted in the final chapter. We agree with the intangible definition in paragraph 5 and paragraph 13, and therefore the commercial law in each country will define what is, for example, patentable. For example, a business process can be subject to a patent in the US whilst the same business process may not be patentable in Europe. However, once we find that there is, or is not, an intangible asset (the patent) the transfer pricing process applies accordingly. We consider that as the OECD discussion draft defines intangibles by reference to what would happen between unrelated parties there is no need to be more specific in identifying country differences; we are of the view that to do so might confuse rather than clarify the guidance.

Paragraph 20 provides an example noting that limited rights to use intangibles are intangibles themselves. Because the object is not the intangible being regulated through the contractual arrangement, but the arrangement itself this would mean that other rights to use an asset would also be an intangible within the meaning of section A. Such contractual arrangements could be a lease to a specific building or space. We agree that this is correct, and if this is the intention if would be beneficial to amend the example accordingly. As this would increase the work of identifying intangibles in general the wording ‘economically significant intangibles’ of paragraph 11 becomes even more important and could be further emphasised.
Paragraphs 21 and 22 set out that goodwill is an intangible but provide a very broad definition of the term, acknowledging that it can encompass a number of different concepts. This broad definition arguably eliminates the requirement that intangibles be identified with specificity, see comments to paragraph 5, and may lead to increased controversy because taxpayers or tax authorities could assert that any unexplained cash flow (or lack of cash flow) is goodwill. For example, in the UK in a commercial sense the term ‘goodwill’ is defined as ‘the emotional connection of the consumer base to the products or service’\(^1\). A narrower definition, such as the UK commercial definition cited, would be preferable.

Paragraphs 25 and 26 deal with assembled workforce, but are unclear if an assembled workforce is an intangible asset. We believe that further work is required to clarify the guidance.

The draft recognises that a long term contractual commitment may constitute an intangible, which is in line with the guidance in paragraph 20. It then goes on to mention a transfer of an existing assembled workforce, but it is unclear if it is intended that this ‘assembled workforce’ should be considered to be an intangible. The objective of such a transfer is more likely to be a business transfer than a workforce transfer. Also, it is difficult to see how an assembled workforce may be owned or controlled, at least to the point of keeping the workforce intact and constant, and when that is not the case it is more likely that the intangible will be know-how than the workforce itself. Therefore in accordance with the definition in paragraph 5 we do not consider an assembled workforce to be an intangible for the purpose of Chapter VI. We do consider that the qualities of an assembled workforce may be something to take into account in considering the value of any service provided by the employer.

\(^1\) IRC v Muller & Co Margarine Limited [1901] AC 217, a UK Stamp Duty case where in answer to the question “What is goodwill?” Lord Macnaghten said: “It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start.”
Section B – Identification of parties entitled to intangible related returns (Paragraphs 27-58)

Overview

Contrary to the intent expressed by Working Party No 6, the preamble of Section B presents a view that may be capable of being interpreted as departing from the arm’s length principle articulated in Article 9 of the OECD Model Tax Convention by proposing that legal ownership and contribution of capital cannot in any circumstances be determining factors in allocating intangible related returns without the performance of, or control over, functions involved in intangible related activity. As set out below, the discussion draft does not take into account the balance that one expects to find in transactions between unrelated parties regarding legal ownership, functional control and capital when providing guidance concerning the issues relating to the identification of the parties entitled to intangible related returns. We believe that the principles set out in Chapters I to III of the guidelines should be the basis for Chapter VI. For this reason we consider the current draft to lack an appropriate balance between legal ownership, contribution of capital and functional capacity as found in comparable transactions between unrelated parties.

We suggest that the starting point for analysing transactions involving intangibles should mirror the framework that was developed in Chapter IX (Business Restructuring) of the OECD guidelines for the allocation of risks. To recap, Chapter IX establishes a two-step process for assessing whether the allocation of risk between associated enterprises is arm’s length: (1) Is there reliable evidence of a similar allocation in comparable uncontrolled transactions, and, if not, (2) is the allocation one that might be expected to have been agreed between independent parties in comparable circumstances? Relevant (but not conclusive) factors to consider in determining whether the allocation is one that would have been agreed between arm’s length parties are the ability to control, and the financial capacity to bear, the risk. In applying a similar framework to transactions involving intangibles, the allocation of intangible related returns between associated enterprises should be considered arm’s length if there is reliable evidence of a similar allocation in comparable uncontrolled transactions. When lacking such evidence, the arm’s length nature of the allocation of intangible related returns between associated enterprises should then be assessed by hypothesising the allocation that would be expected to have been agreed between independent parties in comparable circumstances. This assessment may rely on the relevant-but-not-determinative factors listed above (functional control of, and financial wherewithal to bear, the associated risks) as well as on the ‘commercial reality’ of the transaction, including evidence of arm’s length behaviour in a commercial setting or dispute. This approach is founded on the primacy of a comparative (as opposed to an econometric) analysis in applying the arm’s length principle, see OECD guidelines paragraph 1.6, but it is also supported by judicial precedents in commercial cases between unrelated parties. For example, Canadian commercial case law establishes that a reasonable royalty should, in the first case, be determined by reference to pre-existing royalty rates (i.e., searching for what we describe as a CUP) when appropriate comparability can be established, absent which the alternative is to consider a hypothetical situation.2

We consider that Section B should explicitly state that actual evidence of a similar allocation in comparable uncontrolled transactions or other hypothesised arm’s length behaviour (hereinafter collectively ‘commercial arm’s length allocation’) is the best indication that the allocation of intangible related returns between associated enterprises satisfies the arm’s length principle. The performance of, or control over, functions involved in intangible related activity should not be the sole or favoured

determining factor in allocating intangible related returns applying the arm’s length principle absent an indication that such would be the case under a commercial, arm’s length allocation.

We also believe that Section B too easily favours an economic substance over legal form analytical framework and, as a result, may in certain circumstances move toward recharacterisation outside the narrow scope provided in Chapter I Section D.2 of the OECD guidelines. In addition to arguably departing from the arm’s length principle, this analytical framework is very likely to cause increased controversy and in our view it therefore creates a potential risk of double taxation. We would welcome more clarity and examples from the OECD as to what would, and would not, be subject to recharacterisation in the context of the issue aiming at identifying the party(ies) entitled to the intangible related returns.

For these reasons, we believe that the draft as written may fall short of reflecting the intention presented by Working Party No 6 in the preamble, although we also recognise that the OECD has made some significant progress in clarifying some important aspects of the critical issue at the centre of Section B. We have recommended a number of clarifications and revisions, as further described below.

**Detail**

Paragraph 27 addresses the identification of member(s) of a MNE that should be entitled to intangible related returns as the second step of a transfer pricing inquiry associated with intangible related matters, and suggests that any such analysis should be based on case specific facts. We agree with this statement. The paragraph concludes that more than one party to a particular transaction may be entitled to intangible related returns. We also agree, but wish to point out that arm’s length business arrangements seldom result in co-ownership of intangible property in the sense that both parties to a transaction may have specific registrations of intangible property, not a joint registration. Beyond the typical scenario where both a licensor and licensee can be seen as being entitled to intangible related returns, the discussion draft seems to go further in suggesting that intangible ownership can be spread throughout a MNE, which is likely to lead to controversy between tax authorities and the potential for unrelieved double taxation.

Paragraph 28 states that intangible related returns are those that exist after costs and expenses are deducted and ‘routine’ business functions have been remunerated and that these might be positive, negative or zero. In general, we agree that it is prudent and desirable to include a definition of what is to be considered intangible related returns. However, in its current form, we believe that the definition leaves room for interpretation errors (and hence controversy and potential for double taxation) and we question whether this definition is entirely consistent with the arm’s length principle and other parts of Chapter VI. For example, in transactions between unrelated parties a loss-making enterprise that makes use of intangibles owned by another party may still pay a fee for that use. Hence in that case the intangible related return is not a value derived after expenses and costs are met and ‘routine’ business functions, risks and assets are rewarded. As written this paragraph might be taken to support the proposition that no fee is to be paid by the loss-making licensee irrespective of the facts of the case.

Chapter VI specifically excludes from the definition of intangibles certain attributes of a business that can drive increased profitability (e.g. location savings and group synergies). Paragraph 5 restricts the discussion in Chapter VI (admittedly also in the rest of the OECD guidelines) to only consider an

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3 A leading UK case on this point is *Scandecor Developments AB* and *Scandecor Marketing AV* [2001] UKHL21 (14 April 2001)
intangible that ‘...is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities’, while paragraph 9 excludes ‘...market conditions and other circumstances that are not capable of being owned...’. This notion is expanded through several illustrations provided in Section A.4. We agree with this approach, but note that Paragraph 28 in its current form could be misconstrued to actually include these very same attributes. For example, it is conceivable that in a particular case all residual profits in an MNE group is attributable to group synergies (or similar aspects that fall short of being an intangible within the definition of paragraph 5) which, absent the discussion in paragraph 9, could be taken as intangible related returns under the current definition in paragraph 28.

In addition, paragraph 28 suggests that Chapter VI is focused on ‘profit driven’ (and, therefore, variable) compensation arrangements for intangible related transactions, which unfortunately discounts the importance of fixed rate arrangements. In our view, paragraph 28 inappropriately favours the former both from a theoretical and practical perspective and in so doing it strays from the arm’s length principle. The business world is full of situations where the use of, or access to, an intangible asset is granted under a fixed rate top line arrangement (or even fixed [dollar] amount arrangements). For instance, we routinely observe royalty rates for the use of trademarks and patents across a broad spectrum of industries that are calculated based on a fixed percentage of gross or net sales or even fixed dollar amounts.

Associating intangible related returns with residual (super) profits, while concurrently recognising that intangible related returns can be positive, negative or zero, is conceptually correct but as presented in paragraph 28 is at risk of suggesting that payment for the access to and use of intangible assets under intercompany license or franchise arrangement should occur only insofar as the licensee/franchisee generates non-routine profit. This would not accord with commercial reality, in our view. For example, many franchisees make an initial payment to enter into a franchise (at this time they have no income, and therefore no super-profit), and may not have sufficient income in the early year(s) of the franchise to be profitable net of the franchise fee (and therefore still have no super-profit). Therefore as written we believe that paragraph 28 does not follow the arm’s length principle.

Paragraph 29 introduces two ideas with which we agree. These are repeated in other parts of Section B and in essence advocate the following:

a. Legal rights (and in some cases legal registrations leading to legal rights) and contractual arrangements are generally the foundation of ownership and, therefore, the core to understanding who has the right to intangible related returns; and
b. When more than one party has a role in developing an intangible, it is important to understand the legal and contractual position and whether the roles taken in practice match the apparent legal and contractual position.

Paragraph 29 (iii), however, suggests that the arm’s length nature of remuneration provided to parties involved in developing, enhancing, maintaining and protecting the intangible asset is a factor that should be considered in deciding who is entitled to the income derived from the asset. We disagree, based on our commercial experience. We believe this statement should be adapted to conform to the arm’s length principle, as explained below.

In our view, the quantum of remuneration provided by one party to another in respect of services rendered in developing intangible property is irrelevant in ascertaining the ownership of any intangible property created in many, if not most, commercial transactions between unrelated parties. We are aware
of various arrangements between unrelated parties whereby party A creates intangible assets, under contract, for party B (e.g., patentable inventions), which by virtue of contractual terms results in Party B being the owner of the intangible under commercial law. There is (usually) no consideration of the remuneration paid by party B to party A for the contracted services. We believe that an alleged deficiency of the remuneration for these services would only be evidence of a need to review the payment for the service. It is not relevant to any question of who is entitled to enjoy intangible related returns. Subsequent paragraphs (e.g., paragraph 46) should be revised to reflect this change.

In support of this view, we believe that the recent UK commercial case of *Meridian International Services Ltd.*[^4] might provide some clarity. The case revolved around certain software that was developed by Meridian for use by the consumer healthcare UK division of GlaxoSmithKline. Meridian (appellant) could not create all of the software and so it contracted with Richardson [& others] (respondents) to develop part of that software as a ‘contract developer’. In an action brought before the UK High Court, Meridian claimed that it was an express or implied term of its agreement with Richardson that, in effect, the copyright in the software should be assigned to it. The court rejected both claims. Meridian appealed on the basis that given its payment to Richardson and the economics of its agreement with GlaxoSmithKline it was necessary to imply the transfer of copyright from Richardson (as author) to Meridian. Meridian’s claim was rejected; despite the economic evidence that element of the software was still owned by Richardson because copyright was not transferred to Meridian under the contract between them (by express or implied term). Because of that Richardson was entitled to benefit from any value that could be earned through licensing the software to anyone but Meridian. Without a transfer of the copyright all that Meridian held was essentially a royalty-free license to use the software. We note that, contrary to the current draft paragraph 29, the remuneration paid by Meridian to Richardson for services rendered was not cited by either side as a matter relevant to the question of who owned the copyright in the software.

Paragraphs 30 through 36 are referred to as Section B.1, and in general discuss legal registrations and contractual arrangements. Paragraph 30 advances an economic approach to discern the contractual arrangement between parties absent written agreements. The last sentence of this paragraph states the following:

> Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises

The absence of written terms is not in and of itself evidence that there is no contract, insofar as a contract may also be verbal or implied or otherwise present or imputed by virtue of law. This is in part recognized by paragraph 30, which states that ‘terms of a transaction may be found (…) in correspondence and/or other communications between the parties’. We agree that the fact that the conduct of the parties is also a relevant consideration in the absence of expressed or implied contractual terms. However, referring to economic principles as a determining guiding principle in this case may possibly lead to an answer that is different than that achieved by unrelated parties, thus contravening settled contract law in several member states. This could result in one party being entitled to returns from intangible assets on the basis of ‘economic ownership’, whereas the other party would have been entitled to these returns had the parties been dealing at arm’s length. That would be a departure from the arm’s length principle, and could potentially lead to controversy and potential for double taxation.

[^4]: *Meridian International services Ltd v Richardson & Ors* [2008] EWCA Civ 609
We note that paragraph 1.52 of the OECD guidelines contains a similar reference to economic principles in establishing the contractual relationship between two parties. This framework, in respect of transfer pricing more generally, may indeed be reasonable but it is not appropriate in the context of entitlement to intangible related returns under Chapter VI. Specifically, we consider that matters of intangible property are subject to a distinct body of law which creates the intangible and it is our experience that unrelated parties do not rely solely on economic principles to discern contractual arrangements in this context. Economic principles are certainly relevant in this analysis, albeit always in a context where their use is circumscribed by relevant legal principles as they would be in the context of commercial arm’s length allocations.

Paragraphs 31 to 33 include a general discussion of the legal rights and registrations that may or may not be afforded to an entity in respect of various classes of intangible property in various jurisdictions. In general, we have no concerns about these paragraphs except for paragraph 32, which ends with a comment that some intangibles might not be covered by a specific law. This is at risk of potentially creating an inference that there should be no return associated with the intangible under these circumstances. In the absence of a specific law, the intangible can also be protected by contractual arrangements (which go beyond employment contracts specifically mentioned in paragraph 32) and, thus for clarity’s sake this sentence should be adapted to cover those other circumstances where intangibles are protected contractually. One example would be know-how associated with a manufacturing process (which is otherwise not protected by any enforceable laws) made available to another entity pursuant to a contract manufacturing agreement.

Paragraph 34 describes, in general terms, a license arrangement and correctly identifies the frequent occurrence of licenses in the business world. The paragraph also suggests that terms of the license, specifically restrictions, which are also found in unrelated party license agreements, would be important in assessing which entity in an MNE group is entitled to intangible related returns. We agree with this statement.

Paragraph 35 emphasises the importance of legal registrations and contractual arrangements as the core to determine entitlement to intangible related returns. We agree and specifically commend the reference to the applicable law. It also stipulates a requirement that substance and form be in alignment. For reasons discussed elsewhere, we believe this concept should be clarified. The last sentence of paragraph 35 states that, in a licensing or similar arrangement, the licensee will be entitled to the intangible related returns attributable to its licensed rights, subject to its obligation to provide arm’s length compensation for the grant of the license. Similarly to our comments on paragraph 29 (iii), it should be clarified that the discussion draft is not implying that failure to pay arm’s length compensation for the grant of the license (assuming it is not a failure to pay that constitutes an event of default, which could put into question the entitlement to the intangible related returns) could be a determinative factor in assessing which entity will be entitled to the intangible related returns attributable to the associated licensed rights. Subject to the legal rights and contractual arrangements, that failure should solely call into question the arm’s length nature of the payment for the grant of the license.

Paragraph 36 again highlights the importance of contractual arrangements in the assessment of which entity in an MNE group should be entitled to intangible related returns. Legal registrations and contractual arrangements are essential for determining ownership and we, therefore, agree with the draft in this regard. However, we stress the importance of considering applicable law in this context and suggest that paragraph 36 be revised to make reference to this point.
Paragraphs 37 through 47 are referred to as Section B.2 and contain a discussion regarding functions, risks and costs associated with intangible assets. Section B.2 echoes the preamble of Chapter VI and the pre-established analytical framework referenced therein for allocating intangible related returns under certain circumstances. We have several comments aimed at clarifying and adapting certain propositions in this section, which in our view would be required to align with the tenets of the arm’s length principle and, by extension, to a number of fundamental principles of Chapters I and IX of the OECD guidelines.

The cascading sequence of Section B.1 (reiterating the core role of legal registrations and contractual arrangements) and Section B.2 (mandating a specific analysis of the functions, risks and costs related to intangibles) in the identification of the entity entitled to the intangible related returns is welcomed and constitutes an appropriate sequence of analysis on this issue. That being said, we believe that fundamental clarifications and safeguards found in Chapters I and IX need to be layered on this proposed analytical framework, as detailed below.

Paragraph 37 appropriately states that in evaluating which entity is entitled to the intangible related returns, it is important to examine whether the conduct of the parties is in alignment with the terms of the legal registrations and contracts or whether the parties’ conduct indicates that the legal form and contractual terms have not been followed. It also mentions that when comparing the conduct of the parties to the legal registrations and contractual arrangements, it is necessary to examine the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles.

We generally agree with these statements, but as described in further detail below we consider it ought to be put in the context of the current guidance and requirements of Chapters I and IX relating to the following elements:

- the importance of respecting transactions as they are structured by the parties (see paragraphs 1.64 and 9.161 to 9.168); and
- the exceptional circumstances under which a transaction may be recharacterised (see paragraphs 1.65 to 1.69 and 9.168 to 9.180).

While we recognise that the discussion draft is an early stage document aimed at soliciting comments from the business community sooner rather than later in the process, we emphasise the importance of ensuring consistency with established principles of the OECD guidelines’ approach to arm’s length pricing.

We would welcome some clarifications from the OECD on the issue of whether paragraphs 37 to 47 are meant to be guiding principles to be applied in the context of recharacterisation of transactions relating to intangibles (i.e., essentially meant to follow the guidance presented in paragraphs 1.64 to 1.69 and 9.168 to 9.180), or whether the analytical framework contained in Section B.2 is meant to apply on a standalone basis. Leaving aside the issue of the context of application, the framework of analysis could also benefit from examples of situations in which the conduct of the parties may be viewed as not according with the legal registrations and contractual arrangements. The guidelines already contemplate instances where associated enterprises may not necessarily have the same incentives as unrelated parties to conform to all terms and conditions of their legal agreements (see paragraph 1.53), and therefore controversy and potential for double taxation could be reduced by clarifying what would represent a non-conforming conduct leading to a transfer pricing adjustment following a risk reallocation (see paragraph 1.48) as opposed to a non-conforming conduct leading to a transfer pricing adjustment following a reallocation of intangible related returns.
Paragraph 37 states that (where the conduct of the parties is not aligned with the terms of legal registrations and contracts) it may be appropriate to allocate all or part of the intangible related returns to the party that, as a matter of substance, performs functions, assumes risks and bears costs related to the intangible (see also paragraph 55). As currently articulated, we do not fully support this proposal as it seems to create a disconnect with common arm’s length situations, notably when one entity performs certain services for the benefit of the other (e.g., contract R&D services). Actual evidence of a similar commercial arm’s length allocation is the best indication that the allocation of intangible related returns between associated enterprises satisfies the arm’s length principle. We therefore think that paragraph 37 should be modified to include a clear reference that the allocation of intangible related returns should be consistent with an allocation that was agreed to between two arm’s length parties, or would have been agreed between arm’s length parties in the circumstances.

Without reference to what arm’s length parties would have agreed to in the circumstances (i.e. evidence of a commercial arm’s length allocation), paragraph 37 favours a concept of ‘economic ownership’ over legal relationships that actually drive commercial transactions, which treads very closely to recharacterisation outside the strict guidance provided in Section D.2 of the guidelines (paragraphs 1.64 – 1.69). The notion of ‘economic ownership’ lacks a commonly accepted and clear definition, but we recognise that it is used in certain commercial situations, for example, within the confines of a cost contribution arrangement. In this regard, it is accepted elsewhere in the OECD guidelines (Chapter XIII). However, the concept of ‘economic ownership’ is introduced in relation to cost contribution arrangements (and expected to be fully detailed and circumscribed in the context of the actual cost contribution contractual arrangement) on the basis that the expectation of mutual benefit, which is fundamental for pooling resources and skills without separate compensation, may not accord with legal ownership that would otherwise result in a license or similar arrangement.

Paragraph 8.6 of the OECD guidelines provides clarification of this concept and states:

‘Perhaps the most frequently encountered type of cost contribution arrangement is an arrangement for the joint development of intangible property, where each participant receives a share of rights in the developed property. In such a cost contribution arrangement, each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications. Stated more generally, a participant uses the intangible property for its own purposes rather than in a joint activity with other participants. The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners. In cases where a participant has an effective ownership interest in any property developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed property consistent with the interest that the participant has acquired.’

It is widely appreciated that cost contribution arrangements are unique and specifically intentional arrangements whereby, typically, each participant proportionately shares in the overall expected benefits to be received under the arrangement (determined ex ante) in direct correlation to the contributions made by each participant. For reasons noted above, ‘economic ownership’ may be a prudent concept under these circumstances. The same is not true for the identification of entitlement to intangible related returns in the context of Chapter VI. It is not, in our experience, accepted by third parties dealing at arm’s length nor, to our knowledge, imposed by virtue of law. The analogy is inappropriate. In cases between
unrelated parties, the economics of the transaction will be, at best, only one of the factors taken into account in determining who has the right to enjoy the profit arising from an intangible; more often the economics of the transaction carry little weight in the decision, as opposed to other factors such as the statute dealing with the intangible, registrations held and contracts entered into.

As noted above and in Chapter I of the guidelines, recharacterisation of legitimate transactions would be wholly arbitrary. Paragraph 1.64 and paragraphs 9.161 – 9.167 of the OECD guidelines establish that in all but two narrowly defined sets of cases it is appropriate to recognise transactions between an entity and its non-resident related parties as they have been undertaken. This doctrine of respecting transactions permeates the OECD guidelines and is respected by the vast majority of member states.

The guidelines permit recharacterisation in only two exceptional circumstances. The first circumstance involves situations where the substance of a transaction is different from its legal form. The second circumstance relates to transactions between associated entities where the arrangements, when viewed as a whole, are contrary to those that arm’s length parties acting in a commercially rational manner would have agreed and the actual structure of the transaction impedes the ability to determine an arm’s length price.

As noted above, allocating all or part of the intangible related returns to the party that, as a matter of substance, performs functions, assumes risks and bears costs related to the intangible without reference to commercial, arm’s length allocations is effectively akin to recharacterisation within the ambit of the first circumstance above and without justification within the terms of guidelines Chapter 1 Section D.2. It is not clear whether or not it is the intention of Working Party No. 6 to make a significant change to the guidelines and create a new classification of recharacterisation and we welcome further explanation on this important issue. Clarification is important because, based on experience, we anticipate that some tax authorities may disagree with a finding that this would amount to recharacterisation (and should be considered in light of the existing limitations on recharacterisation). For example, we are aware of occasions when tax authorities have sought to adjust transfer prices on the basis of ‘economic ownership’ arguments, notwithstanding domestic tax law under which, absent a sham or an application of specific tax law provisions allowing recharacterisation, economic realities cannot be used to recharacterise a taxpayer’s bona fide legal relationships.\(^5\) We consider that recharacterisation without the limitations imposed by paragraph 1.6, 1.65, 9.168 and 9.169 of the OECD guidelines would be to depart from the arm’s length principle.

The final sentence of paragraph 37 should, in our view, be removed or revised. It appears to blend concepts and does not add to the understanding of an appropriate application of the arm’s length principle in the context of intangibles. Unlike arm’s length parties, related parties do not necessarily enforce each other’s adherence to their contractual arrangements, and thus applying the arm’s length principle requires examining whether their conduct accords with their contracts, because the true terms of the arrangements, including the true allocation of risk, are best evidenced by the parties’ conduct (see paragraph 1.53 of the OECD guidelines). However, the parties’ conduct in this case only serves as evidence to determine the true arrangement (most notably allocation of risk) and not the arm’s length nature of that arrangement. In this regard, the parties’ conduct is important but it can only be assessed in relation to the consequences that would have arisen had that same conduct occurred between unrelated

\(^5\) See for example the decision of the Supreme Court of Canada in Shell Canada Ltd. v. R., [1999] 3 S.C.R. 622, which strongly upheld that economic realities could not be used to recharacterise a taxpayer’s bona fide legal relationships.
parties. Without evidence that the actual arrangement accords with arm’s length behaviour, one cannot say that the parties’ conduct should generally be taken as the best evidence concerning the allocation of intangible related returns.

Paragraph 38 sets out that performing or controlling the functions related to development, enhancement, maintenance and protection of an intangible is a necessary prerequisite for the parties’ conduct to be aligned with the terms of registration and contractual arrangements, and hence for a party to enjoy intangible related returns. When read in conjunction with paragraph 42, this framework, in essence, presupposes that returns follow risks (and the underlying capital) and risks follow functions. In our experience, though control of these functions and the risk associated with them often go hand in hand that is not always the case; therefore in our view the draft is too mandatory in its approach. In fact, as currently drafted this is similar to the fiction of economic ownership of assets mandated by the Authorised OECD Approach (AOA) for attributing profits to permanent establishments under Article 7 of the OECD Model Tax Convention. While the proposed framework seems to be in line with the AOA concepts of significant people functions relevant to the assumption of risks and significant people functions relevant to the attribution of economic ownership of assets, one should remember that those concepts were established to deal with situations characterised by the absence of legal agreements describing the respective functions, risks and assets of two or more constituent parts of the same legal entity. While practicality may have led to such concepts underpinning the AOA to attributing profits to permanent establishments, the situation in Article 9 OECD Model Tax Convention circumstances is entirely different.

As specified in paragraph 9.21 of the OECD guidelines, this framework is inappropriate in analysing separate legal entities in an Article 9 of the OECD Model Tax Convention context. Specifically, paragraph 9.21 provides that the ‘reference to the notions of ‘control over risk’ and of ‘financial capacity to assume the risk’ is not intended to set a standard under Article 9 of the OECD Model Tax Convention whereby risks would always follow capital or people functions’. Under the proposed framework, risks and functions seem to be inevitably linked, which we believe could produce results that are inconsistent with the arm’s length principle.

We suggest that the starting point for analysing transactions involving intangibles should mirror the framework for the allocation of risks outlined in Chapter IX of the OECD guidelines, which establishes a two-step process for assessing whether the allocation of risk between associated enterprises is arm’s length. Applied in the context of intangibles, this analytical framework could be as follows: (1) is there reliable evidence of a similar commercial arm’s length allocation, and, if not (2) is the allocation of intangible related returns one that might be expected to have been agreed between independent parties in comparable circumstances. Relevant (but not determinative) factors to consider in determining whether the allocation of intangible related returns is one that would have been agreed between arm’s length parties are:

- which entity performs or outsources (under control) functions related to the development, enhancement, maintenance, deployment and protection of the intangible;
- which entity bears the risks associated with the development, enhancement, maintenance, deployment and protection of the intangible, considering factors such as the ability to control and the financial capacity to bear, such risks; and
- which entity bore the costs (i.e. capital) related to the development, enhancement, maintenance, deployment and protection of the intangible (recognizing that this capital would normally require a certain rate of return).
The discussion draft rightly states that relevant functions will vary and depend on the particular facts of a case (paragraph 39). However, paragraph 39 appears to favour development and enhancement functions as being of particular importance; as are maintenance and protection, albeit of less importance. This appears consistent with the narrative in other paragraphs of Section B, but the reference to control of the development and enhancement functions is confusing. Several classes of intangible property are by definition relatively ‘static’ in that they typically require maintenance and protection activities (e.g., patent registration, prosecution activities, etc). In this context, it would be appropriate to revise paragraph 39 such that it is clear that a review of relevant functions should occur taking into consideration the nature of the intangible property at stake (i.e., a relatively static-type of intangible such as a patent compared to a more dynamic type of intangible such as a copyright in a rapidly evolving software source code).

Paragraph 40 notes that a taxpayer may hire a related or unrelated party to perform functions related to development, enhancement, maintenance and protection of an intangible asset. We concur that this reflects commercial reality and it is appropriate to recognise these arrangements in Section B. However, paragraph 40 requires that the party claiming entitlement to intangible related returns must physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles, which would typically include the following:

‘...design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of the intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have material effect on the value of the intangible.’

In the first instance, we believe that this concept diverges from commercial practice and therefore from the arm’s length principle. Our experience is that many arm’s length situations exist where a party that commissions, pays for and ultimately owns the intellectual property resulting from research does not retain most, or occasionally any, of these functions to be performed by its own employees. Arguably, the only functions that the intellectual property owner must always perform are: make the decision to outsource the development and manage the outsourcing relationship. Accordingly, under the arm’s length principle, performance of, or control over, functions involved in intangible related activity should not be the sole or favoured determining factor.

As discussed above, we believe that the draft currently imports some concepts of Chapter IX of OECD guidelines that are inappropriate in Chapter VI such that returns follow risk, and risk follows function. In relation to an appropriate risk analysis under Article 9 of the OECD Model Tax Convention, paragraph 9.22 of the OECD guidelines contains some important guidance:

a. It is only in the absence of comparable transactions evidencing the consistency with the arm’s length principle of the risk allocation in a controlled transaction, that the examination of which party has greater control over that risk is relevant;

b. In such circumstances, the examination of which party would have greater control over the risk ‘...can be a relevant factor’, meaning both that it need not be a relevant factor and that even if it is, it is not the only (or determinative) factor; and

c. The financial wherewithal to bear risk is also a relevant-yet-not-determinative factor.

Considering Section B of the discussion draft in respect of each of the points above leads to the following conclusions:
a. It does not explicitly give any recognition to the first point, and thereby inappropriately requires an examination of control over risk in all cases;
b. It treats a control test as determinative of an arm’s length risk allocation (and inappropriately extrapolates this to treat a control test as determinative of an arm’s length allocation of intangible related returns); and
c. It does not address the financial wherewithal factor.

The OECD guidelines do not support, in our opinion, the underlying position of Section B that, applying the arm’s length principle, intangible related functions or control thereof should determine the allocation of intangible related risks and therefore intangible related returns.

Assuming that a control test or standard is necessary leads to a desire to define a minimum level of control. Section B (see paragraph 41) states that the principles set out in paragraphs 9.23-9.28 of the OECD guidelines apply by analogy when assessing control. However, in our view, Section B does not follow such guidance and as a result seeks to set an inappropriately strict control standard for intangible related functions and risks, as discussed below.

Paragraph 9.25 presents an example where an investor hires a fund manager. The fund manager may be given authority to make all decisions on behalf of the investor on a day-to-day basis, but the investor controls its risks through three relevant decisions as follows: 1) the decision to hire the manager; 2) the authority given to the manager and the objectives the investor assigns; and 3) the decision on the amount of investment the fund manager can manage.

Similarly, paragraph 9.26 gives an example involving a principal that hires a contract researcher. The technical personnel of the researcher make the day-to-day research decisions, and the principal controls its risk by making decisions as to the hiring of the researcher, the type of research and its objectives, and the budget allocated to the researcher.

Section B, arguably, can be interpreted as requiring significantly more operational control over intangible creating activity than illustrated by these examples. This can be seen in paragraph 40 and it becomes more apparent in the examples associated with Section B. Examples 1 and 11 in the Annex both involve contract research and development arrangements where the fact that the contractor has no technical research and development personnel is a factor in the conclusion that it does not control the research and development functions and risks and is therefore not entitled to intangible related returns (compare with the example provided in paragraph 9.26). It is inconsistent with the arm’s length principle to require that a contractor must have in-house technical capability relevant to performing the activity outsourced in order to satisfy the control standard. Indeed, one of the normal commercial drivers for outsourcing an activity is that the contractor does not have the expertise needed to perform the activity itself. Thus, for instance, in the investment fund manager example at paragraph 9.25 of the OECD guidelines, the investor does not seek to control the manager’s day-to-day investment decisions and does not need to have expertise in investing (that is the very reason for employing the manager). The facts in the UK commercial case of Meridian International, mentioned above, further serves to support this concept. The expertise residing in the contractor (Richardson & others) was arguably the primary reason for Meridian to outsource these activities and it was not contended that Meridian had any knowledge of actually writing the software code.

In conclusion, the level of control exercised by independent parties in relation to outsourcing activities varies from situation to situation. It is, therefore, inappropriate to prescribe a strict control standard for purposes of applying the arm’s length principle. We suggest a change to paragraph 40 (and to others...
that follow by necessity) such that the control standard for purposes of allocating intangible related returns is determined based on the general proposition that the level of control required is that which an independent party would be expected to have in comparable circumstances.

We believe that paragraphs 41 to 47 should be changed to align them with our suggested changes above. Particular attention should be afforded to the concepts of control over risk and the fact that a contribution or investment of capital into a business venture or project involves bearing risk of loss of that capital so as to give an entitlement to an expected return on that investment. Finally, we highlight that paragraph 41 correctly provides that failure to pay arm’s length remuneration for outsourced activities does not call into question the ownership of any intellectual property that is created under the contractual relationship between the parties, but it is possible to misconstrue the wording of paragraph 42 to make this mistake. It would be better, in our opinion, to reword this paragraph to clarify that any failure to provide arm’s length remuneration to the party dealing with the outsourced activity calls into question only the arm’s length nature of that payment and nothing else. Paragraph 44 should be changed for the same reasons.

Paragraphs 48 to 52 are referred to as section B.3 and in general contain a discussion on the remuneration of local distributors that undertake marketing activities in their local jurisdiction (by reference also to related contract research and development providers). In general we agree with the principles discussed in Section B.3 but we note that there is no reference to what happens between unrelated parties. However, paragraph 48 creates a precondition for entitlement to intangible related returns that the compensation paid to an associated enterprise for routine functions performed be arm’s length, which in our view is not appropriate as discussed above. In addition, paragraph 48 contains references to the ‘level of activity undertaken’ by an associated enterprise retained to perform functions related to the development, enhancement, maintenance and protection of intangibles as a matter of importance for the inquiry. We agree with this concept in so far as it relates to comparability, but we would welcome a clarification so that it is understood that the extent (level) of expenditures assumed by a service provider should not, in and of itself, override legal relationships. For example, it would be inappropriate for ownership of intangibles to be imputed to a distributor if it incurs large marketing expenditures but consistently achieves arm’s length profits.

We believe that the discussion should be revised to include a specific reference to what happens between unrelated parties in similar circumstances, without which Section B.3 could be misapplied to inappropriately reallocate entitlement to intangible related returns under circumstances where the costs incurred by the local entity (e.g., the distributor) exceed a certain (theoretical) level. There should be no presumption that this is the case, unless so evidenced by comparable uncontrolled circumstances, or hypothesised as what would have happened between independent parties in comparable circumstances with support from commercial circumstances or disputes (i.e., a commercial arm’s length allocation).

Paragraph 53 contains an attempt to respect the standard for recharacterisation, adopted in Section D.2 of the guidelines, by providing that this should only occur under exceptional circumstances. We agree with this statement currently articulated in the OECD guidelines, but question whether or not Section B in practice is fully compliant in this regard as discussed above. In addition, as written, paragraph 53 presents in our view a rather narrow view of the standard for recharacterisation in that it appears to only concern transactions between associated entities in the second exceptional circumstance outlined in paragraph 1.65 of the guidelines. It does not appear that the draft is attempting to reflect situations where the substance of a transaction is not the same as its legal form, which as set out in paragraph 9.170 of Chapter IX of the OECD Transfer Pricing Guidelines may involve situations where it is the conduct of the
parties that does not accord with the legal form of a transaction. Given the reference to Section D.2 of Chapter I of the OECD guidelines as a whole, we question whether this is intentional, particularly in light of the importance of this issue as discussed above.

Paragraphs 54 and 55 provide a summary of the discussion in Section B. We suggest changes to these paragraphs to the extent necessary due to our suggested changes discussed above.

Paragraph 56 includes a reference to the examples associated with Section B. See below.

**Examples**

In general, we suggest revisions to the examples associated with Section B to reflect the following:

- a. The allocation of intangible related returns between associated enterprises is considered arm’s length insofar as there is reliable evidence of a similar allocation in comparable uncontrolled transactions;
- b. Lacking such evidence, the arm’s length nature of the allocation of intangible related returns between associated enterprises is assessed by hypothesising the allocation that would be expected to have been agreed between independent parties in comparable circumstances;
- c. Actual evidence of similar commercial arm’s length allocations is the best indication that the allocation of intangible related returns between associated enterprises satisfies the arm’s length principle;
- d. The performance of, or control over, functions involved in intangible related activity should not be the principal or favoured determining factor in allocating intangible related returns applying the arm’s length principle;
- e. The control standard for purposes of allocating intangible related returns is determined based on the general proposition that the level of control required is that which an independent party would be expected to have in comparable circumstances; and
- f. Risk must be supported by capital (financial wherewithal). If risk is properly supported by capital, that capital should receive an adequate return.

Example 1 involves a situation whereby the group parent (Premiere) is performing on-going research and development functions to support its business. Resulting patentable inventions are assigned to a subsidiary (Company S) that is responsible for the group’s global patent administration. Company S makes a small payment (i.e., below arm’s length value) each time an invention is assigned to comply with applicable contract law. Concurrently, Company S grants to Premiere an exclusive, royalty free patent license for the full life of the patent. It is established that Company S does not have any technical research and development personnel, nor does it bear any research and development related expenses.

The example concludes that Premiere and not Company S is entitled to the intangible related returns on the basis that Company S did not control the risk related to intangible development nor did it bear the related expenses. It also states that Company S should be entitled to an arm’s length remuneration for its patent administration services and underlying costs, but nothing else.

As written, Example 1 mechanically favours a subjective ‘economic ownership’ concept over legal form. We believe that the analysis could be clarified by adding a statement that the allocation of intangible related returns in the example is foremost influenced by the legal form of the transaction structured by the parties (and a concurrent analysis of the behaviour of the parties), which specifically did not call for the payment of an arm’s length compensation payable by Company S to Premiere for the full ownership
rights of the patentable inventions; as opposed to the bare ownership, evidenced by the compensation paid to Premiere and the granting of an exclusive and royalty free license back to Premiere.

Reference to the control of the research and development functions relating to the development and enhancement of inventions is also confusing. Patents are by definition relatively ‘static’ intangibles in that they typically mostly require maintenance (e.g., patent prosecution activities) and protection activities at that stage. As mentioned above, the relevant functions relating to intangibles depends on the particular facts of a case (paragraph 39), which also need to take into consideration the nature of the intangible at stake (i.e., a relatively static-type of intangible vs. a more dynamic-type of intangible). As a result, we can only reconcile those references (in the example) to the control (or rather absence thereof at the level of Company S) of development and enhancement functions as a confirmation of the legal form of the transaction as structured by the parties; that of a bare ownership transfer of the rights in the patentable inventions. Otherwise, we would disagree with the appropriateness and timing of such a control analysis to divert the intangible related returns from an entity, which while not having controlled the research and development functions, has paid an arm’s length price following the research and development stage for the full ownership right in the developed intangible.

Once the transaction as structured by the parties has been considered, we suggest (for pricing purposes) clarifying the example to illustrate that the proposed allocation of intangible related returns would only occur if a similar allocation has been (or would have been) agreed to between two unrelated parties or imposed by a competent court. As a matter of fact, and in view of identifying comparable arm’s length allocations, one needs to consider the wealth of information that exists in the telecommunication industry regarding patent wars and the various forms of legal arrangements in place between patent creators (whether or not currently legal owners), patent prosecutors (i.e., patent administrators), and non-practicing entities (that hold a registration of a patent but who may or may not be legal owners of that patent).

Our comments should not be interpreted as meaning that we believe that the outcome of Example 1 is unreasonable, but rather as a recommendation to re-emphasise the fact that the identification of the party entitled to the intangible related returns needs to be aligned with the legal form of the transaction as structured by the parties (unless, exceptionally, a recharacterisation is appropriate) and based on the arm’s length principle rather than some form of hypothetical reasoning.

Example 2 addresses a situation where there is a mismatch between the legal form of a transaction as structured by the parties and the ensuing functional characterisation of the parties on the one hand, and the transfer pricing outcome of the transaction (but not the substance of transaction), on the other hand. In general, we agree that it would be appropriate to reallocate the recall and product liability related costs from Company S to Primero. This, however, presupposes a number of points, including that the arrangement in its legal form and substance is consistent with that of a limited risk distributor, that the contractual arrangement provides for similar compensation, or that, failing such contractual terms, an assessment of what arm’s length parties would have agreed to in the circumstances (i.e., direct or indirect evidence of a commercial arm’s length allocation) would support such compensation, and that the entity that is entitled to the intangible related returns is also the entity that bears the risks associated with a defective product.

Despite our comments above, we find it somewhat confusing that Example 2 seems to make a direct link between recall and product liability costs and the entity entitled to the intangible related returns. One would expect that the proper analysis to conduct would be to assess the nature of the risks involved, and
then follow the Chapter IX framework to identify the entity bearing such risks. That being said, the ownership of the intangible asset being closely linked to the materialisation of the relevant risks would be an important consideration as part of this analysis.

We have no suggested revisions to Examples 3 and 4.

In relation to Example 5, we assume that the conclusion provided in respect of the marketing expenditures is due to a higher functional intensity than could be observed from the comparable independent marketers/distributors. If so, we can agree that directly compensating Company S for its excess marketing expenditures may be warranted. However, this again seems to be an issue of comparability. It would be inappropriate to reduce the sales price of the R brand watches or apply the residual profit split method unless this adjustment can be supported by what would have been agreed to between arm’s length parties.

We find paragraph 201 to be puzzling. Directly compensating Company S for its excess marketing expenditure is a matter of comparability. We strongly disagree with doing so on the basis that Company S is entitled to intangible related returns unless it is supported by comparable arm’s length allocations. It is not appropriate to infer that a distributor’s functional intensity relative to other (arm’s length) distributors mechanically gives rise to ownership rights, which is arguably the basis for the statement in paragraph 201.

The conclusion of Example 6 is given based on the assumptions presented in paragraph 203. However, it is not a necessity that Company S is entitled to intangible related returns. This may be the case under a co-marketing or co-development arrangement frequently occurring in the pharmaceutical industry, but not the only outcome of the facts provided in Example 6. We agree that Company S is entitled to additional compensation but that need not be due to its entitlement to the intangible related returns. Again, this is a matter of comparability for the pricing analysis in our view. In addition, one would also expect an analysis as to whether or not comparable arm’s length arrangements would also be on a royalty-free basis, and if that is not the case, then compensation to Company S may already be indirectly provided.

We question the rationale for the conclusion in paragraph 208 of Example 7. It is expected that a royalty would not be paid in an arm’s length context where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles (other than the right to use such intangibles in distribution of a branded product supplied by the entity entitled to the intangible related returns attributable to such intangibles). A distributor of products with a well-recognised brand can expect increased sales and market share, especially with a longer-term arrangement. Why would a distributor in this case be entitled to share in that upside potential without assuming the risk of downside potential at the inception of the new arrangement? Also, and assuming that a conclusion is reached that the return of Company S is below an arm’s length return under the circumstances, we believe that it would not be appropriate to deny the royalty payment without first determining that there is in that particular case an absence of intangible related returns, which it would seem to us would be a prerequisite. Absent such a determination, adjusting the purchase price of the R watches would be the more appropriate alternative. Economically it may not matter to the extent the entity entitled to the intangible related returns is the same as that supplying the R watches (although both the royalty and the purchase transactions may have different withholding tax and custom implications), but a theoretically sound approach as suggested above would matter where the entity entitled to the intangible related returns is in a different jurisdiction to the entity supplying the R watches.
We agree with Example 8 only in respect of additional remuneration to Company S on the basis that the pricing analysis ought to account for the intense marketing activities. We may also agree with the conclusion that Company S is entitled to intangible related returns for years 4 and 5 if it is evident in comparable arm’s length allocations that the increased marketing activities would result in such claim. Going back to the concept of what arm’s length parties would have agreed to in the circumstances (i.e., direct or indirect evidence of a commercial arm’s length allocation) is the only way to avoid diverging positions on the entity entitled to intangible related returns when examining the specific issue as to whether or not certain outlays or expenditures are creating such entitlements (see the discussion above). It is, however, likely that even years 4 and 5 could be adjusted by simply awarding Company S additional remuneration for its marketing activities. We set out further comments in this area when discussing Example 14 below. The above analysis should also take into consideration whether Company S may have pursued a market penetration strategy, which may in the short term result in a lower margin and progressively potentially in a much larger profitability in absolute cash terms.

We agree with Example 9.

We generally agree with Example 10 but the determination should be made with reference to commercial reality and an appropriate analysis of what arm’s length parties would have agreed to in the circumstances (i.e. direct or indirect evidence of a commercial arm’s length allocation).

We disagree with the control standard set out in Example 11 because it seeks to set an inappropriately strict control standard for intangible related functions and risks, which does not conform with what arm’s length parties would have agreed to in the circumstances. As a result we disagree with the outcome of the example. We suggest that the level of control required is that which an independent party would be expected to have in comparable circumstances (respecting the arm’s length principle); nor should this standard go further than that set out (and referred to in some examples) in Chapter IX.

A few additional observations are warranted, assuming for a moment that the outcome of Example 11 would accord with the arm’s length principle:

- one would have to assess whether the price paid by Company T to Shuyona for the patents and other technology related intangibles was determined on the basis of, for example, future cash flows reflecting the deployment of future technology related intangibles, in which case one could come to question the arm’s length nature of the payment for the original transfer;
- how would such a reallocation of intangible related returns be operated (i.e., what would be the imputed transaction to allocate intangible related returns to Shuyona), and what would be its appropriate characterisation for treaty purposes; and
- since Shuyona would need to be a licensee of the ‘legacy technology related intangibles’ in order to be able to perform its research and development activities, one could envision that Company T would also be entitled to a portion of the intangible related returns with respect to the ‘new technology related intangibles’ (see above regarding paragraph 35).
Section C - Transactions involving the use or transfer of intangibles (Paragraphs 59 – 78)

Overview
We are generally supportive of the concepts described in Section C and of the examples used to illustrate those concepts. In terms of potential to improve this section, we believe that more references can be made to what actually happens between unrelated parties in similar transactions in order to make the guidance both more accurate and more easily understood. We have identified a small number of instances where the guidance departs, in our view, from the arm’s length principle.

Detail
Paragraphs 57 and 58 require the identification of the transaction in which intangibles are concerned in addition to the identification of the intangible itself and the person entitled to the intangible. Two discreet types of transaction are identified: a transaction involving the transfer of that intangible to another party and a transaction involving the use of an intangible in connection with another transaction, but without a transfer of that intangible to another party. We agree that this is an important distinction for transfer pricing purposes.

Paragraphs 59 to 61 are identified as section C.1 and deal with circumstances in which intangibles are used in connection with another transaction (the ‘actual transaction’) but without a transfer of those intangibles to another party. We agree that the comparability analysis relating to the actual transaction would be incomplete and inaccurate if the role and value of the intangible is not considered. We agree that it is appropriate to reference the arm’s length principles set out in Chapters 1-3 of the guidelines but we consider that the specific reference to paragraphs 1.39, 1.42, 1.44, 2.109 (which we assume to contain a typing error) and 3.18 to be less helpful than a more generic reference to those chapters. We come to this conclusion because all of the concepts contained in Chapters 1 – 3 relating to the arm’s length principle may, in particular cases, be useful in completing a comparability analysis of a transaction which benefits from intangibles. For example; paragraphs 1.42 and 1.44 are referenced, but not paragraph 1.43 which itself deals with intangibles. We consider that the rephrasing of this reference provides the opportunity to provide a more general reference to adherence to the arm’s length principle and to the concepts laid out in Chapters 1 – 3 of the guidelines.

We agree with the examples included in paragraphs 60 and 61.

In section C.1, either immediately prior to the two examples or within the examples, we believe that it is appropriate and important to reference the caution given in paragraph 9 of the draft. The example in paragraph 9 is that non-unique intangible property might be present in relation to a transaction but would not give rise to value additional to that which is inherent in the actual transaction.

Paragraphs 62 to 75 are identified as section C.2 and deal with circumstances in which the transfer of intangibles, or of rights in intangibles, to a controlled party is the actual transaction. We agree with the comment in paragraph 63 that it is necessary to specifically identify the intangible that has been transferred and note that this is a repetition of the guidance at paragraph 11; we wonder if it might be better to link paragraph 63 back to paragraph 11 rather than to use part of the same language as stand-alone guidance in paragraph 63.

The closing sentence of paragraph 63 and all of paragraph 64 deal with restrictions and limitations in rights transferred; noting the importance of these as aspects of the valuation exercise. Paragraph 64 presents a seemingly balanced view that, as between unrelated parties, sometimes the rights to any further development of the actual intangible fall to the transferor / licensor or to the transferee / licensee. We are not aware of situations concerning unrelated parties in which the transferor (as opposed to a
licensor) retains rights to further development of the intangible. In our view, the position stated in paragraph 64 is correct in relation to licensor / licensee situations and we consider that the reference to transferor / transferee should not remain in this context. In respect to this statement relating to licensor / licensee we are also concerned that, without further clarification, this seemingly balanced statement might be misinterpreted as amounting to a permission to recharacterise the actual transaction to achieve the opposite solution. We suggest that the guidance include a statement immediately following to affirm that as both circumstances are seen between unrelated parties, either arrangement is likely to be acceptable unless there is clear evidence to the contrary. We believe that this point is one for comparability and valuation, as noted in the closing sentence of paragraph 64.

In our view the entirety of Chapters 1 – 3 are important in the consideration of the transfer pricing of intangibles. We support the concept advanced in paragraph 65 - a potential to ignore license terms that are not respected by the controlled parties in their action – but not the specific wording in this case. For example, where unrelated parties deviate from the express terms of the written contract other than temporarily with the knowledge of both parties, and without objection by either party, then the contractual arrangement that subsists between the parties is changed from that point. Therefore in a similar controlled transaction MNEs and tax authorities cannot ignore the contractual relationship but are bound to respect it; the contractual relationship is, however, not accurately stated in the written agreement. Similarly, a contract drawn for a set period of five years might expire and yet the parties continue to transact as if the terms of the contract continued. It would be inappropriate to contend that the contract should be treated as having been renewed for a further period of five years, or that the original time limitation should be disregarded so that the contract is treated as being for an indefinite period, as this is not reflective of the arm’s length situation.

Paragraphs 66 to 70 deal with the transfer of intangibles in combination. We agree with the general thrust of these paragraphs and the example contained in paragraph 68. We believe that these paragraphs - particularly 69 and 70 - would benefit from a greater connection to the arm’s length principle.

Paragraph 69 deals with situations in which several intangibles are intertwined and it is not possible ‘....as a substantive matter.... to transfer one without the other(s).’ We believe that this statement would benefit by replacing the phrase italicised above with one such as ‘....in uncontrolled transactions...’. We believe that this change would reduce the possibility of an MNE or tax authority departing from the arm’s length standard.

Paragraph 70 contains the following statement:

‘Similarly, it is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of substance, cannot be separated.’

We consider that this would depart from the arm’s length standard. We believe that this paragraph should more accurately read:

‘Similarly, it is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of commercial reality in unrelated-party transactions, cannot be separated.’

Paragraphs 71 to 75 deal with transfers of intangibles in combination with other business transactions. We believe that these paragraphs would benefit from a greater connection to the arm’s length principle and that, as currently written, there is a risk that a taxpayer or tax authority could depart from the arm’s length principle by asserting that a combined transaction that occurs also between unrelated parties should be split when considering the price paid by related parties in a similar transaction.
Paragraph 72 would benefit from the inclusion of a note of caution that splitting a single transaction into several component parts and pricing each of them independently would not be appropriate if, as between unrelated parties, that bundle is priced as a single transaction. It would also be appropriate to caution that inappropriate splitting of a bundled transaction may lead to a higher transaction price than that which would be agreed between unrelated parties in a similar bundled transaction.

Paragraph 73 deals with separation of bundled intellectual property identified in paragraphs 71 and 72 using the example of a franchise. Where a franchise is the business transaction then, through comparable data or through profit-split, it is the transaction that needs to be understood and priced. At paragraph 53 the draft has already supported the view that only in rare circumstances would it be appropriate to recharacterise a transaction into something that it is not. However, paragraph 73 now suggests that:

‘If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparable data cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.’

It is our view that the separation of a franchise into constituent parts is not a valid approach to pricing the arm’s length fee for a franchise. The constituent elements of a franchise might include patents, trademarks and other intangibles that, under a completely different and hypothetical transaction, might have been made available under different agreements, different terms, and at different prices. A franchise represents a different business model, common in business, to an intellectual property licence (or series of intellectual property licences) and that different business model carries a lower risk profile for the franchisee, compared to a licensee. As a result the constituent parts are of a franchise are, we believe, not able to be valued by reference to third-party licences for intellectual property. In our experience the exercise of breaking down a franchise to identify all of the elements made available is difficult, if not impossible. It is likely that the exercise will end without producing evidence that all intangibles made available have been identified and resulting individual valuations of those intangibles that have been identified are more likely to sum to a price significantly in excess of the arm’s length price of an appropriate franchise fee.

We propose that this example is removed from the draft, or that it is redrafted to show the danger of inappropriate splitting of a bundled transaction such that the exercise deviates from the arm’s length standard.

**Examples**

**Example 12**

We suggest that the facts of this example be improved (paragraph 225). As drafted, the example does not make clear that the patent obtained by Primarni is applicable in country B. The granting of a patent by one country gives the patentee rights to prevent activities, such as manufacture or sale of an infringing item, in that territory. A clear statement that Primarni has been granted a patent enforceable in both country A and country B would remove ambiguity and aid clarity.

In addition, it is not clear from the facts given that Primarni has a valid patent in other countries, notably those of Asia and Africa. Without an enforceable patent in those countries Primarni has no rights, contrary to the conclusion reached in this example.
These points are correctly dealt with in example 13, for example.

For the purpose of the following comments we assume that Primarni has a valid patent in all territories referred to in the example. We consider that the solution given for this example in paragraph 227 does not accord with the arm’s length standard. Company S has met the terms of its license in that it has manufactured and sold products only in country B. The export of products to other territories was not an act of Company S, and assuming all parties to be unrelated Primarni would have no complaint against company B that would be actionable before a court in either Country A or Country B. In commercial transactions this is known as ‘grey’ market or ‘parallel importing’. Primarni is unlikely to have suffered any financial loss as a result of the export of products to other countries if the transaction between Primarni and Company S follows the arm’s length principle; the patent royalty paid by Company S would include the value of sales made to all of its customers. Therefore the price of goods charged to related parties would include the patent royalty value paid to Primarni. If the patent royalty is paid based on sales price by Company S, then as between unrelated parties we would expect to see a different royalty rate applied to sales made as a distributor to customers (in this example, sales made in country B to unrelated parties) and to sales made as a manufacturer, or wholesaler, to other distributors (in this example, the sales made to related parties who exported the goods to Asia and to Africa). The difference in royalty rate would be expected to correct for the sales price difference between Company S and the related party distributor.

Therefore we conclude that the solution given in paragraph 227 should be revised in line with the comments above.

Example 13
We have no suggestions in respect of this example.

Example 14
Whilst we agree with the solution to this example, on the facts given, we believe that it would be improved by reference to what would happen between unrelated parties. It is not uncommon for distributors to take a role in local advertising or carry at least a part of the cost of such advertising. In considering whether by action of the licensee or distributor that party becomes part-owner of the goodwill associated with the trademark, the test applied to unrelated parties is whether the total burden placed on the licensee or distributor (in this case, the price of goods and cost and the activity of advertising) is, qualitatively or quantitatively, more than would be expected of a licensee or distributor. Only if this test is passed would the licensee or distributor become simultaneously entitled to some reward in relation to the marketing intangible.

The above test has been applied in several UK commercial cases. In the case of Gromax Plasticulture Ltd and Don & Low Nonwovens Ltd [1998] Ch. there is an example of this test being applied in seeking a solution to the question of whether a trademark owner or a distributor (unrelated parties) were entitled to the reward generated by goodwill in the trademark. We also note that this ‘bright line’ test has echoes in some tax cases, notably the Indian case of Maruti Suzuki India Ltd v Additional Commissioner of Income Tax Transfer Pricing Officer New Delhi W.P.(C) 6876/2008 (High court of Delhi at New Delhi, 2010) and the US case of DHL Corp., TC Memo 1998-461, RIA TC Memo.

What is clear from unrelated party disputes is that the party who is entitled to the income from an intangible is the party to which a court would award the income. The primary rule is that this will be the party that holds title to, or registration of, the intangible and that rule will be set aside only if there are
circumstances so special that a bright line is crossed. If the bright line is crossed then the parties can become simultaneous joint owners of the intangible.

Example 15

We are generally supportive of this example. However, we note that the price paid by Birincil to acquire the shares in company T may have been influenced by other factors that are not mentioned in the example and hence the clear statement that value should not be considered to have been created nor destroyed and that the value should be considered to be either retained in company T or transferred to company S might be incorrect in a particular case. Suppose that part of the price paid by Birincil was driven by an incorrect assessment of the true value of company T then that part of the price paid for the shares in Company T was never a value in the business of Company T and hence would not be reflected in either the value of intangibles transferred to Company S or in the value of the business retained by Company T. Equally, suppose that Birincil paid a premium to acquire the share capital of Company T because it saw strategic advantage for the group (removal of a future competitor, competitive advantage enjoyed because of a complete product range, or other factor). In those circumstances the full price paid by Birincil to acquire the shares of Company T would not be reflected in the value of the business of company T and therefore would not be reflected in the sum of the price paid by Company S for the transfer to it of intangibles plus the remaining value of the business of Company T.

As drafted we conclude that this example would incorrectly persuade an MNE or a tax authority that there must always be parity between the sum total of the value of the business remaining in Company T and the value of intangibles transferred to Company S and thereby to allocate erroneously an additional value to the transfer of intangibles to Company S when there might be other factors to be taken into account.

Example 16

We find this example to be unclear. The facts stated in paragraph 240 do not make clear whether Zhu provides a service to Company S using its employees or whether it seconds its employees to Company S. We assume that the former is the case but we suggest clarification of the facts on this point.

Nevertheless, we do not agree with the solution to this example.

If Zhu provides a service to Company S using its employees who make reference to computer code written by Zhu (copyright owned by Zhu) then that act alone is not evidence of a potential breach of any copyright of Zhu. The facts supplied therefore do not support a conclusion that Company S receives rights in Zhu software amounting to a transfer of rights from Zhu.

Having knowledge of the copyright software developed by Zhu for client Bank A, suppose the team write software for Company S, and in turn for client Bank B, that achieves the same ends and utilises some of the same ideas but does so in a way that would not be a breach of copyright in the software that Zhu had developed for client Bank A. In that case the second element of value identified in paragraph 241 is incorrect; the knowledge of earlier software which was used to form a base of the new software is a comparability factor to be taken into account in analysing the value for the service being given by Zhu to Company S and it is not a transfer of any rights in the original software to Company S.

This example, if it is intended to illustrate that a second value ought to be identified in any transfer pricing analysis based on the transfer of copyright in the original software (as a contrast to the solution proposed in example 17) must make clear that the repetition of code in the new software is of an extent that, as between unrelated parties, would lead to a claim for breach of copyright in the original software.
Example 17

We agree with the content of this example.
Section D – Determining Arm’s Length Conditions in Cases Involving Intangibles

Sections D1 & D2 - Conducting a comparability analysis in a matter involving intangibles and selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles (Paragraphs 79 – 116)

Overview

We are generally supportive of the concepts described in Section D and of the examples used to illustrate those concepts. In terms of potential to improve this section, we have included comments on relevant paragraphs below.

Detail

Paragraphs 79 – 105 discuss the conducting of a comparability analysis in a matter involving intangibles.

Paragraph 80 makes reference to the need for a transfer pricing analysis on the use or transfer of intangibles to consider the options realistically available to each of the parties to the transaction. This analysis should be performed applying the principles of paragraphs 9.59 to 9.64. We would point out the reference in paragraph 78 where it is stated that associated enterprises might, for wholly legitimate business reasons, sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. This reference should be kept in mind when reviewing the guidance in paragraph 9.60 where it is stated that alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. It could be advisable to re-iterate or refer to the statement in paragraph 78 when discussing the evaluation of options realistically available further in paragraphs 80 – 83 to emphasise the fact related parties do not always face the same choices as unrelated parties.

It should be noted that according to paragraph 9.64 the reference to options realistically available is not intended to create a requirement for taxpayers to document all possible hypothetical options realistically available. In light of the above, this is of importance when dealing with transfer pricing analysis on the use or transfer of intangibles. If associated enterprises do structure a transaction in a manner that independent enterprises would not contemplate and do this for wholly legitimate business reasons, the expectation must not be for the taxpayers to document all options available. In particular in connection to cases involving e.g. the use of comparable controlled price or transactional net margin methods, the documentation of the analysis supporting the comparability analysis and the transfer pricing method selected should be viewed as reflecting the options realistically available as these analyses are ultimately based on third party data.

Paragraph 83 proposes that an intellectual property transaction might be disregarded in circumstances where the minimum price for the transferor and the maximum price for the transferee do not overlap, based on a pricing exercise of ‘options realistically available’. We do not agree that this test satisfies the requirements in paragraph 1.65 of the guidelines to limit recharacterisation only to cases where the economic substance differs from the legal form of the transaction, or cases where the transaction differs from that which ‘would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price’. The former case deals with artificial situations and is not what is being
discussed here. The latter circumstance does not apply if the transaction can be priced, for example, by means of a comparable uncontrolled price. Disregarding or recharacterising transactions is sensibly dealt with in paragraph 1.64: “Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other administration does not share the same views as to how the transaction should be structured.’ We consider that the proposed reference to restructuring transactions is unhelpful and contrary to paragraph 1.65 of the guidelines, and should be removed, or re-worded to say that only in exceptional circumstances that are clearly within the two circumstances of paragraph 1.65 of the guidelines should recharacterisation be considered.

In relation to the discussion on intangibles as a comparability factor in transactions involving the use of intangibles in paragraphs 84 – 89 in modern business transactions it is unlikely that any party will be identified that has no intangibles whatsoever. We agree with the conclusion in paragraph 87 where it is stated that in many cases the parties to comparable uncontrolled transactions will have same type of intangibles as used by the tested party at their disposal. We also support the call for restraint, in paragraph 89, in rejecting potential comparable data on the grounds of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill.

We agree with the importance of the factors that are raised in paragraphs 90-101 as something that may be an essential part of a comparability analysis. It should be noted that care should be exercised in performing any comparability adjustments for the purposes of comparability analysis on intangibles, rather, focus should be on the actual comparability of selected comparable data.

Paragraphs 103 and 104 refer to the difficulties in making adjustments to potential comparable uncontrolled price data to allow for differences in comparability. We agree that sometimes seemingly minor differences in comparability can make significant differences to the appropriate price for transfer of intellectual property, or for the license of intellectual property. We do not believe that this is restricted to cases where the proposed adjustment is small in percentage terms; perhaps the adjustment should have been large in percentage terms, for example. We believe that this section of the guidelines should address the difficulty in making any adjustment to potentially comparable data and note that, save in cases where the adjustment is documented and evidenced to a high degree of certainty, such adjustments should not be accepted and an alternative methodology should be employed. This observation extends also to what have been termed D.1.vi intangibles.

Paragraph 107 notes that the economic consequences of a transaction might be similar from two different transactions – in the example, a service using an intangible and the transfer of an intangible - and concludes that the economic substance is therefore more important than the ‘label’ in selecting a transfer pricing method. We believe that this statement contradicts guidance given earlier to identify the intangible, to respect the transaction actually undertaken, and not to recharacterise the transaction save under exceptional circumstances. The provision of a service using an intangible may have a similar short-term economic consequence for the recipient of the service as would a transfer of that intangible; however, as the intangible is not transferred the long-term consequences are considerably different. Therefore we believe that this view is incorrect and the statement should be removed from the guidance. Paragraph 108 correctly identifies that it will be incorrect to allocate all but routine profits to the intellectual property holder. Typically both a licensor and licensee will enjoy some of that profit. We believe it would be useful to make reference to how that profit would be shared between unconnected parties.

We agree in principle with the comments on the use of valuation techniques included in paragraphs 109-111. However, we consider that the comment in paragraph 110 in relation to valuations contained in
purchase price allocations is too prescriptive. Though care should be exercised when looking at analysing valuations of intangibles in purchase price allocations performed for accounting purposes, dismissing them by stating that they ‘are not relevant for transfer pricing purposes’ may lead to situations where, even if useful, the valuations of intangibles in purchase price allocations may be unnecessarily overlooked.

Paragraph 112 points out that there is little reason to believe that there is any correlation between the costs of developing intangibles and their value or transfer price once developed. Whilst we agree with this statement in regard to fully developed intangibles, to which the reference in paragraph 112 is made, it should be noted that in the case of early stage intangibles, where the activity and risk to completely develop and commercialise the intangible is high, intangibles are sold at cost, or a margin over cost, between unrelated parties. It would be appropriate to make reference to the fact that cost based pricing is acceptable where evidence is presented that such a pricing basis is used between unrelated parties.

We agree with the statement on the discouragement on the use of a rule of thumb for the purposes of dividing intangible related returns. It is also inappropriate as a methodology for determining what is an intangible related return. This principle is also supported in recent intangibles-related commercial case law, namely in a decision of the US Court of Appeals for the Federal Circuit (‘the Court’) on 4 January 2011 in the case of Uniloc USA, Inc. Et al. v. Microsoft Corporation. In its ruling the Court decided that the ‘25 percent rule’ used to estimate a fair royalty was ‘fundamentally flawed’. In this particular case the Court looked at examples where the rule had been used in US cases, and also at criticisms of the rule, to hold that there was no scientific basis for the rule and therefore concluded that it held no evidential value before a US court. This decision, in addition to dismissing the 25 percent rule as admissible evidence before a US Court provides a valuable insight into the assessment of a fair royalty between a willing licensor and a willing licensee further supporting the statement on the discouragement on the use of a rule of thumb.

Section D3 - Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services ( Paragraphs 117 – 131)

Overview

We are in agreement and supportive with the general direction of the paragraphs contained in Section D.3., which follow a logical approach to establish clear guidance for determining arm’s length prices for transactions involving the use of intangible property in connection with sales of goods or services. In terms of opportunities for improvement, we suggest that the text should clarify the reasons surrounding the inapplicability of comparability adjustments between controlled and uncontrolled transaction. More specifically, the current draft links the inapplicability of comparable adjustments to the materiality of the difference(s) to be explained. We are not supportive of that link. We believe that irrespective of the materiality of the difference(s), once a material difference has been identified between the controlled and uncontrolled transaction the only factor to be considered to assess the appropriateness of a comparability adjustment should be the accuracy and reliability of the proposed adjustment.

Detail

Paragraphs 117 and 118 are introductory and present the objectives and lay out the structure of Section D.3.

The categorisation presented in paragraph 118 is based upon the availability (or not) of reliable uncontrolled comparable transactions allowing the application of a transfer pricing method based on
comparable data in order to determine an arm’s length price. This subdivision with, on the one hand, a first category grouping cases for which reliable comparable data exists and, on the other a second category grouping cases for which no reliable comparable data exists, gives to Section D.3. its two-part structure. Paragraph 118 refers to what has been previously termed in Section D.1. (vi) intangibles paragraph 105 as the ‘differentiator’ between the two categories.

Paragraphs 119 through 124 deal with situations where reliable comparable data exists. We agree with the view expressed in Paragraph 119 that it may be the case that reliable comparable data can be identified. In such instances, paragraph 119 makes appropriate references to the applicability of the five OECD transfer pricing methods as described in Chapter II.

Paragraphs 120 and 121 set up the principles of the appropriateness, and if so, under which circumstances, a transfer pricing method relying on comparable data could be utilised. We are supportive of paragraph 120 which emphasises that, while the nature of the intangibles remains a common issue for comparability purposes, intangibles used by the tested party are potentially comparable to intangibles used by unrelated parties, unless the intangible under review falls within the category defined per Section D.1. (vi) intangibles. Paragraph 120 draws a logical path and structured framework to be followed when it comes to determining arm’s length prices.

Paragraph 121 clarifies that only for Section D.1. (vi) intangibles there would be a need to make comparability adjustments or to adopt a transfer pricing method less dependent on comparable uncontrolled transactions. Conversely, for intangibles not falling into the Section D.1. (vi) intangibles category, paragraph 121 indicates that uncontrolled transactions may provide a reliable basis for determining arm’s length conditions. For this latter category, paragraph 121 then makes reference to the principles outlined in Section D.1. (ii) (i.e., intangibles as a comparability factor in transactions involving the use of intangibles) to determine whether the use of intangibles by the tested party will preclude reliance on identified comparable or require comparability adjustments. We are supportive of these concepts and in particular the guidance that reinforces the need to look to transactions between unrelated parties to provide support for an assertion that a tested transaction is, or is not, priced in accordance with the arm’s length principle.

Paragraphs 122 to 124 provide guidance with respect to comparability adjustments. Paragraph 122 makes references to Chapter III, paragraphs 3.47 to 3.54 as well as paragraph 103 of the discussion draft. We are supportive of the cross-referencing of Chapter VI to Chapters I-III as this reinforces the point that Chapter VI provides additional guidance of how to apply the arm’s length principle, as set out in Chapters I – III and that it does not stand alone. We also note that stringent attention to the comparability of transactions advanced as evidence of the arm’s length price of controlled transactions accords with the burden placed on unrelated parties. This is apparent from the UK court decision in General Tyre & Rubber Co. V Firestone Tyre & Rubber Co Ltd [1976] R.P.C. 197 HL when, in an infringement case, several licenses between unconnected parties were proffered to the court as evidence of a royalty rate that would have been agreed by willing parties:

‘Before a ‘going rate’ of royalty can be taken as the basis on which an infringer should be held liable, it must be shown that the circumstances in which the going rate was paid are the same, or at least comparable, with those in which the patentee and the infringer are assumed to strike their bargain.’

Paragraph 123 is critical because it highlights the factual issues that are key to quantifying reliable comparability adjustments and, most importantly, it also defines the conditions of a reliable use of comparability adjustments.
Paragraph 123 suggests that comparability adjustments may be inappropriate if the impact on price attributed to a difference in the nature of intangible is ‘clearly material, but not subject to accurate estimation’. Where material differences exist but they cannot be subject to accurate estimation of the value of their impact the guidance intends, we believe, to suggest that an alternative transfer pricing method -- less dependent on identification of reliable comparable data -- should then be preferred. We support the concept advanced in paragraph 123, but we believe that its current drafting could be improved and, in particular, that only the accuracy of the adjustment, and not the materiality of the adjustment, is relevant in deciding what adjustments should be made or whether to move to another methodology. As currently drafted, an inappropriate interpretation of paragraph 123 might lead to an assertion that where the difference in nature of the intangible is not subject to accurate estimation but would be immaterial it would be acceptable to perform a comparability adjustment. We note that guidance on the application of the CUP method in Chapter II is clear on this matter:

2.14 Following the principles in Chapter I, an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the CUP method if one of the following conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or, b) reasonably accurate adjustments can be made to eliminate the material effects of such differences.

We are therefore of the view that when the difference that has been identified between the tested and the comparable transaction is not material then condition (a) above is met and no adjustment is either required or authorised by the guidelines. Therefore the accuracy of the adjustment is not relevant, nor is the question of whether to swap to another more appropriate method. Accordingly, we suggest removing the reference to ‘materiality’; if there is a need in Chapter VI to reinforce the point we would prefer to have a cross-reference to paragraph 2.4.

Finally, paragraph 124 points out, correctly in our view, that the factors to be taken into account when determining comparability adjustments should not be limited to the sole nature of the intangibles. Whenever appropriate these factors should also include elements that are not themselves intangibles but will affect the price that would be paid by unrelated parties for access to the intangible, such as differences in markets, locational advantages, business strategies, or assembled workforce.

Paragraphs 125 to 131 deal with situations where reliable comparable data does not exist. Paragraph 125 starts by laying out the situations for which no reliable comparable uncontrolled transactions exist.

Such situations can either be due to the uniqueness of the intangibles -- reference is made to Section D.1. (vi) -- or to the lack of available comparable data. Paragraph 125 also indicates that, despite the lack of reliable comparable data, it is possible to determine the arm’s length price of the controlled transaction as long as the structure of the arrangements made in relation to the transaction does not impede the task (reference is made to paragraph 1.65).

Paragraphs 126 and 127 discuss the important factors that need to be considered in the absence of reliable comparable uncontrolled transactions. In particular, paragraph 126 outlines factors such as functions, assets, and risks of the respective parties to the transaction, the business reasons for engaging in the transaction, the perspectives of and options realistically available to each of the parties to the transaction, the market advantages and other important factors such as locational advantages and market differences. Most importantly, paragraph 127 highlights the fact a detailed and complete analysis of the characteristics peculiar to the controlled transaction is essential. Paragraph 127 also points out, correctly in our view, as a corollary to paragraph 1.65, that while it may be legitimate for related entities to structure their transactions differently from unrelated parties, the effect of the potential differences on
prices and other conditions resulting from these atypical structures should be taken into account when evaluating the profits that would have been agreed to each of the parties at arm’s length.

Paragraphs 128, 129, and 130 discuss the application of the profit split methods. Paragraph 128 introduces the possibility of utilising the transactional profit split methods, particularly when, as outlined in Chapter II, both parties to the transaction make unique and valuable contributions to the transaction. In our view, and consistent with the view expressed in the draft that a license is itself an intangible, the granting of a license in intangible property means that both the licensor and the licensee will make unique and valuable contributions to the transaction and hence a profit split method would be appropriate. Paragraph 129 makes references to the relevant paragraphs of Chapter II of the guidelines containing guidance for the application of the transactional profit split method. Paragraph 130 reminds us of the issues to be taken into account when applying a profit split method in a case involving the use of intangibles, which includes (i) the identification the intangibles in question, (ii) the evaluation of the contribution of these intangibles to the creation of value, and (iii) the evaluation of other income-producing functions, risks, and assets. Paragraph 130 states, correctly in our view, that a reliable application of a profit split method cannot rely on ‘vague assertions’ of the existence and use of unspecified intangibles.

We note that profit split is a method that has found approval before the courts in several countries when faced with the question of determining the value of a license between a willing licensor and a willing licensee, usually in a case concerning infringement. For example, the UK courts in the case between Ultraframe (UK) Limited and Eurocell Building Plastics Limited [2006] EWHC 1344 (Pat) considered the fair value of a license. The court found that a total profit split was the most appropriate method to ascertain this license rate.

Finally, paragraph 131 makes reference to the potential use of valuation techniques. Our comments are the same as those made with respect to paragraphs 109-111.

Section D4 - Determining arm’s length prices for transactions involving the transfer or intangibles or rights in intangibles

Organisation / ranking of methodologies

Overview

In this section, we have summarised our views on intangible property valuation methods used by transfer pricing and corporate finance specialists.

- It is not appropriate for the guidance to consider in-depth all potentially applicable valuation techniques. Such in-depth analysis is the province of specialist books / educational material and the volume of material required to cover adequately the application and use of all techniques is very large. We welcome the fact that this is recognised.
- Given the above, we consider that it is inappropriate for one valuation methodology to be singled out for in-depth discussion. Though it is not the intention, such treatment could be misinterpreted as giving a relevance of that methodology above all others.
- We therefore are strongly of the view that the guidelines should remain at a higher level and not deal with the detailed application of a particular method.
- We believe that the guidance should support the use of any applicable method but stress the importance of evidencing why the method is appropriate in the circumstances of the transaction and why the result is as accurate as possible.

Given the above conclusion we take a slightly different approach to this section; we will approach the issue in totality rather than by paragraph.
Detail

On the basis of the discussion draft, the existing OECD guidelines, the day-to-day practice in intangible property valuation, advance pricing agreements and transfer pricing audits, we note the following:

- Valuation / benchmarking methodologies are not discussed in a structured, streamlined fashion. Many references are made to both OECD transfer pricing methods and to 'corporate finance' methods.
- There are some discussions on priority of methods – namely the Comparable Uncontrolled Price method (CUP method). As Chapter VI supports the application of principles contained in Chapters I-III of the guidelines this is consistent with those Chapters. We agree that where no CUP, or adjusted CUP, is available it would be inappropriate to stress any hierarchy of methodologies. We would prefer the guidance to emphasise the need to choose a methodology that is appropriate to the circumstances of the transaction and to record evidence of why that methodology was thought to be the best alternative.
- The guidance makes indirect references to the use of more than one method at the same time. In many cases, however, we consider that this may be the most appropriate course of action, and we note that this is common practice in commercial valuations (in corporate finance, for example).
- Valuation techniques have been in existence for many years and are routinely applied for determining pricing of intangibles / rights to intangibles exchanged between unrelated parties, in a strictly arm's length context. It would therefore be inappropriate to dismiss these techniques just because they are used by another fiscal profession.

We consider that three broad categories of valuation techniques are used routinely to value intangible property in transactions between unrelated parties. These are:

- CUP under which prices for the sale or license of similar intangible property are observed in the market between unrelated parties and used to ascertain the arm’s length price of the tested transaction. As between unrelated parties this approach is generally considered to be straightforward to apply and to give robust results if it can be applied accurately. The key weakness is that outside of transactions in the same intangible property by the tested party with unrelated enterprises it is often the case that comparability between tested transaction and the market reference material cannot be evidenced.
- Cost approach under which the cost of producing or reproducing the intangible property is considered and used as a base, together with a mark-up, for the price of the sale or license of the intangible property. Cost-based approaches are appropriate in certain circumstances and are used by unconnected parties in setting a price for a sale or license. It is the benchmark employed in practice for ‘make or buy’ related decisions where the intangible property is not so unique that it could not be replicated. In that case it is not the cost incurred to date by the seller / licensor but the anticipated costs to be incurred by the potential purchaser / licensee that are appropriate. Cost-based methodologies are also applied in cases of sale of early stage intangible property, where the risks remaining in the period to completion are greater than the risks taken so far. In these cases it is the costs incurred by the potential seller / licensor that are important. The cost approach will lead to a value that has little correlation with the actual value of the intangible property if it is used inappropriately.
- Income approach under which the (difference in) profitability of the user of the intangible property is assessed and used as a basis for valuation of outright sale (based on the net
present value of the relevant profit stream) or license (based on a split of the anticipated additional profit). The income approach suggests that where excess return can be obtained through the use of an intangible property, its user is ready to pay a price for it. The key weakness of the methodology is that it is generally dependent on forecasted financials; the accuracy of these as a predicative tool might be less than uncertain.

Given intrinsic benefits and shortcomings of all three approaches it is conceivable that though on occasions any one methodology might lead to the most appropriate valuation there will be other times when this is not the case. In those circumstances a combination of methods might be advisable.

We consider that traditional OECD methods like the resale price method and (gross) cost plus method are generally inappropriate as intangible property tends to be ancillary to other business activities of its owner rather than being an actively traded good / services. The exception to this would be, for example, an entity that acts as a software reseller; though the legal form of the transaction might be a sale of software followed by a resale of software the arm’s length transfer price might be ascertained by allowing the reseller to make an appropriate gross margin based on a resale minus method to reward it for the sales activity.

Taking into account all the observations listed above, we believe that:

- It is important to distinguish the approach to, or framework for, valuation from methods for performing a valuation. The approach considers how to address the valuation problem and leads to the selection of one or more methods, which are the techniques of valuation.
- It is extremely important to provide guidance to MNEs and tax authorities in the matter of a robust approach / framework.
- This guidance should retain sufficient flexibility for the MNE or tax authority to select the appropriate method(s) and should encourage the development and retention of evidence to support that selection.
- Using multiple approaches can be appropriate if the accuracy of a single method cannot be substantiated. In such cases the use of multiple methods is market practice between unrelated parties. Therefore, dismissing by default one approach (e.g. cost approach, as in the current draft) or overemphasising another (e.g. market approach, as in the current draft) appears to be too simplistic, and is not reflective of the need for careful analysis of all facts and circumstances surrounding any specific transactions.

We also make the following observations which are more specific in nature:

- It might be useful to indicate that, when no cash flow data is available, accounting profit may serve as reasonable proxy for cash flows.
- Discussion contained in the draft on the topic of sensitivity analysis is less appropriate if the framework for the valuation demonstrates that there is a high degree of accuracy in the valuation method. Where there is less confidence in the accuracy of a single valuation method it is more appropriate to resort to multiple methods and to seek a value that is supported by two or more methods than to undertake sensitivity analysis for that one method. We favour an emphasis on providing support to the selection of data and assumptions made that underlie the chosen methodology. We believe, though, it is appropriate to mention that sensitivity analysis may be used to arrive at valid conclusions, by e.g. allowing the computation of ranges.
• Weighted average cost of capital (WACC) as a discount rate is generally appropriate. The WACC of the business may provide some guidance as to the applicable rate but it would usually not be reflective of the specifics of a single intangible property. Therefore, intangible property-specific WACC is recommended.

• The discussion on the use of tax rates is inappropriate as pre- or post-tax calculations will result in the same value if the correct pre- or post-tax WACC is applied.

• We generally agree with the discussions on variability of royalty rates, hindsight and forms of payment.

**Timing**

We are of the view that Chapter VI should include guidance on timing issues relating to material available to review transfer prices, or we suggest that Chapter VI be cross-referenced to that guidance if it is to be given elsewhere in the guidelines. To remain true to the arm’s length principle, material used by MNEs in setting an arm’s length price, or by tax authorities in reviewing the arm’s length nature of that price, should include only material that would have been available to the transacting parties at the time of the transaction. To include material that became available only at a date subsequent to the transaction, or to take into account events that happened after the transaction but which could not be foreseen, would depart from what actually happens between unrelated parties.

That is not to say that the parties must always set a single price or license fee at that time; it may be that the uncertainty surrounding the position at that time might be so great that, for example, a royalty fee stepped by turnover might be agreed or a sale value including an earn-out structure might be selected.

However, these options would be considered and decided based upon the evidence available at the time of the transaction and not at a later date when more / different evidence is available.

Our view is based upon experience of transactions between unrelated parties, but is also illustrated by the decisions of the UK court. For example, in the commercial case of *Force India Formula One Team Limited and Aerolab SRL* [2012] EWHC 616 (Ch) a fair royalty between a supposed willing licensor and licensee was sought by the court in settling damages for infringement because Aerolab had divulged the intangible property of Force India to another party, Lotus. One point argued between the parties was whether the license would be set by reference to the facts known at the time of the infringement – when the Lotus team had applied to enter Formula 1 but had not then been accepted – or whether the parties should be deemed to have reached an interim agreement in which the value of the royalty would be settled only later when it became clear that Lotus would, or would not, be admitted to Formula 1. Admission to Formula 1 (F1) was agreed by the parties to affect the willingness of Lotus to pay a higher royalty rate. The Hon. Mr Justice Arnold dealt with the point thus (paragraph numbers here relate to the case report):

432. The Defendants contend that the date of the hypothetical negotiation is the beginning of August 2009, that being the date when any misuse of confidential information started. Force India contends that the parties would not have concluded a deal at that point, but rather would have postponed finalising the negotiation until 14 September 2009 when Lotus obtained its F1 entry. In support of this contention counsel for Force India argued that the value of the licence would only be clear once the parties knew whether or not Lotus had gained entry into F1.

433. In my judgment the Defendants are correct on this point. *Prima facie* the date of the negotiation is when the misuse of confidential information started. The parties are to be taken to know at that point what use the defendant is going to make of the confidential information. The
misuse I have found largely took place in August 2009. Although some of that misuse continued after 14 September 2009, there was very little new misuse after 14 September 2009. Thus the majority of the misuse took place before Lotus had gained entry into F1, and would have to be paid for either way. Furthermore, as I shall discuss in more detail below, the purpose and effect of the misuse was to enable Aerolab and FondTech to arrive an initial model more quickly. It was always intended that the initial model would be the subject of extensive aerodynamic development from October 2009 to March 2010, and thus the design of the initial model was relatively unimportant. Still further, relatively little of the misused confidential information found its way into full-sized parts on the actual racing car. It follows that the value of the licence was not going to be significantly affected by whether or not Lotus achieved entry into F1.

Looking at this case it is clear that although the value of the license that Force India would be prepared to pay might have been higher had it already been accepted into Formula 1, the licence was set based upon only their hope to be admitted. In this case the use of the intangible property did not support a suggestion that the settling of a royalty rate would be delayed until admittance to Formula 1 was either granted or refused.

Conclusion

In concluding we would like to take the opportunity once again to thank the OECD for releasing the draft at such an early stage and to allow for comprehensive and timely input from taxpayers and tax professionals. We appreciate that this is particularly important for a topic like intangible transfer pricing as its implication will not only affect OECD countries but other major trading partners of OECD countries around the world. Hence, we expect a discussion that is likely to engage the wider public as well.

It is quite natural that there might be significantly different opinions represented in the comments. Differences might arise from a desire to reach a particular solution or be based on the different legal and tax legal traditions by country or the specific administrative structures and procedures prevailing in a country. We believe that by addressing the specific point at issue – providing guidance for the application of the arm’s length principle, as explained in Chapters I to III of the OECD guidelines – the solution to most of these differences can be found.

Though outlined in detail above we would like to re-emphasise the three main areas of concern. The common thread running through these concerns is that there is a risk that the draft guidance could be viewed as having departed from the arm’s length principle:

(1) There appears to be a bias towards an econometric definition of intellectual property or intangible assets. The correspondingly broad definition tends to eliminate the requirement that intangibles be identified with specificity.

(2) We are concerned that the approach adopted by this draft is in part moving away from the evidence that can be found in transactions between unrelated parties. Instead we observe a tendency to partly replace taxpayers’ legal arrangements with generalised assumptions on the alleged economic substance of a transaction.

(3) The comprehensive introduction and description of discounted cash flow valuation methods, might be taken to be giving undue importance to such methods at the expense of traditional methods that are grounded in evidence from transactions between unrelated parties.
Clearly a lot of work and preparation has already gone into the draft. With its more than 180 paragraphs and numerous examples the OECD discussion draft on intangibles is a significant step towards updating Chapter VI of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and making it address the relevant issues in respect of intangible property. We are sure that the draft will inspire a large number of comments and will shape the discussion on intangible property transfer pricing going forward. We are looking forward to the further process and are at the disposal of Working Party No.6 should you require any additional input.

Yours sincerely

John Henshall
Partner
Deloitte LLP
The following independent member firms of the Deloitte Touche Tohmatsu Limited network have contributed to and concur with this submission:

Signed

On behalf of Deloitte & Touche GmbH Wirtschaftsprüfungsgesellschaft
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By Achim Roeder, Partner

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On behalf of Deloitte Tax LLP
United States
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14 September 2012

Joseph L. Andrus
Head of Transfer Pricing Unit
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RESPONSE TO DISCUSSION DRAFT – REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER V1 OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

We welcome the opportunity to comment on OECD’s Discussion Draft of 6 June 2012, and its proposed re-write of Chapter V1 of the OECD Transfer Pricing Guidelines.

Diageo is a major Multinational Group, domiciled in the UK, and listed on the London (FTSE 100) and New York (NYSE) Stock Exchanges. It is the world’s leading premium drinks business, and owns a range of global iconic brands, including Smirnoff, Johnnie Walker, Captain Morgan, Baileys and Guinness.

With much of our value inherent in our intangible assets, and in particular in our brands, Chapter V1 of the OECD Guidelines is highly relevant for us, and we are very aware from our own experience, and from discussions with peer companies, and, indeed, discussions with tax authorities, of the enormous amount of time and resource expended by companies and by tax authorities in understanding and arguing about the nature, ownership and value of intangible assets, and the taxing rights attaching to them.

We think it is critical that Chapter 6 – particularly with its probable increased length - addresses as specifically as possible those issues which companies and tax authorities appear to find the most difficult. We appreciate that the more specific (and less conceptual) the draft becomes may make it more challenging to get consensus among OECD members, and may cause the timetable to be extended, but we think this would in the long- run be a worthwhile investment of time.

We believe there are three areas in particular which Chapter 6 should cover in the necessary depth; these are –

1. “Marketing Intangibles” – whether (and to what extent) an MNE’s in-market sales companies create valuable intangible assets through their local sales and marketing effort and spend;
2. “Group Intangibles”— the extent to which an integrated MNE group creates or contains inherent advantages, which group entity or entities “own” them, and whether and how income can be attributed to them for taxation;

3. “Market and Location – Specific Intangibles”— whether a local sales company in an MNE group should command a premium reward, on account of the location, size, potential or pricing structure of its local market.

The overall approach to intangibles, as summarised in Para 5, is in our view the correct approach. We agree an intangible (asset) for the purposes of Chapter 6 should be capable of being owned or controlled for use in the business. We would suggest “controlled” is clarified to mean the ability to use it yourself and/or to prevent or restrict others using it.

Adoption of this approach takes out of Chapter 6 both the “Group Intangibles” and the “Market / Location-Specific Intangibles”, as listed above. This is confirmed in Paras. 8 and 23-25, and we believe this is right.

However, while we agree it is possible that some of these factors may be relevant – and need adjusting for - in a comparability analysis, we believe in many, indeed in the majority, of cases they may not be relevant. We would be happy to elaborate on this point as necessary in subsequent consultations.

We would suggest Chapter V1 makes very clear that the relevance of such factors in a comparability analysis would have to be demonstrated on the particular facts of each case, and that it will not in many instances in fact be demonstrable.

We believe the “marketing intangibles” issue is sufficiently important to warrant much closer attention than is currently in the draft, as this is something which frequently leads to controversy between companies and tax authorities.

While examples 3 to 8 inclusive attempt to offer illustrative guidance, we believe these examples could usefully be more concise, and also bring out more clearly the key considerations. We believe the use of examples is in principle helpful, and that it is worth investing more time to ensure they cover the most difficult areas.
We would respectfully suggest it is inappropriate to bundle marketing expenditure with R&D (as in Paras 6 and 10) because – although they have some superficial similarity - there are fundamental differences between them. While R&D seeks to invent new intangibles or develop and/or improve existing intangibles, marketing may – as stated – lead to the creation of new intangibles, but is often not so aimed, and is more about maintaining the position and perception of a brand or trademark in the public eye. We would suggest the narrative says more about the real nature of R&D and marketing spend, to bring out these differences, as well as the similarities.

We believe Para 6 should make clear that it is normal accounting practice to expense marketing spend (as it is, indeed for R&D). In addition, we believe it would be more accurate if Para 10 said that while marketing expense may create an intangible asset, in the majority of instances it will not; (and, arguably, the comment on R&D spend should be similarly rephrased.)

We have not offered line by line, or paragraph by paragraph comment at this point, but will be happy to do so as further drafts are released for comment. At this early stage, we think the priority is to ensure the re-write covers those areas of greatest sensitivity, and we hope our suggestions above will prove helpful.

Yours sincerely,

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Re:   Transfer Pricing Aspects of Intangibles  

Dear Mr. Andrus:

Respectfully, and pursuant to your request and that of the OECD, please find contained herein comments, suggestions, and observations pursuant to the Model Tax Convention of the OECD Guidelines as they relate to Transfer Pricing Aspects of Intangibles. Please find clarification on issue identification and recommendations that I addressed in my earlier correspondence to the OECD regarding this matter on September 14, 2010. I look forward to discussing these matters in more detail in person with you, the OECD, and its relevant Working Party No. 6. I look forward to continuing to work with you throughout the course of the year and on other Transfer Pricing Initiatives on-going with the OECD including, but not limited to, Transfer Pricing as it relates to Timing Issues and Safe Harbours.

Introduction

Having testified before the IRS and Treasury numerous times since 2004 with regard to Transfer Pricing Regulations on the Service Regulations and Cost-Sharing Regulations, I am intimately familiar with many of the global transfer pricing issues that have surfaced in a global legislative and regulatory environment with regard to Transfer Pricing Reform. Moreover, I have also provided testimony and acted as a Delegate to the OECD in 2009 and 2010 on Transfer Pricing in the Context of Business Restructuring.

Having practiced Transfer Pricing in both a U.S. and OECD context I will set out what I consider to be global issues that may not only impact OECD Based Countries, but countries that adopt OECD Guidelines for Transfer Pricing or some variant thereof. Based on practical experience, countries may adopt the OECD Guidelines as a partial
foundation to their Transfer Pricing Laws, Regulations, Guidelines, Information Circulars, Country-Specific Statutory Authority, or a combination of two or more of the above aforementioned compliance mechanisms. As the U.S. Treasury, the IRS, and the House Ways and Mean’s Committee of the U.S. Congress have discovered, any disparate changes in Transfer Pricing will create a challenge for global harmonization to a Multinational Enterprise (“MNE”) working in a global context with the only real resolutions leading to treaty relief or Competent Authority or MAP. The OECD’s endeavor into the area of Intangible Property is quite timely as many countries, including the United States\(^1\), India\(^2\), and Guatemala\(^3\) are now reviewing intangible property in the context of Transfer Pricing.

**Intangible Property Discovery and Quantification**

Prior to the OECD’s “Discussion Draft” on the “Revision of the Special Considerations of Intangibles” it could have been said that the United States Treasury Regulations provided the most comprehensive enumeration of various forms of Intangible Property (Now Herein “IP”). Countries such as India, Guatemala, and the United States, and now the OECD are identifying and quantifying new forms and insights into IP from which related parties are entitled to for the exploitation of IP rights. Several countries have passed tax legislation taking a more expansive view of IP more akin to that of the US Treasury Regulations under Section 1.482-4. However, the OECD has now taken an even more aggressive approach to determine the true supply chain value drivers and who the beneficiaries of the IP should be based on a facts and circumstances basis. I applaud the OECD’s efforts to gain more meaningful insight into the true supply chain value drivers. In Paragraph 22-26, the OECD discusses the various forms of IP that may be classified as group synergies, market specific characteristics, and assembled work forces that may possess imbedded IP in their provision of services. Moreover, in Paragraph 108 of the Discussion Draft, the OECD reiterates its more expansive view of potential value drivers in an IP Analysis. The Discussion Draft states in pertinent part that which follows.

> “In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from the transactions after routine functional returns should necessarily be allocated to the party entitled to intangible property returns. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE’s global business processes and how intangibles interact with other functions, assets, risks, that comprise the global business. The functional analysis should identify other factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions.”

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\(^1\) IRS Regulation Notice 2012-39.  
\(^2\) Indian Finance Bill, 2012 (FB 2012) and Indian Tax Law (“ITL”).  
\(^3\) Tax Legislation Update Law (“TLUL”).
Unbundling Intangible Property Value Drivers And Observations

In Paragraph 27 of the OECD’s “Discussion Draft” the OECD attempts to define which related parties are properly entitled to IP related returns. Paragraph 29 and other applicable portions of the “Discussion Draft” attempt to define by example IP related offsets or adjustments that may be applicable to licensing arrangements and a two-sided functional analysis assessment to determine whether the licensor or licensee is creating IP related returns and thus is entitled to a portion of those returns. The OECD in its efforts to establish entitlement to IP related returns proffers an example in the pharmaceutical industry that provides a keen insight into how deep and thorough an analysis can go into determining the proper parties entitled to IP related returns. I agree that a determination of the proper parties entitled to IP related returns are needed to draw a clear distinction between IP services that are merely just maintenance and protection and those of a higher value added enhancement nature. The appropriate analogy and threshold question would be whether the IP is being enhanced from a Platform IP to a Second Generation IP Stage rather than just being routinely maintained.

The OECD example cited in Paragraph 68 states in pertinent part that which follows.

“A pharmaceutical product will often have associated with it three or more types of IP. The active pharmaceutical ingredient may be protected by one or more patents. The product will also have been through a testing process and a governmental regulatory authority may have issued an approval to market the product in a given geographical market and for specific approved indications based on that testing. The product may be marketed under a particular trademark. In combination, these intangibles may be extremely valuable. In isolation, one or more may have more of less value. For example, the trademark without the patent and regulatory marketing approval may have limited value since the product could not be sold without the marketing approval and generic competitors could not be excluded from the market without the patent. Similarly, the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval”.

Consistent with this example and the OECD’s general theme of dissecting the IP Value Chain, the IP licensing practices of the pharmaceutical industry can also provide a useful paradigm to examine some of the core concepts that the OECD is advancing including the common practice in the Pharmaceutical Industry of utilization of cross licensing agreements. The cross licensing model provides an analogous platform where industry competitors may share IP for the goals of mutual market penetration, market gain, and profitability. This comparative paradigm is observed in the PriceWaterhouseCoopers Publication entitled, “Mastering the Intellectual Property Lifecycle”. Similar analogies are also found in the Software Industry.

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The cross licensing paradigm provides the most similar paradigm in unbundling the IP Value Chain to share IP in a licensing agreement or unbundling of risks, functions, and asset utilization between third parties. In some case, the cross licensing of IP may result in a complete offset or netting or royalty rates or two-way royalty rates to provide the proper allocation and compensation for the value of services, risks, functions, and existing or prospective assets. I encourage the OECD to consider the Pharmaceutical Cross Licensing Model as they continue to determine the proper IP apportionment methods between related parties. I would also encourage the OECD in its analysis to adhere to the “substances over form analysis” that it enumerates in Paragraph 37 by maintaining the requirement of a two-sided functional analysis of the IP Value Chain instead of just relying on unilateral Transfer Pricing Documentation or the prima facie mutual representations of intercompany licensing agreements to determine the proper IP Value Drivers and the proper parties to share in IP Returns. Paragraph 107 of the Discussion Draft states, “Accordingly, in selecting the most appropriate Transfer Pricing Method it is important to consider the economic consequences of the transactions rather than proceeding on the basis of an arbitrary label”. I agree that this approach is consistent with the Arm’s Length Approach.

Paragraphs 48 – 52 set out different scenarios in which the IP returns can be shared or allocated to related parties depending on the facts and circumstances of the intercompany transaction at hand. The threshold question and perhaps to some extent, the question of first impression for the OECD is whether the distributors or independent sales agents may be entitled to IP related returns based upon their assumption of risks, asset utilization, and or contractually agreed to agency or distribution agreements or whether these business assumptions are already imbedded within the transfer pricing of the two related parties as would be the case between two independent parties. I recommend that the OECD honor the time tested principles of freedom of contract and the CUP Methodology which the OECD advances in numerous cases within the “Discussion Draft” as being the most reliable Transfer Pricing Methodology along with its long standing tradition and position on the hierarchy of Transfer Pricing Methodologies. I believe that what is characteristic at arm’s length is most reflective of what would be characteristic between associated enterprises.

I also observe that the OECD raises a “novel approach” to determine the proper value of IP through traditional valuation principles as a methodology of last resort. This author notes that the OECD has provided some guidance on its preference against Traditional Valuation Methodologies in its “Draft On Timing Issues Relating To Transfer Pricing” and the concepts of ex ante decision making and valuation and ex post decision making and valuation which is discussed by this author under separate cover.

OECD’s Commentary And Observations On Valuation Methods

The OECD’s starting point is codified in the Discussion Draft entitled “Special Considerations For Intangibles” and takes the following position.
“While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques.”

The OECD starts with the premise that ex ante valuation advocates maintain that their approach is superior because it only requires what business would have to do in transactions with unrelated persons. Advocates of ex post valuation argue that their approach is superior as it allows business the ability to adjust their results to contemporaneous third party outcomes as those outcomes become known. The OECD Discussion Draft also advances the position that “some countries are less willing to accept valuation techniques based on financial projections if the Guidelines take a restrictive view of the information that may be used to test the reasonableness of the projections or of the ability of tax administrations to impute renegotiation clauses or other risk sharing mechanisms to address the uncertainty of the valuation”.

Moreover, in Paragraph 110, the Discussion Draft, in full, states, “While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. [In particular, it is important to consider the assumptions and other motivations that underlie particular applications of valuation techniques”. (Emphasis Added).

Discussion Draft Comments Of Valuation Methods And Options

The OECD Guidelines as they currently stand capture the essence of all of the subjectivity and assumptions entailed in ex post decision making and valuation methodology. Given the common law tenants of freedom of contract and the benefits and perils associated with contract execution, absent a re-negotiation clause, the risk of making a losing contact rests with the parties in an arm’s length setting. It is clear that Profits Based Transfer Pricing Methodologies are only preferable as a Method of last resort. As such, Profits Based Transfer Pricing Methodologies more closely share the characteristics of ex post valuation or ex post decision making in that they look to imperfect predictions of “what is reasonably foreseeable by the associated enterprises at the time the transaction was entered into” or more simply put – predictions or estimates. The “Reasonably Foreseeable Standard” should take into consideration information of predicted market and economic changes for up to 20 years or longer and or market or economic changes that are likely to occur or are anticipated to occur. The test for the threshold question of the tax authorities is “whether the parties to the transaction would have reasonably anticipated these assumption at the time of the transaction” and would have reasonably realized the benefit of their bargain in the transaction. This author believes this “Look Back Approach” yields results that are unreliable and that have the potential to fluctuate from year to year based on assumptions of useful life, estimated discount rates, and up to 20 years of uncertain forecasted sales estimates. Moreover, the approach seems to limit the tax authorities
ability to achieve optimal tax compliance as the results of the methodology and transaction may drastically change after the Statute of Limitations expires.

Moreover, valuations that produce variable results such as royalty rates on intangible property that vary from year to year are inherently unreliable as the nature of IP should be static if the contract provisions of the licensing agreement are being complied with and as any decay would ultimately be calculated into an unrelated party licensing agreement otherwise. This author disagrees with the OECD’s assertion that “In effect, independent parties in comparable circumstances would not base their pricing decisions on historical data alone.” In fact, negotiation and enforcement via intellectual property litigation of licensing agreements is most commonly and most accurately based on comparable and historical third party licensing agreements executed at arm’s length. One of the unique characteristics of Intangible Property is that it carries with it an inherent and intrinsic value as long as it is being legally protected and maintained. It is counterintuitive for a patent or trademark to lose all of its value, or double in value or lose half of its value within a one or two year time period that can be observed based on an ex post ante Valuation Approach that relies on arbitrary and capricious forecasted sales data, useful life estimates, and discount rates that all are typically predicted out for a 20 year time period. This anomaly or skewing of results can most commonly be observed during “Bull and Bear” Market Cycles when sales forecast fluctuations are erratic or uncertain.

New Transfer Pricing Methodologies And Approaches
This author does realize that often times, an OECD based CUP Analysis may not be able to achieve the precision required pursuant to the OECD Guidelines as required for accuracy in areas of “Industry Comparability” and thus proposes a new Proposed Transfer Pricing Methodology called the “Subtractive Comparable Uncontrolled Price” in an OECD Based Context or under the United States Treasury Regulations the “Subtractive Comparable Uncontrolled Transaction” (Now Herein Respectively “SCUP” or “SCUT”) instead of resorting to a less reliable Profits Based Approach for valuing the Intangible Property. Under this new Transfer Pricing Methodology, if an inexact or unreliable CUP or CUT cannot be determined with the degree of precision required under the OECD Guidelines or the US Treasury Regulations or because the tested party is in an industry where there is a lack of reliable CUP or CUT data, perhaps due to Industry Monopoly or Oligopoly with Bundled IP then the “SCUP” or “SCUT” Transfer Pricing Methodology would be employed. For example, the IP Bundle included Product Manufacturing IP and Marketing IP for a Fully Bundled IP Royalty Rate of 8%. If no reliable technology CUP’s or CUT’s could be identified, internal or external, then the search would resort to a valuation determination of the trade name or brand which loosens the standard and criteria for calculation as there are more trade names and brands in a CUP or CUT Licensing Database than for the relevant and applicable technology and less variability from industry to industry. Thus instead of benchmarking a royalty to each of the two components of the Bundled IP or resorting to a less reliable Profits Based Methodology, the search would determined the royalty for the trade
name and or brand of 3% and back it out of the IP Bundle of an Arm’s Length Rate of 8% to produce a Manufacturing Licensing Technology Royalty Rate of 5%.

In conclusion, this author believes that OECD Guidelines in Paragraph 4.38 and 4.39 further complicate the Ex Post Valuation Process as Paragraph 4.39 states, “However, compensating adjustments are not recognized by most OECD Member Countries, on the grounds that the tax rate should reflect the actual transaction”. This paragraph seems to infer a lack of a “Look-Back Period” for a type of True-Up Payment before the tax return is filed. This author believes that the arbitrary and capricious and ever changing IP Valuation that changes from year to year based on projected sales forecast versus actual, the expanded time period for which the forecasts have to be accurate, and uncertain decision making will make ex post decision making for Valuation and Transfer Pricing purposes an untenable, unreliable, and unwieldy proposition for tax authorities and taxpayers to administer and comply with.

Intangible Property Definitions and Comparable Data Reliability
This author notes that while it is both preferable and desirable to disaggregate transactions such as those listed in Paragraph 72 to obtain a more discrete pricing analysis, it is not always reliable or practicable. I see the greatest hurdle to the OECD’s IP Enhancement Initiative as overcoming intercompany transactions that are Soft Forms of IP that are disguised as Low-Level Services. Inherent in any potential and precise disaggregation would be agreement and subsequent codification by the OECD of what the Transfer Pricing Community considers to be Soft IP.

Inherent in any discussion on Transfer Pricing and IP is the issue of recharacterization of high-level services to Soft Forms of IP. The earlier suggestions to the OECD to define and enumerate the various types of IP would assist the taxpayers and the tax authorities in voluntary compliance and the efficient administration of tax compliance. More transparency by the OECD in this particular area would prevent the unwinding of tax planning structures of MNE’s and ease the tax administration burden of tax authorities.

I do agree with the OECD’s Discussion Draft Paragraph 89 that states in pertinent part that which follows.

“It is appropriate for both the taxpayers and tax administrators to exercise restraint in rejecting potential comparables based on the use of intangibles by either parties to the potentially comparable transactions or by the tested party. Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill. If identified transactions or companies are otherwise comparable, they may provide the best available indication of arm’s length pricing notwithstanding the existence and use by whether the tested party or the parties to the potentially comparable transactions of relatively insignificant intangibles. Potentially comparable transactions should be disregarded on the basis of the existence and use of non-comparable intangibles only where the intangibles in question can be clearly and distinctly identified and where the intangibles are manifestly section D.1 (vi) intangibles”.
I agree by way of observation that “exact comparables” are the exception rather than the rule. Specifically, whether seeking CUP’s or Profits Based Comparables, the provision of our efforts is limited by reliable data availability. Even within North America we observe a large discrepancy in data availability. While the United States requires public companies to file regulatory filings with the Securities and Exchange Commission (Now Herein “SEC”), the same comparable search in Canada may yield no comparable companies. If geographical comparability is achieved, size and scale comparability may be sacrificed and not easily or accurately accounted for in a comparable search. I observe similar data restraints outside of North America for comparable data when testing for IP may be hindered by requisite data such as Income Statement Data or Balance Sheet Data. Challenges also often occur when there is a lack of Market To Book Ratios or R&D to Net Sales Ratios that would allow for precision in screening and selecting for a proper IP Analysis whether it be a Profits Based Approach or a Transactional Based Approach. I applaud the OECD’s recognition of the data restraint issues and support its approach. We also applaud the OECD’s recent work on its increasing acceptance of Profits Based Transfer Pricing Approaches when reliable Transactional Based Approaches are absent as codified in Revisions to Chapter III of the OECD Guidelines.

Discussion Draft Issues Needing Further Clarification And Amplification

I have identified several areas in the “Discussion Draft” that through further clarification, amplification, and illustrative examples will assist taxpayers and tax authorities in gaining transparency on the interpretation of the OECD Guidelines. I discuss several examples below.

(1.) I observe that the OECD has raised another question of first impression for the Transfer Pricing Community in Paragraph 102 of the Discussion Draft. While we believe that the comparability analysis for IP is an effort at gaining more precision in IP comparability, we also believe that the new analysis will be difficult to administer with any precision and impracticable. In short the analysis calls for, “In conducting a comparability analysis where intangibles are present, the existence of risks related to the likelihood of obtaining future economic benefits from the intangibles must be considered. The following types of risks, among others, should be considered in evaluating whether intangibles or combinations of intangibles are comparable”. The new IP analysis goes on to list several criteria that we believe can only, at best, be answered in a speculative manner without a lack of precision. The four criteria enumerated in Paragraph 102 include risks related to the future development of the intangibles, risks related to product obsolescence and depreciation in the value of the intangibles, risks related to infringement of the intangible rights and a predictor of a successful litigation defense, and product liability risks and similar risks related to the future use of the intangibles. All requisite criteria and inputs are thus encumbered by speculation.
(2.) Paragraph 47 of the Discussion Draft warrants further amplification via examples and illustrations. It states, “It is important to recognize, however, that bearing costs related to the development, enhancements, and maintenance and protection of intangibles does not, in of itself, create an entitlement to intangible related returns”.

(3.) Paragraph 78 of the Discussion Draft warrants further clarification, as it seems to deviate from the arm’s length standard. It states, “Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving a transaction involving intangibles in a manner related that independent enterprises would not contemplate”.

(4.) Paragraph 86 would be enhanced from a taxpayer and practitioner perspective with the provision of additional examples or illustrations on making comparability comparisons and adjustments. Paragraph 86 states, “For example, a tested party engaged in the marketing and distribution of goods purchased in controlled transactions may have developed trademarks and related intangibles in its geographical area of operation, including customer lists and relationships. It may also have developed advantageous logistical know-how or software and other tools that it uses in conducting its distribution business. The impact of such intangibles on the profitability of the tested party should be considered in conducting a comparability analysis”.

(5.) Paragraph 127 without further clarification may cause confusion with taxpayers and their advisors and is worthy of further clarification. It states, “there is no requirement that associated enterprises structure their transactions in precisely the same manner as unrelated parties might have done. However, where transactional structures are utilized by associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm’s length”.

Once again, I appreciate the opportunity to provide testimony on these all-important issues of intangible assets as they relate to Transfer Pricing and look forward to our continued work with the OECD and its attendant Working Party No. 6 on Transfer Pricing and International Tax Issues. If you have any comments or questions, please do not hesitate to contact me directly.

Kindest Regards,
John K. Drewno, B.A., M.A., J.D.

*****
Mr. Joseph L. Andrus  
Centre for Tax Policy and Administration  
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Amsterdam, 14th September 2012

Dear Mr. Andrus,

Introduction

Duff & Phelps welcomes the opportunity to provide comments in response to the discussion draft on the Transfer Pricing Aspects of Intangibles released by the OECD Centre for Tax Policy and Administration on June 6, 2012. In this letter we have provided a number of observations and recommendations in order to contribute to the discussions in relation to this newly released draft chapter.

Reasons for our comment letter

In our practice, we deal on a regular basis with valuation issues that occur at the intersection of accounting and transfer pricing. We believe the experience we gained in this field may provide interesting insights and enhance further discussions with respect to the released interim draft chapter. Therefore we gladly share our observations and recommendations with you. We took the liberty to focus our comments on the fundamental question of how transfer pricing, accounting and valuation techniques are intertwined in the context of (the valuation aspects of) intangibles, instead of providing drafting and editorial suggestions.
Accounting related valuations

It is noteworthy to observe that throughout the new draft chapter many references are made to accounting standards and valuation techniques. The flavor of the relevant paragraphs range from: “not relevant” and “used with caution” to “informative” and “helpful tools for transfer pricing purposes”.

In our view accounting related valuations -and more specifically Purchase Price Allocations (“PPAs”) - could be very relevant and applicable in the process of establishing transfer prices in transactions involving the use of intangibles, especially when there is a transfer of intangible assets (including such transfer in the context of a business restructuring) and when this takes place at a time close to the moment when a PPA is performed. The main reason for our view is that we believe that a valuation of intangible assets performed for accounting purposes using the accounting Fair Value Measurement principle as a basis should be (largely) similar to a valuation of specific intangible assets that might be transferred under a transfer pricing arrangement.

As you are all probably aware, the International Accounting Standards Board (IASB) has issued IFRS 13, Fair Value Measurement, which will be effective from 1 January 2013. With the comparable ASC 820 Fair Value Measurement standard for US GAAP, as issued by the Financial Accounting Standards Board (FASB), there is now a single consistent Fair Value Measurement framework that is introduced by the two most important, authoritative accounting standard bodies in the world.

IFRS 13 defines fair value (“Fair Value”) and sets out in a single IFRS a framework for measuring Fair Value and requires disclosures about Fair Value Measurements. The interesting aspect for transfer pricing is that a number of the key elements stated in IFRS 13 contain analogies with the arm’s length principle and certain requirements mentioned in the OECD Transfer Pricing Guidelines, for example:

- The starting point for IFRS 13 is Fair Value. The definition states: “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. This premise contains in our view large similarities with the arm’s length principle of the OECD.

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1 In Appendix I to this letter a number of paragraphs are cited to illustrate how the new draft chapter speaks about the usefulness of accounting standards and valuation techniques for the definition of an intangible and the establishment of transfer prices in relation to use or transfer of intangible assets.
2 In transactions involving the use of intangibles in connection with the sale of goods or services, we believe that the discussions on accounting standards and valuation techniques are less important since the relevant intangibles are often covered through a residual payment (i.e. in case the intangibles are owned by the entrepreneur) or considered a comparability factor which is taken into account in a benchmark search.
3 For a summary of the main content of IFRS 13 please refer to Appendix II.
Transfer Pricing Guidelines, and also takes into consideration the separate entity approach;

- A Fair Value Measurement requires an entity to take into consideration a number of specific facts and circumstances. For example, Fair Value Measurement of a non-financial asset takes into account its highest and best use. In the context of the OECD Transfer Pricing Guidelines an analogy could be made with the premise that independent parties would explore “all options realistically available”;

- The guidance on Fair Value Measurement in IFRS 13 suggests that, for example “An entity takes into account the characteristics of the asset or liability being measured that a market participant would take into account (…)”. Such an analysis of relevant characteristics could be part of a comparability analysis as prescribed in the OECD Transfer Pricing Guidelines and further adds to the analogy with arm’s length principle;

- The Fair Value hierarchy defines 3 levels of inputs. Level 1 (and, to a certain extent level 2) of this hierarchy describes that a certain quality of inputs is required to come to a reliable and comparable fair value measurement. In more or less similar wording the OECD Transfer Pricing Guidelines require sufficient reliability of comparable data.

Furthermore, considering the above and taking into account our valuation experience, we do not necessarily agree with the sentence in paragraph 110 of the draft chapter saying that: (...) “For sound accounting purposes, some valuation assumptions may sometimes be biased in favor of conservative estimates of the value of assets reflected in a company’s balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to valuation approaches that are not necessarily consistent with the arm’s length principle (…)”. Although we sympathize with this statement as far as it relates to day to day accounting, this does not apply to purchase accounting where accounting is based on Fair Value. As one can observe from the definition of Fair Value, conservative estimates would simply not be in alignment with IFRS 13.

We assume that the argument of ‘conservative estimates’, as mentioned by the OECD, was probably the main reason for categorically rejecting a valuation of intangibles as part of a PPA to be a relevant basis for transfer pricing purposes. Based on our previous comment, we would like to support the view that a PPA should be considered as a relevant starting point for the valuation of intangibles, especially when the value measurement date for PPA and the transaction relevant for transfer pricing purposes coincide.

Valuation techniques

Throughout the interim draft, valuation techniques are mentioned as either being part of one of the five OECD approved methods described in Chapter II (e.g. in a profit split situation), or as a tool that can be usefully applied in identifying an arm’s length price. If we would weigh all references to the two alternatives, it is our perception that the OECD considers valuation techniques as an alternative method (i.e. not being one of the five approved methods). This thought is supported by a comment in the interim draft indicating that valuation techniques are the field of work of valuation professionals.

We believe, however, that valuation techniques as applied by valuation professionals for accounting related valuations show large similarities with some of the OECD approved

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4 Reference is made to paragraph 147 of the OECD Guidelines.
methods. As included in IFRS 13, the three widely used and commonly accepted valuation techniques are:

- **Market approach** – uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business) – shows resemblance with the OECD-recognized CUP method;
- **Cost approach** – reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost) – shows resemblance with the OECD-recognized cost plus method;
- **Income approach** – converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts – the OECD-recognized profit split method shows resemblance with the excess earnings method, which is a variation of the income approach.

Even if an exact comparison would not be possible, a particular valuation technique would in our view at least be a sound starting point to which adjustments can be made.

Therefore, we would like the OECD to consider that certain valuation techniques may be put on equal footing with their respective approved transfer pricing methods of the OECD Transfer Pricing Guidelines, assuming such techniques are used in a manner that is consistent with the arm’s length principle and the principles of these Guidelines.

**Overall conclusion**

Overall, we believe that the accounting standards, and more in particular, the Fair Value Measurement envisages to achieve the same objective as the arm’s length principle, i.e. to establish a price that would have been agreed between independent third parties (for a similar transaction under similar circumstances) or -in accounting terminology- the price that would have been agreed between a willing buyer and a willing seller. If we would assume that this holds true, then the valuation techniques that are applied under IFRS 13 to achieve a Fair Value of a transaction would be equally helpful in establishing an arm’s length price of similarly defined intangible assets for a transfer pricing transaction.

Based on the above we would like to suggest to the OECD to give more relevance to the role of accounting standards and valuation techniques in the determination of arm’s length prices for intangible assets. In our opinion qualifying bodies like IASB and FASB spent a considerable amount of effort in establishing a fundamental, robust and widely accepted framework for establishing Fair Values, which framework also applies to intangibles. With the help of the goals and guidance of IFRS 13 in mind, there is at least a robust starting point. Combined with the requirements of the OECD Transfer Pricing Guidelines, e.g. performing a sound comparability analysis, we feel that the combination of the two angles could provide a solid basis for pricing specific intangible assets.

A consistent and transparent approach for both accounting and transfer pricing purposes would be helpful to lower costs in relation to the work to support the prices, enhance consistency between accounting and tax books and mitigate risks on double taxation.

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5 Reference is made to paragraph 146 of the OECD Guidelines.
We would like to thank the OECD again for the opportunity to comment and would greatly appreciate the opportunity to further elaborate on this subject during the public consultation in November 2012\(^6\).

Yours sincerely,

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Appendices (2)

\(^6\) The opinions found within this letters are those of the authors and do not necessarily reflect the opinions of Duff & Phelps.
Appendix I

To provide a number of illustrations of how the new draft chapter speaks about the usefulness of such standards and techniques for the definition of an intangible and the establishment of transfer prices, we cited a number of paragraphs:

- Par. 5: “In these Guidelines, the word “intangible” is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”.

- Par. 6: “Intangibles that are important to consider for transfer pricing purposes are not always recognized as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalized for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless carry significant economic value and may need to be considered for transfer pricing purposes (...). Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterization for accounting purposes, but will not be determined by such characterization only”.

- Par. 22: (…)Such treatment in no way implies, however, that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily appropriate measures of the price that would be paid for the transferred business or license rights, together with their associated goodwill and ongoing concern value, by independent parties. In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis”.

- Par. 109: “Some valuation techniques drawn from financial valuation practice may have application both in cases involving the use of intangibles in connection with sales of goods or services, and in cases involving transfers of intangibles or rights in intangibles. Depending on the circumstances, they may be used either as a part of one of the five OECD approved methods described in Chapter II (e.g. in determining how to split profits as part of a transactional profit split method), or as a tool that can be usefully applied in identifying an arm’s length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions. (…)”.

- Par. 110: “While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. In particular, it is important to consider the assumptions and other motivations that underlie particular applications of
valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes be biased in favor of conservative estimates of the value of assets reflected in a company’s balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to valuation approaches that are not necessarily consistent with the arm’s length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm’s length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes”.

- Par 147.: “It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilized by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilized by valuation or accounting professionals or to describe in detail one or more specific valuation techniques or methods that may be especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm’s length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available. (...)”.

- Par 131.: “In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions may be utilized to determine arm’s length conditions for the sale of goods or services where intangibles are used in connection with the transaction”.

- Par 136.: “Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances”.

- Par 145.: “In situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified, it may be possible to use valuation techniques to estimate the arm’s length price for intangibles transferred between associated enterprises”.

- Par 146.: “Where valuation techniques are utilized in a transfer pricing analysis, it is necessary to apply such techniques in a manner that is consistent with the arm’s length principle and the principles of these Guidelines”.
Appendix II

The paragraphs below provide a summary of the main elements of IFRS 13\(^7\).

Objective

The objective of IFRS 13: [IFRS 13:1]

- Defines fair value
- Sets out in a single IFRS a framework for measuring fair value
- Requires disclosures about fair value measurements.

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), with a number of exceptions [IFRS 13:5-7].

Key definitions

In IFRS 13: Appendix A one can find the key definitions:

**Fair value**

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

**Active market**

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis

**Exit price**

The price that would be received to sell an asset or paid to transfer a liability

**Highest and best use**

The use of a non-financial asset by market participants that would maximize the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used

**Most advantageous market**

The market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs

**Principal market**

The market with the greatest volume and level of activity for the asset or liability

Fair value hierarchy

**Overview**

IFRS 13 seeks to increase consistency and comparability in fair value measurements and related disclosures through a ‘fair value hierarchy’. The hierarchy categorizes the inputs used in valuation techniques into three levels. The hierarchy gives the highest priority to (unadjusted) quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. [IFRS 13:72]

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Level 1 inputs

Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. [IFRS 13:76] A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions. [IFRS 13:77]

Level 2 inputs

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. [IFRS 13:81] Level 2 inputs include:

- Quoted prices for similar assets or liabilities in active markets
- Quoted prices for identical or similar assets or liabilities in markets that are not active
- Inputs other than quoted prices that are observable for the asset or liability, for example
  - interest rates and yield curves observable at commonly quoted intervals
  - implied volatilities
  - credit spreads
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means ('market-corroborated inputs').

Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability. [IFRS 13:86] Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity’s own data, taking into account all information about market participant assumptions that is reasonably available. [IFRS 13:87-89]

Measurement of fair value

Overview of fair value measurement approach

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions. A fair value measurement requires an entity to determine all of the following: [IFRS 13:B2]

- The particular asset or liability that is the subject of the measurement (consistently with its unit of account)
- For a non-financial asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use)
- The principal (or most advantageous) market for the asset or liability
- The valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use when pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorized.
**Guidance on measurement**

IFRS 13 provides the guidance on the measurement of fair value, including the following:

- An entity takes into account the characteristics of the asset or liability being measured that a market participant would take into account when pricing the asset or liability at measurement date (e.g. the condition and location of the asset and any restrictions on the sale and use of the asset) [IFRS 13:11]
- Fair value measurement assumes an orderly transaction between market participants at the measurement date under current market conditions [IFRS 13:15]
- Fair value measurement assumes a transaction taking place in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability [IFRS 13:24]
- A fair value measurement of a non-financial asset takes into account its highest and best use [IFRS 13:27]
- A fair value measurement of a financial or non-financial liability or an entity's own equity instruments assumes it is transferred to a market participant at the measurement date, without settlement, extinguishment, or cancellation at the measurement date [IFRS 13:34]
- The fair value of a liability reflects non-performance risk (the risk the entity will not fulfill an obligation), including an entity's own credit risk and assuming the same non-performance risk before and after the transfer of the liability [IFRS 13:42]
- An optional exception applies for certain financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk, provided conditions are met (additional disclosure is required). [IFRS 13:48, IFRS 13:96]

**Valuation techniques**

An entity uses valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs. [IFRS 13:61, IFRS 13:67]

The objective of using a valuation technique is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants and the measurement date under current market conditions. Three widely used valuation techniques are: [IFRS 13:62]

- **Market approach** – uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business)
- **Cost approach** – reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost)
- **Income approach** – converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

In some cases, a single valuation technique will be appropriate, whereas in others multiple valuation techniques will be appropriate. [IFRS 13:63]
The OECD's Discussion Draft on Transfer Pricing for Intangibles

by Michael C. Durst

July 16, 2012

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Michael C. Durst is a columnist for Tax Analysts. He is a member of the District of Columbia Bar and has extensive experience in tax practice.

In this column, Durst addresses the implications of the OECD's new discussion draft on the transfer pricing rules for intangibles. He concludes that the discussion draft offers reforms that could significantly help curtail international tax avoidance through the use of income shifting. Durst also identifies ambiguities in the draft that could allow for the continuation of large-scale income shifting, and he suggests ways the draft should be clarified and made more effective. Finally, he comments on the role of the OECD as a standard setting body. To fulfill that role, the OECD should articulate best practices clearly and firmly, even if some member governments might be politically unable to fully implement the OECD's recommendations.

The views stated in this article are entirely those of the author.

Introduction

On June 6 Working Party 6 of the OECD's Centre for Tax Policy and Administration released two discussion drafts suggesting improvements to the portions of the OECD transfer pricing guidelines that concern (i) the apportionment of intangibles-related income among related companies and (ii) the use of safe harbors in simplifying the administration of transfer pricing rules. This article analyzes the discussion draft on intangibles; a subsequent article will address the draft on safe harbors. This article interprets the discussion draft on intangibles as a serious attempt by Working Party 6 to offer member governments a way to control what has become an epidemic of intangibles-related income shifting to low- and zero-tax countries, to the detriment of effective tax administration around the world. However, this article also identifies several ambiguities and potential weaknesses in the discussion draft's language that should be addressed if the attempt to bring income shifting under control is to succeed. This article (1) briefly reviews the nature of the income-shifting problem on which the discussion draft appears to focus; (2) describes why income shifting, as it typically is practiced today, violates the arm's-length principle on which the OECD guidelines are based; (3) evaluates the way the discussion draft would try to curtail income shifting; and (4) recommends clarifications that could render the discussion draft more likely to achieve its apparently intended goals.

Anatomy of Income Shifting

Much has been written in recent years about the problem of income shifting and its tendency to reduce the ability of governments around the world to collect corporate tax revenues. Income-shifting transactions can take many forms. They commonly include:
i. the funding of a multinational group’s research and development or other intangibles-creating activities (such as advertising) by a subsidiary (often a shell company) located in a low- or zero-tax country, with the subsidiary later claiming the right to income from exploitation of the intangible in many countries around the world; and

ii. the contractual assignment of global business risks to a subsidiary in a low- or zero-tax country, with the subsidiary later claiming the right to substantial portions of the group’s global income as compensation for bearing the risks.

Regardless of their form, income-shifting structures have a crucial point in common: They involve the claimed movement of income to a low- or zero-tax country in amounts that appear substantially disproportionate to the amount of business activity occurring in that country. Sometimes the subsidiary to which income is shifted is a virtual shell company, perhaps located in a very small country, with few if any employees. In other instances, the subsidiary may perform real business activities such as manufacturing or sales, but the relative amount of activity conducted is small compared with the amount of income that ends up in the hands of the tax-favored subsidiary. For example, a subsidiary in a low-tax country might conduct manufacturing activities accounting for about 3 percent of a multinational group’s global business expenditures, or it might conduct 2 percent of the group’s sales, but attract 20 percent of the group’s global taxable income. By using income-shifting structures, today’s multinational companies annually reduce their tax bills by many billions of dollars below what they would owe if those structures were disregarded for tax purposes. And in every case, the structure works because income is attracted to subsidiaries in amounts that appear greatly disproportionate to any business activities that the subsidiaries conduct.

This article and the OECD discussion draft on intangibles directly address only the first kind of income shifting mentioned above: income shifting facilitated by intragroup contracts regarding the ownership and use of intangibles. They generally do not address income shifting through risk-stripping contracts and similar arrangements. Nevertheless, income shifting through risk-stripping and similar arrangements has many points in common with income shifting involving intangible property. An effective attempt by the OECD to protect national revenues from continued erosion through income shifting will require attention to both intangibles-based and risk-based income-shifting arrangements. This means that a successful effort by the OECD to remedy income shifting will require repair of not only Chapter VI of the guidelines, which deals with intangibles, but also Chapter IX, which deals with risk-stripping and similar arrangements. This article will briefly note some of the connections between the two kinds of income shifting; a future article will focus on income shifting through risk-stripping and the OECD’s potential role in curtailing it.

**Income Shifting and the Arm’s-Length Principle**

The most frequently cited statement of the arm’s-length principle is in paragraph 1, article 9 of the OECD model income tax treaty, and it is quoted in full in paragraph 1.6 of the OECD guidelines:

> [When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions,
have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The OECD guidelines, at paragraph 1.8, provide an economic rationale for the arm's-length principle, based on the desirability of economic neutrality in taxing different kinds of businesses:

There are several reasons why OECD member countries and other countries have adopted the arm's length principle. A major reason is that the arm's length principle provides broad parity of tax treatment for members of [multinational enterprise] groups and independent enterprises. Because the arm's length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

The statement of the arm's-length principle in paragraph 1.6 of the guidelines, coupled with the rationale of economic neutrality that the OECD has provided in paragraph 1.8, permits a concise summary of the arm's-length principle:

Members of groups of commonly controlled companies should not, because of the fact of common control, be permitted to enjoy more favorable tax treatment of the income derived from their business activities than would independent companies engaged in similar activities.

That is, the arm's-length principle is a standard of tax enforcement designed to prevent multinational groups from deriving, in the course of their business operations, tax benefits that are unavailable to businesses that conduct similar operations as independent entities which can transact with other entities only on an arm's-length basis. The point of the arm's-length principle is that international tax laws should not give groups of commonly controlled companies tax advantages simply because they are commonly controlled.

All of the income-shifting practices used around the world have an important feature in common: They can be engaged in only through the use of commonly controlled companies acting together in concert. Independent companies transacting with one another at arm's length cannot possibly conduct business activities in one jurisdiction yet transfer the profits from those business activities, for tax purposes, to companies in other countries that do not conduct the business activities. In short, income-shifting transactions constitute a means by which members of a multinational group can and do achieve tax advantages by virtue of their use of multiple entity structures in ways that are systematically unavailable to independent companies transacting with one another at arm's length.

The Discussion Draft

The OECD discussion draft reflects an attempt to prevent income shifting by requiring groups of related entities to observe the same correlation between business activities performed in a jurisdiction, and the income apportioned to that jurisdiction under
applicable principles of international tax law, that independent companies must observe when transacting with one another at arm's length. This principle is so important to the authors of the discussion draft that they state it prominently:

Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more. This view is consistent with other sections of the Guidelines and does not reflect an intention to depart from the principles of Article 9.

The heart of this statement is the rule that the funding of R&D or other intangibles-creating activities does not justify the transfer of the right to income from the resulting intangibles to the funder. Rather, under the arm's-length principle, it is the performance rather than the funding of intangibles-creating activities that entitles a party to the right to income from developed intangibles.

The language of Working Party 6 represents an important (and long overdue) clarification of the arm's-length principle. For decades, many have apparently believed erroneously that under generally applicable principles of international tax law, bearing the financial costs of business activities entitles a party, for tax purposes, to income derived from those activities. That view is and always has been flatly incorrect. Working Party 6 already has performed a valuable service by correcting the apparently widespread misapprehension of this important point.

'Control' of Intangibles-Creating Activities

The discussion draft would seek to distinguish between situations in which companies attempt to shift income by virtue of the funding of intangibles, which the discussion draft would disallow, from situations in which an entity performs the "controlling" activities of intangible development, in which case some degree of income shifting apparently would be permitted. As a general matter, this language has logic to it: Unrelated entities acting independently can expect compensation for functions, controlling or otherwise, that they perform, and therefore so should related entities when transacting with one another. Nevertheless, in important ways, the discussion draft's statement and discussion of the control test fall short of what will be needed to prevent large-scale tax avoidance in violation of the arm's-length principle. The discussion draft will need to be clarified and strengthened to achieve the goal of preventing tax avoidance.

First, the discussion draft may be allowing a serious loophole in suggesting without additional clarification that control of R&D or other intangibles-creating activities can entitle a company to the residual income generated from successfully created intangibles. The discussion draft appears to be operating under the assumption that contracts to this effect are common among unrelated entities transacting with one another at arm's length, but it offers no empirical evidence in support of this important assumption. In fact, contract R&D arrangements among unrelated parties can contain many possible provisions governing the sharing of ownership in intellectual property that might be developed under the arrangements. For a high-end contract R&D service provider, which has the sophistication required to develop potentially highly valuable
intellectual property, to agree to do so for only fixed compensation would place the R&D
provider at great economic risk. That R&D provider probably will demand a share in
future income from developed intangibles as part of the compensation under its
contracts. Indeed, it seems unlikely that for intangibles of potentially high value,
contracts in which the party purchasing R&D services receives full residual rights to
developed intangibles exist at arm's length. This expectation as stated may be incorrect,
but the only way to determine whether those kinds of contracts exist, despite their
apparent economic improbability, is to conduct a careful empirical analysis of available
data sources.\textsuperscript{10} Given the potential for the shifting of income to low- and zero-tax entities
that claim to control intangibles-creating activities conducted by other entities, it is
important that the OECD perform a thorough empirical review of actual unrelated-party
arrangements before finalizing changes to Chapter VI of the guidelines.

Similarly, the discussion draft gives the appearance -- perhaps unintended -- of
acquiescing in the notion that when one related entity exercises control and another
performs the actual intangibles-creating activities, the presumptively most reliable
transfer pricing method under the arm's-length principles is for the party exercising
control to retain the residual right to income from the resulting IP. The empirical analysis
recommended above is likely to shed some light on the validity of that assumption, but in
the absence of definitive empirical evidence, there seems to be no logical reason to
assume that residual income would be apportioned to the party exercising control. That
is, it is not at all clear that the parties controlling research or other intangibles-creating
activities contribute more to the development of intangibles than the scientists or others
who actually conduct the activities. Basic logic would suggest the contrary: Although
scientists and managers are both necessary for successful development of intangibles,
the scientists would seem generally to be more valuable, as a group, than their
managers. This might not be true in all instances; in some cases, the contributions of
those in control might reasonably be seen as outweighing the contributions of those
actually performing the intangibles-creating activities. Even in those cases, however, it
seems inappropriate to apportion all of the residual income to the party exercising
control; instead, a less one-sided division of income would be more compatible with the
arm's-length principle.

If the arm's-length principle is to be applied properly, the relative contributions of those
managing and those implementing intangibles-creating activities need to be determined
so that an arm's-length division of income between the two can be determined. The best
indicator of that arm's-length division of income normally will be the relative values that
the multinational group itself places on the managers and on the implementers -- that is,
the relative values of their compensation. To prevent a continuation of massive income
shifting through one-sided apportionments of income to entities where managerial
functions are located, Chapter VI should make clear that in the absence of compelling
evidence to the contrary, the relative compensation paid to personnel (including both
managerial and operations personnel) performing services for the development of
intangibles will be the most reliable indicator of the arm's-length division of income
resulting from the successful exploitation of developed intangibles.\textsuperscript{11} Business groups
may complain about a rule of that kind, but it will be needed to achieve the goal of
effectively controlling the shifting of intangibles-related income.
Conclusion

The OECD discussion draft performs a valuable service in recognizing that changes to the OECD guidelines are necessary if the arm's-length principle is to be protected, and if large-scale tax avoidance through income shifting is to be stopped. The guidelines suggested in the discussion draft, however, will need to be clarified and strengthened if the discussion draft is to realize its goal of curtailing non-arm's-length income shifting in actual practice. Also, it is important for the OECD to perform empirical research concerning contracting patterns employed by unrelated parties acting at arm's length if its guidelines are to effectively conform to the arm's-length principle.

Of course, any attempt by the OECD to issue guidelines, in final form, that will effectively curtail income shifting will probably encounter fierce political resistance. Even in its current form, the discussion draft will likely be seen by some as a threatening camel's nose under the tent of effective international tax enforcement. If changes are made to further enhance the draft's ability to control income shifting, the reaction will probably be even louder. Not only business interests, but also some OECD governments, are likely to perceive difficulty in rules that would curtail income shifting. In some countries, income shifting has become so deeply engrained within the economics of particular industries, such as pharmaceuticals, electronics, and software, that curtailment of the practice would as a practical matter require offsetting measures such as enhanced R&D incentives to prevent damaging economic shocks. Those offsetting measures might be hard to legislate, posing serious political difficulties in transitioning to transfer pricing rules under which income shifting is effectively disallowed.

Regardless of the political difficulties, however, the OECD should carry forward the attempt begun by Working Party 6 to give force to the arm's-length principle and eliminate opportunities for income shifting under the OECD guidelines. Income shifting today has already largely disabled the corporate tax systems of several countries, and global economic conditions make clear that the systematic curtailment of national fiscal abilities should be seen as unacceptable. The political resistance, possibly including resistance from some member governments, will likely be intense, but it is especially important that the OECD as an institution not permit political attachments to income shifting in some countries to divert it from its task of protecting arm's-length transfer pricing practices.

As a standards-setting body, the purpose of the OECD is to define best practices for member governments (and for other governments that might wish to look to the OECD for guidance) based on sound economic reasoning, without diluting those best practices in anticipation of political concerns that might pose obstacles to the implementation of economically rational rules. The OECD's mission is to articulate best practices. In turn, member governments are to do what they can, within the bounds of pending political constraints, to implement those practices. For a standards-setting organization like the OECD to let existing political constraints in member countries influence the articulation of best practices is essentially to abdicate its role. Member countries, and other countries around the world that look to the OECD for guidance, deserve better than that. The OECD should persist in, and further clarify the efforts begun by, Working Party 6 to eliminate opportunities for income shifting under the OECD guidelines. Further, the OECD as an institution should encourage member governments to take the legislative steps needed to implement the OECD's recommendations for effective reform of transfer pricing practices.
pricing rules, even if that effort poses political difficulties in some countries in the short term.

FOOTNOTES

1 Working Party 6 is comprised of representatives of OECD member governments and is assisted in its work by personnel of the Centre for Tax Policy and Administration.


5 See Clausing, supra note 4.

6 It has erroneously been suggested, in response to the Working Party 6 discussion draft, that the ability of independent companies to obtain equity financing from investors in other countries somehow legitimates income shifting. Alan Shapiro et al., "The OECD Discussion Draft on Intangibles," Tax Notes Int'l, June 25, 2012, p. 1245, Doc 2012-13217, 2012 WTD 120-2. Under universally applied principles of international taxation, however, a company cannot escape taxation on business income by transferring the income to an equity investor.

7 See discussion at note 6, supra.

8 Paragraph 40 of the discussion draft proposes the following rule:

It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm's length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, these functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by
independent or associated enterprises that may have a material effect on the value of the intangible.

9 An analysis written for nontax purposes under United Nations auspices describes the contractual possibilities as follows:

One approach would be for the customer to own all IP improved or created during the outsourcing relationship, with the vendor having the possibility of using the IP through a negotiated license agreement. Another approach would be for the vendor (developer) to own all such IP, with the customer (the party having commissioned the task) taking a license through negotiations. Yet another approach would be for both the customer and vendor to own jointly the resulting IP. Still another approach would be to apportion ownership of different IP assets, so improved or created, amongst the parties concerned, namely, amongst the vendor, customer and one or more third parties; this is done by a formal agreement based on negotiations guided by each parties' current and future business needs. All approaches are complex and must, therefore, be carefully evaluated and negotiated before entering into an agreement. The agreement must be detailed, and, amongst other things, should deal with ownership and use of the intellectual property assets both during and after the termination or end of the outsourcing relationship.


10 Public securities law filings contain many examples of intangibles-related contracts between unrelated parties. Also, business literature, including business school case studies, may provide useful analyses of the kinds of contracts used in transactions by unrelated parties acting at arm's length.

11 In enforcing a rule of this kind, tax administrations will need to be alert to situations in which multinationals pay excessive compensation to personnel located in low- or zero-tax countries to artificially inflate the relative amount of income that can be apportioned to the low- or zero-tax jurisdiction.

END OF FOOTNOTES

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'Risk' and the OECD Discussion Drafts on Transfer Pricing

By Michael C. Durst
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Michael C. Durst is a columnist for Tax Notes. From 1994 to 1997 he served as director of the IRS advance pricing agreement program.

This is the third in a three-part series of articles discussing the recently released OECD discussion drafts aimed at the simplification of transfer pricing rules. In this article, Durst seeks to add precision to the understanding of risk under the arm's-length principle. He argues that under the arm's-length principle, controlled taxpayers should be required, like uncontrolled parties acting at arm's length, to bear the risks of their own activities, unless those risks are transferred through arrangements that are available in the marketplace to independent taxpayers dealing with one another at arm's length.

The views stated in this article are solely those of the author.

A. Introduction

The OECD transfer pricing guidelines, as well as the recent OECD discussion drafts aimed at the simplification of those guidelines, often state that under the arm's-length principle, the income of a taxpayer within a commonly controlled group should be consistent with the assets owned, functions performed, and risks borne by the taxpayer. Historically, however, transfer pricing guidance has never been clear on which of a group's risks a particular member of a group should be treated as bearing. The lack of precision in approaching that question has contributed to difficulty in devising clear and workable rules under the arm's-length principle. A more precise statement of the role of risk under the principle may be useful in promoting the ongoing project for simplification of transfer pricing rules.

Devising effective ways of dealing with risk is of great practical importance for successful transfer pricing enforcement, because risk allocations today are at the heart of much tax avoidance planning. That is true not only for intangibles-development arrangements, such as those addressed in the recent OECD discussion draft on intangibles, but also for business "restructurings," which involve the shifting of various business risks among related entities, and which the OECD has yet to address in its recent simplification efforts.

This article argues that the two recent OECD discussion drafts generally reflect a sensible approach to questions of risk, and therefore can pave the way for simplification of transfer pricing rules even beyond the reforms suggested in the two drafts. Nevertheless, reducing international tax avoidance through risk-shifting will require additional follow-up measures, including (i) a more concise statement of the arm's-length principle as it applies to risk and (ii) refinement of the rules governing profit-split methods. This article recommends measures of those kinds and concludes with observations about the outlook for the OECD's efforts toward reform of transfer pricing laws.
B. What 'Arm's Length' Means for Risk

The heart of the arm's-length principle is the rule that businesses operating under common control must not be permitted, based on the fact of common control, to obtain tax advantages that are unavailable to similar, uncontrolled businesses that need to deal with other businesses at arm's length. Under properly constructed transfer pricing rules, therefore, controlled entities should be treated as bearing the same risks they would bear if they were independent entities dealing with other businesses at arm's length.

Independent businesses acting at arm's length bear all the business risks inherent in their activities (in transfer pricing parlance, their "functions") except to the extent that they transfer those risks, or take on the risks associated with others' activities, through commercially available transactions concluded at arm's length. Under properly constructed transfer pricing rules, therefore, entities within commonly controlled groups should be treated as bearing those risks associated with their business functions, except to the extent that risks are transferred through transactions of a kind that are available to independent businesses which must transact business at arm's length.

Although the statement of this principle is fairly simple, administering it can pose great practical difficulties. In the marketplace, there are an infinite variety of business transactions in which entities can transfer risk among themselves. Indeed, to some extent, every business transaction affects the apportionment of risk between the parties. Given the infinite variety of risk-shifting arrangements, it is difficult for tax authorities to judge whether a particular arrangement is one that would be available to uncontrolled entities transacting at arm's length.

In view of that difficulty, it can be argued that in the interests of practicality, transfer pricing rules should, for tax purposes, ignore risk-shifting arrangements between commonly controlled parties. Under such an approach, a taxpayer's income would be determined based only on the functions that the taxpayer actually performs. The OECD discussion drafts, however, would stop short of denying tax effect to all intragroup arrangements that seek to shift risk, and it seems likely that further reform efforts will, for the foreseeable future, similarly avoid that step. It is important, therefore, to consider how transfer pricing rules might attempt to handle risk in a plausible manner, short of disregarding risk-shifting arrangements among related parties.

C. Categories of Risk-Shifting Transactions

Despite the variety of risk-shifting transactions, it may be helpful for purposes of analysis to consider some basic categories that are of particular interest in tax administration:

1. Equity investments. Probably the purest kind of risk transfer transaction is a party's purchase of an equity interest in a corporation or unincorporated business such as a partnership. In general, however, those transactions do not pose transfer pricing issues, because under universally applied principles of international tax law, business income is taxed in the country or countries where a business conducts its activities, not where the equity owners of the business are located. For that reason, suggestions that equity investments can legitimize intragroup income shifting under the arm's-length principle are mistaken. To the contrary, it is important -- as the pending OECD discussion draft
on intangibles generally reflects -- that transfer pricing rules avoid allowing the shifting of business risks under arrangements that are in substance equity investments.

2. Debt investments. Debt investments involve a shifting to the investor of not only business risks but also of taxable income, because interest payments typically are deductible by the debtor. It has long been recognized, therefore, that tax rules must regulate the treatment of debt investments to prevent what could easily become virtually unlimited depletion of the national income tax base. Typical measures for controlling income shifting through debt arrangements include thin capitalization rules, interest-stripping rules such as section 163(j), and controlled foreign corporation rules that treat interest income that is channeled to low-tax countries as passive income subject to taxation in the multinational group's home country. Because the problems of income shifting through debt are so well known and typically are addressed through means other than transfer pricing rules, it seems most efficient to focus for current purposes on topics other than intragroup debt, except to note that controlling income shifting through debt arrangements must be a central component of any country's international tax regime.

3. Explicit risk-shifting arrangements such as insurance and factoring arrangements. The marketplace has many transactions designed to shift various kinds of risks to the insurers, and to shift credit risks to factors and similar businesses. In theory, under an arm's-length transfer pricing regime, transactions of those kinds between commonly controlled entities should be respected for tax purposes, as long as the particular transactions would be available to independent entities transacting with one another at arm's length, and as long as the transactions are priced as they would be at arm's length. In practice, however, the potential variety of explicitly designed risk-shifting transactions is so great, the estimation of arm's-length pricing in those transactions so subjective, and the moral hazard of manufacturing "paper" transactions which serve no business purpose so large, that controlling income shifting through insurance, factoring, and similar arrangements through traditional transfer pricing regulation is impossible. Therefore, countries that are politically serious about controlling income shifting through insurance, factoring, and similar arrangements rely on specially targeted mechanisms, such as the disallowance of deductions in related-party arrangements, the use of withholding taxes on reinsurance premiums, and the strict application of CFC rules. This discussion will assume that countries with a serious political commitment to preserving their tax bases will have adopted those approaches. Therefore, the current discussion can focus on other kinds of related-party transactions which shift risk, but do so less explicitly than do insurance policies, factoring agreements, and similar kinds of arrangements.

4. Risk apportionments incident to regular business transactions. The kinds of risk-shifting transactions of most practical importance to transfer pricing typically are regular business transactions -- including manufacturing, service, and distribution transactions -- that are not styled explicitly as risk-shifting transactions, but in fact apportion risks in important ways. In the context of transfer pricing practice, important classes of risk-apportioning business arrangements include: (i) "limited risk" distribution arrangements (including, in some instances, consignment and commissionaire arrangements) by which a group member, typically in a low-tax country, engages with a distributor to sell a product to unrelated parties in return for a fee or other limited return so that any residual profits or losses will inure to the low-tax party; (ii) contract manufacturing or similar arrangements, in which a group member, again typically in a low-tax country, arranges...
for an affiliate to perform manufacturing on a cost-plus or similar basis, so that residual profit or loss from the sale of the resulting product inures to the low-tax party; and (iii) service arrangements, in which a group member, also typically in a zero- or low-tax country, engages an affiliate on a cost-plus basis to develop potentially valuable intangibles, with any profits from use of the intangibles inuring to the low-tax affiliate. Much international tax practice today centers on setting up arrangements of those kinds. Through those arrangements, multinational groups recently have succeeded in shifting billions of dollars of potentially taxable profits into low- and zero-tax jurisdictions. To a large extent, it is in connection with transfer pricing enforcement for those kinds of transactions that the battle for simplification and rationalization of transfer pricing rules is likely to be won or lost.

D. Risk and the OECD Drafts

Both of the pending OECD discussion drafts offer approaches that can improve how transfer pricing rules address income shifting involving assignments of risk.

1. The discussion draft on safe harbors. The discussion draft on safe harbors addresses problems of transfer pricing enforcement related to limited-risk distribution, manufacturing, and intragroup services arrangements. The basic enforcement problems for those arrangements tend to be of two kinds. First, the intrinsic imprecision of comparables analyses appears to have enabled some companies to justify implausibly low margins and markups for limited risk arrangements, thereby making it feasible to use those arrangements to strip income excessively from countries where activities are conducted. Income shifting of this kind has been especially damaging to developing countries, where multinational groups have tended to establish many limited-risk operations. Second, members of multinational groups have shifted income by structuring some kinds of limited-risk arrangements that almost certainly are unavailable in the marketplace to unrelated taxpayers transacting at arm’s length.

Prominent among those arrangements are research and development service arrangements, and other intangibles-creating services arrangements, in which limited-risk parties accept limited compensation for developing intangibles that if developed successfully would be exceptionally valuable, so that at arm’s-length a rational service provider would insist on much higher levels of consideration. The toleration by tax authorities of those kinds of risk-shifting arrangements has enabled the shifting of billions of dollars of income to low- and zero-tax countries where little, if any, intangibles-creating activity actually takes place.

The discussion draft on safe harbors would treat as consistent with arm’s-length rules the establishment by tax administrations of presumptive minimum income levels for distribution, manufacturing, and service operations that the taxpayers have styled as limited risk. By taking that approach, the discussion draft could substantially assist countries, especially developing ones, that are struggling to preserve their tax bases in the face of limited-risk arrangements.

2. The discussion draft on intangibles. The discussion draft on intangibles takes an important step against income-shifting through risk-based arrangements by clarifying that the mere funding of intangibles-creating activity does not entitle a party to the returns from the exploitation of developed intangibles. The discussion draft leaves open
important questions concerning how to implement that principle in practice. In particular, the discussion draft envisions that taxpayers might obtain the right to returns from intangibles development from exercising control over the development activities, but it gives little guidance as to how intangibles-related profits are to be split between a party exercising control and the party or parties actually doing the development work. That question must be addressed before the discussion draft on intangibles can be translated into an effective enforcement regime, but the draft's principles nevertheless provide an important and promising starting point. By clarifying that it is the performance, and not the funding, of activities that gives rise to the right to income under the arm's-length principle, the discussion draft articulates principles that could help tax administrations deal more effectively with problems of risk transfer in many different business settings.

E. Specific Recommendations

Considering the OECD's work to date, the following further steps could help the OECD, and countries seeking to follow the principles of the OECD guidelines, to better address risk-related enforcement issues:

1. **A clear articulation of the arm's-length principle as it applies to risk.** The OECD, and both member and nonmember countries, could promote more effective transfer pricing enforcement simply by including in transfer pricing guidance a basic statement of the arm's-length principle as it applies to risk, in language similar to that suggested earlier in this article. Historically, transfer pricing rules have taken a permissive approach to the question of whether risk-shifting arrangements between related parties should be permitted to shift income abroad. Generally, countries have permitted taxpayers to shift income through risk-shifting arrangements as long as the arrangements contain "economic substance" -- that is, as long as the compensation under those arrangements seems reasonable in view of the amounts of income involved in the arrangements.

An economic substance test, however, is inadequate for purposes of enforcing the arm's-length principle. In addition to providing for compensation that itself appears reasonable, contractual arrangements, in order to conform to the arm's-length principle, also must be of a kind that would be available to unrelated parties transacting with one another at arm's length. Such a requirement would, properly, be more exacting than the economic substance test as it is commonly applied today. Nevertheless, unless transfer pricing rules make clear that tax effect will be given only to those risk-shifting arrangements which would be available to unrelated parties acting at arm's-length, related groups of companies will continue to have a serious advantage in tax avoidance over independent business, in plain violation of the arm's-length principle.

2. **Refining rules for profit-split methods.** By making clear that income from intangibles should inure to parties that develop the intangibles rather than merely fund development activities, the OECD draft on intangibles suggests an important way in which rules governing profit-split methods could be made more effective in preventing tax avoidance. In accordance with the principle provided in the draft, both the OECD guidelines and national tax rules should make clear that in constructing profit-split methods, income should be attracted to a participant based only on expenditures (i) paid for activities conducted directly by the participant; (ii) paid by the participant for tangible property, to be used by the participant; or (iii) paid to unrelated parties for the use by the participant of intangible property, or for services provided directly to the participant.
F. Concluding Comments

The pending OECD discussion drafts point the way to reforms that could significantly curtail tax avoidance through the separation of business risks from the activities that generate those risks. Because of their potential utility in reducing tax avoidance, it is likely that the suggestions and principles provided in the discussion drafts will encounter substantial and concerted opposition.

Further, the discussion drafts and the thinking they represent could pose a political dilemma for some OECD governments. In some OECD member countries, risk-shifting through arrangements that violate the arm's-length principle has enabled multinational groups to reduce their tax bills substantially, and governments in those countries face the dilemma of how best to bring their transfer pricing laws into compliance with the arm's-length principle without causing economic disruption to businesses.

The key question now facing the OECD is whether it will be able to proceed with its reform program in the face of the political opposition that it is likely to confront as businesses digest the implications of the pending discussion drafts. For the sake of its relevance as a prescriber of best practices in tax administration, including transfer pricing, it is essential that the OECD meet the coming challenge and persist in the meaningful reforms that the discussion papers appear to envision. The whole point about best practices is that they are aspirational standards which governments should adopt in furtherance of the public welfare, even if existing political alignments do not permit the immediate incorporation of all the proposed best practices into law. To mean anything, best practices must lead, not follow, the current state of legislation and administrative practice around the world. In its discussion drafts, the OECD has made an important step toward reinvigorating the idea of international best practices in tax administration. To the extent it succeeds in the work it has begun, fiscal authorities in many countries will be better able to serve public needs in years to come.

FOOTNOTES


END OF FOOTNOTES

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Ernst & Young comments Intangibles Discussion Draft

Dear Mr. Andrus,

Ernst & Young wishes to thank you for the opportunity to submit comments regarding the Discussion Draft of the OECD project on the transfer pricing aspects of intangibles. This letter presents the collective view of Ernst & Young's global transfer pricing network. We agree to have our comments posted on the OECD website.

We greatly appreciate the willingness of WP6 of the OECD to share working drafts with the business community to provide comments. We also very much appreciate the emphasis the OECD is putting on the practical aspects of transfer pricing, paying specific attention to the practical issues business is running into when applying the transfer pricing rules. Our comments are made with the purpose of refining the draft to improve the ability of taxpayers and tax administration to cost effectively comply with determining arm's length prices for cross border transfers of intangible property.

We have collected specific input from the emerging market countries. This input has been included in our comments. As a general remark, our clients in the emerging market countries indicated that the guidance is rather complex. It could in particular prove helpful to further refine the guidance with clear, practically applicable definitions and examples.
If you have any comments or questions, please feel free to contact any of the following:

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Yours sincerely,

On behalf of Ernst & Young,
Prof. Dr. Thomas Borstell
Global Director - Transfer Pricing Services
Introduction

Our comments on the Discussion Draft are organized as follows:

1. A summary of the key points on which we recommend that WP6 should focus on its further work
2. A more detailed discussion of three of the four sections and some of the examples of the Discussion Draft

Key comments and recommendations

1. The Working Party’s work on the definition of intangibles is helpful. But we think there is a need
   a. further to sharpen the definition,
   b. to keep it as lean as possible to avoid a blurred definition not in line with tax law requirements,
   c. in that context to clarify the distinction between comparability factors and intangibles, and
   d. to recognize that there may be factors too ill-defined to be useful for transfer pricing analysis (e.g. “good management”).

2. We recommend clarifying that comparability factors like low input costs, whether related to people, natural resources, weather, etc. should not be viewed as a unique and valuable contribution, and should not lead to the application of a profit split method.

3. We recommend avoiding general assertions about “goodwill” or “going concern value.” Rather, significantly more effort should be put into identifying the various uses of the terms “goodwill” and “going concern value” and analyzing the extent to which these different uses might have significance in applying the arm’s length standard.

4. We recommend clarifying that proper analysis does not involve
   a. “artificially” splitting an intangible into several “micro intangibles” or otherwise “unbundling” or “atomizing” intangibles, in particular trying to separate artificially “micro intangibles” from goodwill;
   b. or equally, but to the opposite effect, “artificially” aggregating business attributes (or also even “weaker” intangibles) into a larger aggregate that allegedly has a higher aggregated value than its individual elements.
5. More guidance is needed on the new concept of intangible related returns, especially on the remuneration of financing functions and excess profits caused by market circumstances, synergies, etc. The guidance on financial risks with respect to intangibles in our view creates significant and unnecessary uncertainty. We believe that it is at arm’s length – because it occurs in dealings between unrelated parties - and in line with the current guidance in the Transfer Pricing Guidelines that a party financing the development of an intangible is entitled to a portion of the “excess profits” in connection with an intangible if that party has the management and financial expertise to bear such risks.

6. The level of substance and the level of control of important functions required for claiming entitlement to some or all of the intangible related return should, wherever possible, be tested by reference to comparable transactions between third parties, rather than by a hypothesis about arm’s length behavior. Clarification is needed regarding who would be required to perform the important functions, and also that direct participation in the development of the intangible is not a prerequisite for entitlement to the intangible related returns.

7. Although the guidance on the application of valuation techniques is very much welcomed, we are concerned that portions of the guidance may be read to unnecessarily add to the burden of documentation that is necessary for MNEs that use valuation techniques in pricing intangibles, creating expectations of a level of detail that we feel is not appropriate.

8. The language on pricing in case of highly uncertain situations does not shed any additional light on the circumstances in which one would observe a price renegotiation clause or a stepped royalty rate in an arm’s length agreement, or on the nature of such clauses. In our view, this is likely to lead to adjustments based on hindsight. We believe that these kinds of adjustments should not be applied routinely. Much clearer guidance is needed on the circumstances in which such adjustments might justifiably be made, making it clear this is unlikely to be appropriate except in a very small minority of cases.
**Detailed discussion**

We offer the following specific comments to the Discussion Draft.

**Section A**

The Discussion Draft does not provide a clear, explicit definition of the term “intangible”. Rather, it seems to imply that an intangible is something of value – not being a “physical” or a “financial” asset – which a third party would be willing to pay for. However, there are various reasons why we believe it is important to provide a clear definition. First, from a transfer pricing analysis point of view, the presence of an economically significant intangible is an important factor. Second, in many countries, a definition that is not sufficiently concrete could be contrary to domestic law prohibitions, including constitutional prohibitions, on laws that are overly vague. Finally, the Discussion Draft separates the meaning of “intangible” for the purpose of article 9 from other OECD treaty articles, most particularly article 12. A clear definition should also distinguish between intangibles as defined in article 12 clause 2 and intangibles that are outside the definition of article 12 clause 2. We otherwise see a significant risk that the concept of intangible for purposes of article 9 could be “adopted” into article 12 in a manner that could be seen to broaden the scope of article 12 clause 2.

The Discussion Draft already contains notions that can be used in further developing a definition of intangibles. We believe that an intangible should be capable of being owned or controlled, and be capable of being transferred on a stand-alone basis. Other aspects that don’t meet these requirements (e.g. “synergy”, “location savings”) should be factored into the comparability analysis, but should not otherwise be considered a separate intangible. We suggest that the guidance should contain a specific definition that reflects these concepts.

In implementing the requirement that relevant intangibles be identified with some specificity, we think further attention also should be devoted to the issue of the level of disaggregation. We agree with the concern stated in paragraph 70 that “tax authorities may seek to artificially separate intangibles that, as a matter of substance, cannot be separated.” It is our experience that in some jurisdictions, tax authorities feel they have an almost unlimited mandate to disaggregate common transactions into transfers of more and more discrete intangibles, each with its own, separately discoverable, arm’s length return. In other jurisdictions, the opposite tendency is common. Returns are associated with bundles of intangibles, even though neither the intangibles nor their relationships to particular items of income are specifically identified. Although Subsection C of the Discussion Draft discusses transfers of combinations of intangibles, the draft provides very little guidance on the appropriateness of aggregating or disaggregating intangibles for analytical purposes. We believe this issue is best addressed in the context of refining the definition of intangible. We would expect that normally, intangibles would be identified using commonly recognized legal or accounting terminology. However, we recognize that the transfer pricing method and surrounding market circumstances could also have an impact on the aggregation of intangibles (as an example, when there is a valid internal CUP which involves the transfer of several distinct intangible assets for a single price).

We are concerned about the discussion of goodwill and going concern value in paragraphs 21 and 22. Paragraph 11 asserts the reasonable general principle that in transfer pricing analysis “it is important to identify the relevant intangibles with some specificity … it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions.” Yet paragraph 22 provides “[[It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing
purposes." Paragraph 22 dispenses with the specific identification that paragraph 11 requires apparently because the uses of the terms "goodwill" and "going concern value" are uncertain. Paragraph 21 specifically identifies four different possible meanings for goodwill and going concern value. We do not believe that accepting this uncertainty is appropriate since it will simply create abundant opportunity for conflict between and among taxpayers and different tax authorities.

Consequently, we recommend the discussion draft not make general assertions about "goodwill" or "going concern value." Rather, significantly more effort should be put into identifying the various uses of the terms "goodwill" and "going concern value" and analyzing the extent to which these different uses might have significance in applying the arm's length standard. We suspect that the analysis will reveal that to some extent the terms refer to conventional intangible assets that are distinct and separately transferable (e.g. customer information). In other cases, the uses may be attributes of a business which are not properly thought of as separate intangibles, but that are nevertheless "comparability factors" (see e.g., "group synergies" as discussed in paragraph 23). In still other cases, the use may be a concept that is not typically viewed as having significance for transfer pricing purposes (e.g. "business opportunity"). The uses may finally be attributes of a business as a whole that cannot easily be associated with a distinct asset (e.g. informal “knowhow” widely distributed within a business), and that are not commercially transferable except in unusual circumstances. Obviously, each type must be analyzed using different principles appropriate to their characteristics.

However, to reiterate, we are not advocating “splitting” of intangible assets if not analytically necessary since that may result in the attribution of unique and valuable assets to all parties to a transaction involving the transfer or use of intangible assets. We are concerned that the Discussion Draft as written may encourage the artificial division of intangible assets into many “micro-intangibles” resulting in the conclusion that both parties to a transaction are making unique and valuable contributions. This is likely to lead to the conclusion that a profit split is the most appropriate transfer pricing method. We do not believe the profit split methods should be treated as necessarily more appropriate if comparable transactions or functions are available to act as benchmarks in applying the other traditional transfer pricing methods.

Regarding workforce-in-place (paragraphs 25-26), we believe that it is not an intangible for transfer pricing purposes. Instead, the proper focus should be on whether there are business process intangibles in place where the local work force is employed. A workforce-in-place may have developed numerous business process intangibles that allow it to produce at a lower cost than other competitors in the local market. We suggest being explicit that a workforce-in-place is not an intangible asset and introducing more specific language clarifying the consequences of the “transfer” of an existing workforce, including a description of what is meant by a “transfer” of an existing workforce.

**Intangibles vs. comparability factors**

We welcome the distinction between intangibles and (other) comparability factors (often called “soft intangibles”). Although guidance on these “soft intangibles” technically would be outside the scope of this Discussion Draft, because such factors are not considered intangibles, we recommend including more practical guidance in this area. Theoretically, all the factors mentioned in par. 23 and 24, could be taken into account in a comparability analysis. Practically, however, it would be very difficult to take factors like "good management" into consideration. The imprecision of such concepts would also be a source of dispute. Consequently, we suggest taking such factors into
consideration only if they are reasonably reliably determinable and measurable. The range concept deals with other situations. A more general description of how to deal with market specific circumstances as comparability factors in practice would be very much welcomed, especially by the emerging market countries.

The Discussion Draft (paragraph 23) indicates that group synergies contribute to the level of income of an MNE. Based on current guidance, if both parties make unique and valuable contributions, a profit split may be found to be the most appropriate method. We suggest clarifying that the comparability factors, the “soft intangibles” (e.g., group synergies, low prevailing labor costs etc.) as described in the Discussion Draft are not unique and valuable contributions that should lead to the application of a profit split.

As a final comment with regard to the definition of intangibles, we would like to draw the attention to the interaction with other tax laws including tax treaties. We realize that the Discussion Draft states that the definition for art. 9 purposes is not relevant for other tax purposes. However, we believe some topics may require further attention.

The potential double taxation caused by transfer pricing adjustments is supposed to be covered by the relevant double tax treaties. If the definition for transfer pricing is different from the definitions in domestic law for purposes other than transfer pricing, this may cause effective double taxation. The domestic law in the transferee country may have a different, narrower definition. Consequently, the “intangible” may for instance not be eligible for amortization/depreciation in the transferee country, although the transferor is being taxed on the transfer. A similar problem has been observed in the context of article 7. This is a further reason that the definition should not be too broad and not too vague. We also suggest including a strong statement that countries should not lightly refer to limitations in domestic law on non-transfer pricing issues when discussing remedies for double taxation.

Section B

This section of the Discussion Draft discusses the “threshold” question of which entities within an MNE are entitled to intangible related returns. The return related to a specified intangible is defined in the guidance as, essentially, the residual profit after deducting the returns for other business functions, assets and risks.

Concept of intangible related returns

We do not see the necessity for the new concept of “intangible related returns”. If such a new concept would be introduced, it should be clarified. The “economic rent” or “excess profit” earned by companies often is not only related to profits in connection with an intangible, but also to profits as the result of market circumstances – which rightfully are considered to be comparability factors and not intangibles. Although the Discussion Draft indicates that caution should be exercised not to routinely allocate all residual profit to the party entitled to intangible related returns, we believe this topic could be further clarified. At arm’s length, parties can earn high returns (or losses) for taking risks. The Transfer Pricing Guidelines already recognize that risk taking is itself a “function” or comparability factor. We suggest clarifying that synergies and profits associated with entrepreneurial risks should not be treated as excess profits due to intangibles. However, elements of the discussion draft could be read to imply that there is a risk that all excess profits, including synergy benefits, will automatically be allocated to the owner of an intangible.

Financing and intangible related returns
In connection with this, it is unclear whether the Discussion Draft’s definition of intangible related return would include the remuneration for the financing of the development of the intangible. The functions that the Discussion Draft specifies give rise to a claim to the “intangible related return” don’t include providing financing (whether equity or debt). It is unclear whether the Discussion Draft means to imply that a party that bears financial risk with respect to the development or exploitation of an intangible asset is not entitled to share in the potential upside (or downside) risk associated with the intangible asset. We believe that at arm’s length and in line with the current Transfer Pricing Guidelines, a party financing the development of an intangible can be entitled to take part of the “excess profits” in connection with an intangible.

Entitlement to the returns

Another major concern with this draft guidance relates to the proposed approach set out in B.2 to determine which entities should be entitled to intangible related returns, based on an assessment of whether the allocation of functions, assets, risks and costs is “in alignment” with the legal and contractual framework.

We agree that entities within an MNE should have an appropriate level of substance to manage and control the development, enhancement, maintenance and/or protection (“DEMP” functions) related to intangibles, in order to claim entitlement to some or all of the intangible related return. However in our view, the level of substance and the level of control required should, wherever possible, be tested by reference to comparable transactions between third parties, rather than by a hypothesis about arm’s length behavior. Our view is that the guidance as currently drafted is too prescriptive about the behavior that is required in order for an entity to be entitled to intangible related returns. Such prescriptive guidance could not practically address the whole variety of arrangements that are seen at arm’s length, and this likely would lead to implementation problems and a risk of inappropriate deviation from the arm’s length standard. Particular issues that we foresee arising in this regard include the following:

- There are undoubtedly arm’s length situations where third parties retain entitlement to intangible related returns without themselves performing and controlling all the “important” functions to the extent that the guidance appears to require. MNEs should be free to adopt arrangements comparable to those observed between arm’s length parties in comparable circumstances without the risk of those arrangements being disregarded.
- Normal practice in many MNE groups is to allocate different DEMP functions to different entities within the group. (For example, group IP protection may be handled centrally, whilst development and enhancement of IP might be handled by entities in different jurisdictions). In these cases, the entities that perform the protection functions may not exert control over the development or enhancement functions, or vice-versa. The guidance should be able to address this situation without the risk of intangible related returns being reallocated around the group.
- There are arm’s length situations where a party will obtain the right to share in intangible related returns by investing in the development of intangibles or purchasing intangible rights, but will perform little or no “control” activity other than due diligence at the outset, and will only bear risks associated with the loss of its initial investment and the volatility of intangible related returns. Although we can see that this type of arrangement can fit in to the guidance (noting the references to paragraph 9.23-9.28) it would be helpful to confirm this.
Our emerging market practices have observed a great deal of interest in the transfer pricing aspects of marketing intangibles, and we request that the Working Party devote further specific attention to this topic and in the next version of the Discussion Draft. In practice, it can be very difficult to determine whether marketing and promotional expenditures have contributed to the success of a product. In many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures. The level and nature of marketing and promotional spending can also be affected by a variety of business factors, such as management policies, market share, market characteristics, and the timing of product launches. While examples 3-5 of the Discussion Draft provide a useful and conceptual perspective on how the issue may be approached, it would be useful to provide more specific guidance on practical application.

Who must perform the important functions?

A specific point of attention is the question regarding who must perform the important functions. Paragraph 40 indicates that an entity claiming intangible related returns should physically perform through its own employees the important functions. In paragraph 41 it is stated that the parties claiming entitlement to intangible related returns should exercise control over the performance of the development, enhancement, maintenance and protection functions. Paragraph 54 states that for a party to be entitled to an intangible related return, it should perform and control important functions. In practice, within MNE’s, employees often are temporarily seconded without formally becoming an employee of the other company. This fact is acknowledged in the draft paragraph 10 of the commentary on article 5:

Within a multinational group, it is relatively frequent for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract.

Paragraph 9.23 of the Transfer Pricing Guidelines, to which reference is made by the Discussion Draft in paragraph 41, speaks of the company having control by means of people – employees or directors.

Paragraph 9.23 indicates that control means: the capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider. Paragraph 40 of the Discussion Draft seems to imply that a party should physically perform all the functions itself. We recommend clarifying that performing important functions in relation to development, enhancement, maintenance and protection of intangibles means taking the strategic decisions related to intangibles, but that it does not mean that a party must actually perform the development, enhancement, maintenance or protection.

We believe that more examples should be included illustrating the circumstances in which a party performs managerial functions sufficient to entitle the party to an intangible related return.

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1 OECD discussion draft 12 October 2011, “Interpretation and application of article 5 (permanent establishment) of the oecd model tax convention”
Adjustments based on non-alignment

Transfer pricing adjustments in cases where functions, risks and costs allegedly are not aligned with contractual allocations may trigger specific issues. Unlike “traditional” adjustments of prices, such transfer pricing adjustments may cover more than one fiscal year. For example, the development of an intangible in country A could result in losses in the first 8 years, and high profits in the later years of exploitation of the intangible. Suppose the tax authorities in country B argue that the important functions are performed in their country, deviating from the legal ownership in country A. They will adjust the profits in the exploitation years. Even if the tax authorities in country A agree with the line of reasoning, they may not be willing or (due to statute of limitation considerations) unable to apply a corresponding adjustment in the exploitation years, given the losses in the previous years. As a result, the MNE may end up in a situation of double taxation.

These kinds of “non-alignment” adjustments in practice often are perceived to be a recharacterization, and may be considered to be an application of anti-avoidance measures. Some countries don’t allow access to double tax treaties in case of anti-avoidance. Although the Discussion Draft indicates these adjustments are not based on paras 1.64-1.69, we are concerned that the perception of recharacterization could lead to double taxation.

We recommend further analysis of this issue, and the inclusion of guidance that enables and strongly encourages countries to resolve any double taxation resulting from such “non-alignment” adjustments. Second, we recommend making explicit in the draft that “non-alignment” adjustments should fall under the mechanism of a double tax treaty, and that access cannot be denied by reference to anti-avoidance exceptions.

Disregard of transactions, registrations and contracts

The alignment is an important concept in the Discussion Draft. It seems to be based on the actual conduct of the parties. In section B4, disregard of contractual allocation is mentioned. The interaction between an adjustment based on non-alignment and section B4 is unclear to us. Specifically, if a non-alignment adjustment is not in point, we don’t see how non-recognition of the actual transaction based on a difference between substance and form could arise. Furthermore, section B4 only discusses paragraphs 1.64-1.69 in terms of disregarding contractual allocations. We assume that this should refer to both disregarding and re-characterizing.

We further note that the Transfer Pricing Guidelines indicate that adjustments based on 1.64-1.69 should only take place in exceptional cases. However, we are concerned that the concept of misalignment may come to be used routinely as a threat in tax audits as an alternative to 1.64-1.69 without the safeguards therein. We recommend clarifying that non-alignment adjustments should, like re-characterization, take place only in exceptional cases. We recommend that the Working Party conduct further work to define the circumstances in which misalignment adjustments may be appropriate.

Section D

In general

We disagree with the suggestion in paragraph 110 that there is inherent conservatism in valuation assumptions adopted for accounting purposes. This is not consistent with fair value measurement requirements under IFRS,
which are intended to reflect the fair value of an intangible asset in an arms-length sale between a willing buyer and seller, not a conservative estimate of value.

We also rebut the statement in paragraph 110 that “valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes”. We believe this statement is drafted too broadly. Whilst we agree that there are occasions where the valuation approaches and value outcomes may differ, we would not expect material differences in value to arise where asset values for financial reporting purposes are determined based on observable market prices, a cost to recreate (as in the case of non-unique intangibles which are readily replicable) or using income based approaches which rely on assumptions that are consistent with appropriate transfer pricing arrangements (e.g. relief from royalty). It is also unclear if the statement in paragraph 110 is meant to encompass all asset values, for example the fair value measurement of property, plant and equipment.

However, the asset to be valued for transfer pricing purposes is often different when looked at closely to the asset valued for purchase price allocation purposes. In this respect, broad definitions of assets or combinations of assets can be misleading.

**Two-sided analysis**

The Discussion Draft indicates that in principle a transfer pricing analysis must consider the options realistically available to each of the parties. We believe more guidance on the general notion of “options realistically available” would be very welcome, especially given the importance that is being put on this concept in the context of intangibles. For example, we think there should be more attention devoted to the issue of determining what options might be considered “realistically available”? Such discussion should consider issues like whether, if a company has a certain risk appetite, it is a realistic option to invest in projects with a totally different risk profile?

The general notions are illustrated by example 19 in the appendix (paragraph 250-258) based on an analysis determining the net present values (NPVs) of alternatives. We agree that an analysis of NPV can be a useful tool in considering whether the price charged for a transaction seems reasonable. However, our concern is that the way this approach is set out in the guidance suggests that an arm’s length transaction must always give an NPV in a range that can be specified by comparing one or two hypothetical alternatives. In our view:

1. The “next best alternative” cannot always be assessed by a simple NPV analysis. A wide variety of other factors need to be considered, such as the allocation of capital amongst different projects (e.g., although the NPV derived from project X might go down if project X is out-licensed, such an out-license might free up capital to exploit project Y in addition to royalties from project X)
2. A tax authority’s view of what options are realistically available may be quite different from management’s view. Our opinion is that the way the guidance and example are currently drafted, with the reference to recharacterization, may encourage tax authorities to second-guess management decisions.

We suggest clarifying that is not always necessary to perform an explicit two-sided test. As an example, a two-sided test may be unnecessary if one party is not entitled to intangible related returns based on the intercompany
agreement between the parties, as in a licensing arrangement. In such situations, testing the functions of the licensee may be adequate and not require an analysis of the realistic alternatives available to the licensor.

The use of internal CUPs

Paragraph 138 states that where an intangible asset is acquired by an MNE from a third party and then transferred internally immediately following the acquisition, “the price paid for the acquired intangibles will usually ... represent a useful comparable for [application of the] CUP method”. However, if a two-sided analysis were applied to this internal transaction, then, from a theoretical perspective, this statement may often prove incorrect. The value for the acquiring MNE will (usually) be higher than the price paid for it, for example because of synergies for the buying MNE. If a two-sided analysis is now performed on the internal transaction, the minimum value for the internal seller entity will most likely equate the maximum value that it would have been willing to pay to the third party. Only in limited situations will this equate to the actual price paid to the third party. Using the maximum value as an internal resale price would imply that any group synergies will end up with the entity transacting with the third party. In contrast, using the third party price as a CUP would lead to the opposite consequences, attributing all the group synergies to the ultimate buyer.

A similar applies to example 15. In our view, the logic of example 15 is correct if and only if the 100 represents value that company T could realize alone, without having been purchased by the Birincil group. To the extent that the purchase price included a premium over the standalone going concern value of company T, some of the 100 paid to acquire T will represent a synergetic value contributed by, Birincil and its pre-existing affiliates. The example attributes the whole value to company T, which does not seem correct, at least not in all cases.

The underlying assumption of the examples 15, 18 and 19 seems to be that the deal premium necessarily relates to income. In our M&A practice, especially in high tech industry deals, we observe that the premium relates more to the expectation of income assuming several things align. The drivers for the deal are often risk reduction or competitive strategies, legal motivations, or more importantly in today’s marketplace, reverse synergies. We recommend that the Working Party conduct further work to analyze such synergies/premiums, and the consequences of it for transfer pricing purposes, like in example 15.

Use of valuation techniques

The guidance at paragraph 145 – 180 discusses the issues and difficulties surrounding the use of valuation techniques in transactions involving intangibles. We generally agree with the comments in this guidance indicating the need for underlying assumptions to be clearly specified and supported, and we agree that performing some sensitivity analysis (paragraph 151) is a sensible step.

However, we have concerns over the level of length and depth of discussion of the issues and concerns around valuation techniques. We suggest that section could emphasize the need for any assumptions around discount rates, financial forecasts, growth rates, terminal IP values etc to be clearly laid out and supported, but without the level of detail seen in the current draft around the difficulties with each type of assumption. The articulation of the assumptions may add to the burden of documentation that is necessary for MNEs using valuation techniques in pricing intangibles, creating expectations of a level of detail that we feel is not appropriate.
With regard to the use of projections, we think the Discussion Draft places too much emphasis on the use of projections being prepared for non-tax purposes. We suggest including language that expresses the need, when using projections for valuation purposes, to carefully examine how the assumptions underlying the projections have been used within the business.

Concerning discount rates, the Discussion Draft states that “the discount rates should reflect the level of risk in the overall business and the expected volatility of the projected cash flows” (paragraph 162). We believe it might be more accurate to say that discount rates should reflect the level of risk associated with the probability-weighted cash flow projection in question. The current wording may lead to the conclusion that the discount rate associated with a particular cash flow should reflect the overall level of risk in the wider business as a whole, which we believe is not correct.

Although we recognize the inherent difficulties with the application of a transfer pricing method based on development costs, we feel that the tone in Paragraph 112 is too negative. A cost based method may for example well be used in the analysis of the options realistically available.

**Highly uncertain valuation**

The Discussion Draft includes language on the pricing in case of highly uncertain situations. The examples provided relate to situations where intangibles are being licensed or only partially transferred. No examples have been included which look at the outright sale of an intangible. In our experience, renegotiation is seldom observed in practice, in particular in the situation of an outright sale of an intangible. We suggest making this explicit in the document. Hence, applying a renegotiation mechanism, by either the taxpayer or the tax administration, should be thoroughly documented and not be done lightly.

In our view, the discussion here risks being unhelpful because it does not shed any additional light on the circumstances in which one would observe a price renegotiation clause or a stepped royalty rate in an arm’s length agreement, or on the nature of such clauses, but just makes the point that sometimes one sees such clauses and sometimes one does not.

We are particularly concerned over the wording of paragraph 177 which states that “if independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause”. In our view, this is likely to give tax authorities a spurious justification for making retrospective adjustments to licensing arrangements based on hindsight. We feel that much clearer guidance is necessary on the circumstances in which such adjustments might justifiably be made, making it clear these are unlikely to be appropriate except in a very small minority of cases. This guidance may be illustrated with examples.

Paragraph 176 indicates that certain cases might prompt a tax administration to inquire what a third party would have done. We are concerned about the wording of this paragraph. To deviate from contractual allocations, the tax authorities should be required to prove that a third party in similar circumstances would have included some kind of protection against certainty. The fact that a tax administration may inquire about this, should not imply that a taxpayer should be required to prove that a third party would not have done it.
Examples

We welcome the publication of examples to illustrate the guidance included in the Discussion Draft. We realize that there is no consensus yet on the Discussion Draft. Hence, it is not appropriate to comment on details of the examples. We have a few comments that in our view relate to more substantive issues.

Example 5 illustrates the situation that a marketer/distributor incurs more costs than comparable companies. The functions, however, are similar (paragraph 198). Although the marketer/distributor performs far more extensive functions than in example 4, the same then should apply to the comparables. We don’t understand why incurring more costs only (and not performing more functions than comparable marketers/distributors) can lead to the conclusion that a residual profit split is warranted (paragraph 200). We are concerned that this example would lead to the conclusion that excessive marketing expenditure only (without performing additional functions as compared to the comparables) would lead to the allocation of marketing intangible related returns to a marketer/distributor.

Example 19 illustrates the two-sided perspective of section D. Various aspects of the example give rise to questions and/or seem to be at odds with the rest of the Discussion Draft. Some of our observations:

- The discount factor used for Pervichnyi, Company S and the distributors seems to be the same (14% after tax), notwithstanding the fact that the tax rates differ and the risk profiles probably also differ. We would expect that the discount factor for the routine functions would be different from the one to be used for the intangible income. We suggest including an explanation why a uniform discount rate has been applied in the example.

- The conclusion of example 19 is that the range of arm’s length prices should be such that it would generate an after tax return between 735 and 941. Paragraph 258 also states that consideration should be given to how independent parties would deal with cost savings (and tax rate benefits), but that the outcome should be within that range. We are not sure whether this statement is factually correct. Table 3 contains the best option from the transferor’s view and demonstrates the minimum value that the transferor would accept, 735. In our view, in option 3 the fact that Company S is willing to accept a remuneration based on its own COGS of 500 plus 5% effectively means that the location savings are fully allocated to Pervichnyi. At the other extreme, if Company S were able to negotiate remuneration equal to the COGS in Pervichnyi’s country, 600, the location savings would be fully allocated to Company S. The revenues for Company S would be 600 + 5% = 630. In that case, the income after tax of Pervichnyi in Table 3 would be 140 (830 – 630) * (100 – 30%), and the PV for Pervichnyi would be 480. In that scenario, Table 3 would not present the best option for Pervichnyi; in that case that would be Table 1 (the option not to change). The range of values would then be: 594 – 941. Hence, presenting a range of 735-941 already implies a full allocation of location savings to Pervichnyi.
Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit  
OECD Centre for Tax Policy and Administration  

Email: joe.andrus@oecd.org  

18 September 2012  
Ref.: DTA/PRJ/PWE/ACH

Dear Mr Andrus,

Re: OECD Discussion Draft on the Revision of the special considerations for intangibles in chapter VI of the OECD Transfer Pricing guidelines and related provisions

FEE¹ (the Federation of European Accountants, www.fee.be) is pleased to provide you below with its comments on selected topics of the Revision of the special considerations for intangibles in chapter VI of the OECD Transfer Pricing guidelines and related provisions.

FEE welcomes the OECD invitation to comment on the revision of the Transfer Pricing guidelines related to intangibles as this is an issue of high practical relevance for tax practitioners.

Our comments, as set out in this letter, have been referenced with the relevant section in the OECD Discussion Draft.

Chapter VI: Special Considerations for Intangibles

Regarding the purpose of Chapter VI as outlined in paragraph 2 of the Discussion Draft, we would recommend to explicitly define that the “use of intangibles” for purposes of Chapter VI includes not only licensing of intangibles but also the contribution of intangibles to the value and consequently the transfer prices of goods and services being delivered with the use of intangibles.

¹ FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 EU Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700,000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.
A. Identifying Intangibles

A.1. In general

We agree that neither the definition of intangibles for accounting purposes nor a civil law definition of the intangibles is decisive for tax purposes in the area of transfer pricing. Nevertheless, we consider the definition provided by the draft as too broad, thus not providing sufficient guidance.

Especially the statement in paragraph 7 that separate identification and transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes is not assisting in providing certainty to tax payers and tax authorities. Referring to the helpful examples provided in A.4, “goodwill” is in fact the only intangible which cannot be identified and transferred separately from other business assets. “Goodwill” can only be transferred when all or a segregated part of the assets of an operating business are transferred. Moreover, the concept of an asset capable of being owned or controlled for use in commercial activities as correctly used in paragraph 5, rather require that the intangible can be identified and transferred separately.

Therefore, we would prefer that the subject of goodwill is addressed as a special issue which is only referred to for transfer pricing purposes in case a business or part of a business is sold or transferred. In all other cases the concept of “ownership or control” should require the existence of an asset which, in principle, can be identified and transferred separately.

A.4. Illustrations

We agree with the view that - as stated in paragraphs 23 – 25, group synergies, market specific circumstances and an “assembled workforce” (even if it has specific skills and knowledge) do not represent intangibles within the meaning of section A.1 of the Draft.

Under the third case of paragraph 26 it is stated that a secondment of employees may be regarded as a transfer of an intangible (valuable know-how or trade secrets) and that therefore an arm’s length compensation for such intangible may be required. With reference to paragraph 32 it should be clarified that this may only be the case when an entity could claim compensation for unauthorised use of know-how on the grounds of e.g. unfair competition legislation or similar rules or labour law in case the respective employee(s) have been transferred to an independent new employer. The mere fact that an employee is trained and knowledgeable does not mean that an intangible has been transferred; otherwise the scope of application would be far too broad and not in line with the arm’s length principle.

B. Identification of Parties Entitled to Intangible Related Returns

In paragraph 29 it is stated that when “outsourcing” certain development activities the services rendered must be compensated on an arm’s length basis. Although this statement is correct, it is unclear what consequence it has in determining which member of an MNE Group is entitled to intangible related returns.
More specifically, not adhering to the arm’s length principle regarding the remuneration for a service provided should result in a transfer pricing adjustment for the service remuneration but not in an entitlement to the intangible related returns. For example, if a certain development is “outsourced” to a related party against the payment of a cost-plus based remuneration and the “plus” is considered too low by the tax authorities under a transfer pricing analysis, the transfer price will be adjusted. However, the economic (beneficial) ownership of the intangible cannot be questioned merely due to such adjustment.

**B.1. Registrations and contractual arrangements**

In paragraph 40, a “substance over form” approach is proposed to adjust cases where the mere legal ownership is with an entity which is not capable of fulfilling the main functions to develop, enhance, maintain and protect the intangible. On the other hand, it is rightfully accepted that an entity may outsource parts of the activities giving rise to the intangible against an arm’s length consideration to related entities. However, it is then stated that the entity claiming entitlement to the intangible will "physically perform, through its own employees the important functions". Furthermore, budget control and decisions regarding defence and protection of intangibles are mentioned as indicative examples of “important functions”. We doubt whether carrying out these functions through own employees or seconded employees or third parties (such as accountants or patent lawyers) are relevant in deciding the economic (beneficial) ownership of an intangible for tax purposes. In practice unrelated parties do not only use their “own employees” for the mentioned functions.

Paragraph 41 rightfully requires an arm’s length remuneration for services rendered in performing functions outsourced to associated enterprises. Such remuneration will be based on the functions performed, the risks and costs borne as well as other circumstances. Any transfer pricing adjustment due to inappropriate transfer pricing for services rendered in relation to outsourced functions will not influence the allocation of economic (beneficial) ownership of the intangible for tax purposes (see our comment above on Section B, paragraph 29).

The comment made for paragraph 41 above applies for paragraph 46 as well.

**C. Transactions involving the use or transfer of intangibles**

**C.2. Transactions involving transfers of intangibles**

In our opinion, the approach used in paragraph 73 regarding business franchise arrangements is not practical. Even if under certain circumstance it might be difficult to identify comparables for a franchise fee, the solution should not be to try to unbundle the transaction into various services and intangibles and identify a price for each one. A business franchise arrangement is based on a whole business concept, a bundle, which can only be valued as a whole. Therefore, in our opinion, it is preferable to conclude on the value of such business concept by comparing the profitability of the franchisee with competitors not using such concept. Moreover, we believe that especially regarding franchising, comparables are often available.

**D. Determining Arm’s Length Conditions in Cases Involving Intangibles**
D.1 Conducting a comparability analysis in a matter involving intangibles

We fully agree with the statement in paragraph 82, that the perspective of both parties involved in a transaction should be considered when conducting a comparability analysis. All available options for both parties to a transaction need to be properly taken into account in a comparability analysis. We believe that a more precise definition may be required for some of the comparability features mentioned in this section. For instance, the definition of useful lifetime during which an intangible can be used or expected to provide market advantages, which is a fundamental feature in a comparability analysis, is unclear and vague.

D.2 Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

In paragraph 107 it is stated that the performance of services using intangibles may have similar economic consequences to a transaction involving the transfer of an intangible or the transfer of rights in the intangible. We do not believe that this statement is completely accurate. The transfer of an intangible or the transfer of the right to use the intangible has a long-term effect to the entity using the intangible. On the other hand, the provision of a service may be valuable due to the knowledge of the service provider but it usually does not create a long-term benefit to the recipient comparable to the transfer of the intangible (or the rights to use the intangible).

As stated in paragraph 112, the use of cost-based methods is rejected for the determination of the arm’s length price for intangibles. Although this may be the case generally, there are still cases where such methods can be a useful if not the only practical approach. For example, where a development at an early stage is transferred under an agreement to another unrelated party, simply because the entity that initiated the development does not have the resources to complete and further exploit the development on its own. In such cases, unrelated parties may tend to base the remuneration on a cost-plus based approach.

D.4 Determining arm’s length prices for transactions involving the transfer of intangibles or rights of intangibles

In this section, detailed valuation techniques are described to determine the value of an intangible if no comparables can be found. Whether an OECD guideline should be of such detail is a matter that should be further considered. However, it would be helpful also to refer to methods used by civil courts or professional arbitrators to determine a fair license fee e.g. when an entity has made unauthorised use of intangibles of another entity. These court decisions or arbitration rules may be based on unfair competition laws or similar laws protecting the rights of the owner of the intangible. Such decisions could provide an unrelated party approach, as civil courts and arbitrators aim to identify a “fair” license fee. We would recommend drawing on court cases in OECD member states or methodology recommended by professional arbitration bodies in order to get an indication on whether the detailed valuation techniques described are not in contradiction to those rules applied in practice.

Thank you for the opportunity to comment on the Discussion Draft and for the extension of the deadline.
For further information on this letter, please contact Mrs Petra Weymüller, FEE Senior Manager at +32 (0)2 285 40 75 or via email at petra.weymuller@fee.be.

Yours sincerely,

Philip Johnson
FEE President
FIDAL is delighted to respond to the OECD’s request for comments from the business community in connection with the three draft papers that were issued on 6 June 2012. We present our comments in the foregoing sections and would be pleased to discuss these in detail with representatives of the OECD and/or to present our comments at the next meeting with the business community and Working Party 6.

1. **Discussion Draft : Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions**

   a. *General comments*

   **Paragraph 14 et seq**

   We note the difficulty of establishing a single legal definition of the concept of an intangible. The reasons put forward by the OECD are linked notably to the diversity of the national legal systems. Nevertheless, the primary objective is to ensure certainty, stability and sustainability for companies, in terms of the concepts used. Therefore, the starting point should be to define the concept of the asset which underlies the intangible.

   From a legal standpoint, an asset should have three characteristics: legal existence; be eligible for legal protection; and be transferable. If any one of these criteria is not met, there will be some uncertainty over the asset’s legal recognition. Where all three criteria are met, however, it is possible to ensure the certainty of and to justify different valuations based on the validity of the title (patent, trademark, design), or the attached right (copyright, know-how, contract, etc.).

   The OECD may like to take into account the proposition that a consistent approach between the legal reality of the asset and its economic value in any particular transaction makes it more difficult for national courts to undermine the adopted system.

   **Paragraph 17**

   We note that the OECD refers to the existence of trademarks at all market levels. A discussion of the relevance and relative importance of trademarks in different markets, such as consumer markets as opposed to business-to-business markets, as well as the consequent valuation and licensing differences would be welcome. Particularly, we suggest the OECD considers explaining how transfer pricing for the purchase or licensing of trademarks should reflect these differences by market.
Paragraph 26

We note in the third bullet that on occasion the OECD considers that seconded or loaned employees knowledge might represent the transfer of an intangible in relation to know-how and trade secrets requiring compensation as it would between third parties.

We are uncertain that this would be the case in third party circumstances in the case of know-how, as we are not aware of any occasions when new employers compensate previous employers for the knowledge acquired by hiring employees, nor are we aware of such payments routinely being made in relation to trade secrets (except in cases of successful litigation) as in general trade secrets are protected from disclosure under the terms of employment contracts.

Therefore we suggest that the OECD perhaps reconsiders the wording of the latter part of this bullet point.

Paragraph 36

We note that the OECD advocates ex-ante documentation regarding decisions to allocate intangible rights.

We consider that documentation whenever prepared could be helpful in this regard, even if ex-post, in order to clarify matters and the parties intentions. Lack of pre-transaction documentation should not invalidate orally agreed arrangements.

As such we suggest that the OECD refines the wording in this paragraph to de-emphasize the phrase ‘in advance’.

Paragraph 40

We note that the OECD’s expectation that the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of intangibles.

We disagree that such work needs necessarily to be performed by the entity as all of these functions could be effectively outsourced within a multi-national group or even to third parties. It seems to us that the most crucial factors determining entitlement to intangible returns are:

- the decision making as to intangible development and enhancement, maintenance and protection, such as which intangibles to research, when to
instigate legal proceedings for infringement cases and so on; and

- the bearing of the real economic risks in relation to the failure of intangible
development, or the costs of unsuccessful litigation.

Provided these are made and borne by the entity claiming the intangible returns, the
fact that its own employees may not carry out all the work, seems to be irrelevant to
the transfer pricing analysis. It would assist greatly if the OECD could define more
clearly what it considers to be the ‘important functions’ in this context.

We recommend some changes to this paragraph as the succeeding paragraph (41)
emphasizes control of outsourced functions rather than their being carried out by the
entity’s own employees. This would eliminate the apparent contradictions between
the two paragraphs.

Paragraphs 49-51

We note the discussion in relation to the performance of and bearing of costs in
relation to marketing functions as being important determinants in the allocation of
intangible returns in some circumstances.

In practice though, MNEs often distinguish between brand related marketing
activities which might accrue value to the global or regional brand owner, such as
worldwide advertising campaigns, the sponsorship of major sporting activities and so
on designed to raise brand awareness, and those that are more local market focused
and often the responsibility of the related party distributor in its market, such as
developing local customer relationships, sponsoring local events, local advertising
and so on.

This, of course, is a complex area in which to try to comment on the allocation of
intangible related returns, but some acknowledgement from the OECD on real world
scenarios would be helpful here, especially to recognize that marketing functions are
often split between different entities in MNE groups. Another example the OECD
may consider developing in this context might be for MNEs expanding into new
markets. Many tax administrations would expect the trademark owner of such a
MNE to charge new subsidiaries a royalty for the use of the brand and trademarks,
even though these may have no (or a very limited) initial value in the new market.

Paragraphs 97-98

The OECD may like to consider using concepts such as Technology Readiness Level
(TRL) by which to assess the stage of development of a particular intangible. TRL is
a measure used to assess the maturity of evolving technologies and is widely used by
MNEs. The OECD may consider adding other comparability factors such as the
cross-dependency between intangibles; their technical implementation; and the
cohesiveness of a group of patents or brands.

The OECD makes no mention of the quality of legal protection afforded to different
classes of intangible assets. Measuring this according to specific criteria should help
in the determination of the value of intangible assets. For example where a patent is
not strong enough to prevent competitors copying or using a protected device, the
revenues generated are at risk. This can diminish the value of the patent. Overlooking
effective legal protection can lead to misjudgments in the value of intellectual
property rights.

Paragraph 103

It seems clear to us that the preferred method (of the OECD), absent a CUT, is Profit
Split. As such we wonder why this is not referred to specifically in the last sentence
of this paragraph.

Paragraph 110

We note and agree with the OECD’s caution in the use of valuation techniques for
transfer pricing purposes and of purchase price allocations made for accounting
purposes.

We think it would greatly assist taxpayers’ and administrations’ understanding of the
logic here if the OECD could develop the last sentence of this paragraph a little more
fully, perhaps to discuss under what circumstances accounting values might not be
representative of arm’s length pricing. Illustrative examples might help also.

Paragraph 116

We note the OECD’s reluctance to accept rules of thumb.

Since case law from many jurisdictions, together with economic research on
licensing arrangements, may be the basis for commonly applied rules of thumb in
these circumstances, we wonder whether the OECD is totally rejecting such evidence
as too anecdotal in relation to the highly fact specific nature of intangibles valuation
and contribution allocations?

If not, then are there any, however limited, circumstances in which the OECD could
countenance the use of such? If there are, then it might be extremely helpful to
smaller taxpayers or in the case of smaller transactions to provide such guidance.
Paragraph 131

It would be helpful to understand more fully the valuation techniques that the OECD refers to in this paragraph as the context in which intangibles may be valued in relation to their use in connection with the sale of goods or services is not entirely clear to us. It would be useful to have a practical example of such transactions so that the implications for intangible valuation can be further assessed.

Paragraph 138

We note the OECD’s comment on the use of acquisition price for intangibles valuation even in the case of a share purchase.

We would caution against too general a comment without it being significantly developed and further guidance given. This is because, in such circumstances there are many things other than tangible and transfer pricing related intangible assets being included in a share valuation, such as the speculative or hope value of the shares.

It would greatly assist if the OECD could provide further guidance on how it sees intangible assets valuations being derived from purchase prices. Absent this, we are concerned that tax administrations may seek to overvalue intangible assets relying on the statement as it is, focusing on the gap between purchase price and the value of tangible assets as being the value of the intangible assets.

Paragraph 148

We note that the OECD mentions the use of the discounted cash flow as a useful analytical tool. It would be helpful if an example of such could be provided in an annex as this is frequently used by professional valuers.

Paragraph 156

The OECD may consider amplifying the comments in this paragraph. Generally, there should be a coherence and consistency between the period of the projections and the useful life (lives) of the intangibles over which they are likely to generate cash flows. The OECD might like to make comment that the forecast data should ideally cover the period corresponding to the useful life of the intangible(s).
Paragraph 159

To expand the guidance on growth rates, the OCED may like to consider the notion of attrition rates. It is often the case that the cash flow projections related to intangibles decline over their remaining useful lives.

Paragraph 160

In our experience the discount rate chosen in an intangibles valuation exercise is often the factor that affects the value more than any other. There is a lack of agreement within the valuation profession on the different methods by which this should be calculated currently as base rates may be negative. Such disagreement can give rise to conflict with tax administrations and so some guidance from the OECD in this area would be welcome.

Furthermore, it would be helpful if the OECD could clarify whether the discount rate, if based on a WACC or on a benchmark, should be calculated before tax or after tax. In principle if the cash flow is computed without tax, then the discount rate should similarly be calculated before tax.

Paragraph 164

We note the OECD’s comment that the actual useful life of an intangible is a critical assumption and it can also have a dramatic impact on the intangible’s valuation. Tax administrations tend to consider that in the case of brands there is always a terminal value, which is not obviously so. For example MNEs may change their umbrella brands for strategic reasons and in such cases, terminal values are not relevant and yet there is a trend in valuation practice to systematically apply terminal values without analysis as to their necessity.

If the OECD could suggest criteria for determining whether or not a terminal value should be applied it would be very helpful to reduce tax audit challenges.

Additionally, it would be helpful if the OECD could provide greater guidance in the form of illustrative examples with respect to the approaches to adopt in measuring useful lives depending on the nature of the underlying intangibles, as these may be very different for industrial intellectual property, clientele type of intellectual property, or software related intellectual property, for example.
In the case of highly uncertain valuations, we agree that focusing on what third parties would have done in comparable circumstances is in principle an appropriate approach.

We wonder however, how taxpayers and tax administrations are going to be able to apply this in practice due to the potential lack of persuasive third party evidence. In the circumstances, is the OECD going to consider issuing further guidance in the form of percentage parameters, perhaps, but not necessarily the same as those found in the US’ Commensurate with Income rules?

b. French Specific Comments

i. Transfer Pricing and Valuation matters

Paragraph 21

Given the emphasis of the French fiscal authorities on the importance of customer lists as potentially separable intangible assets, especially in the context of business restructurings, it would be helpful if the OECD could consider adding specific paragraphs to describe and illustrate this asset and the approach to their valuation in this context and for transfer pricing more widely.

Paragraph 114

In the context of the French authorities’ valuation guidelines entitled “L’Evaluation des entreprises et des titres des sociétés” issued in November 2006, the Direction Générale des Impôts (DGI) refers to the use of several valuation methods to value a given asset and proposes the weighting of the various results to derive the value of the asset (ref p66-67).

While the application of several valuation methods appear relevant to derive the value of an intangible asset under certain circumstances, it would be helpful to have an explicit comment with respect to the OECD’s views on the application of a “weighting of results” methodology to derive the value of such assets.

Paragraph 168

In discussing the impact of income tax on projected cash flows, it would be helpful if the OECD could consider and comment on the potential impact of other taxes. For example in France there are turnover taxes for certain industries. There is for instance a specific 1% tax added to the usual income tax for the cosmetics industry.
ii. Taxation matters

**Paragraphs 12 and 57**

The draft is intended to address transfer pricing matters exclusively, concluding for example that Article 12 of the OECD Model Tax Convention has no relevance for determining what should be deemed as an intangible for transfer pricing purposes, although this example is relevant, not only for the Article 12, but also Article 9 or the Article on benefits or royalties or under the other income clauses.

The OECD may like to adapt the wording of paragraph 57, replacing the reference to Article 12 with a reference to “other Articles of the OECD Model Tax Convention”.

**Paragraphs 169 and 170**

The emphasis on a pre-tax basis here may conflict with tax valuation case law, which often determines intangible values on post-tax cash-flows. Applying different valuation methods could result in different prices for similar transactions depending on whether the transaction is undertaken cross-border or not, or may lead to potential divergence in the amount of reassessments, depending on the legal basis chosen by the tax authorities. For example, in France, a cross-border transaction can be reassessed by the tax authorities differently, either for transfer pricing or as an act of abnormal management. For the latter, the tax authorities may apply a post-tax valuation.

Such differences of approach may result in inconsistent tax reassessments of transactions carried out by comparable companies in similar circumstances. The OECD may like to consider the potential implications of this in the next version of the draft.
2. Discussion Draft: Proposed Revision of the Section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines

This guidance seems particularly welcome and well considered.

We have no particular comments to make on it.
3. **Draft on Timing Issues Related to Transfer Pricing**

We limit our comments on this draft to the following:

- In our experience, tax authorities rightly expect taxpayers to make their best efforts to set transfer pricing on an arm’s length basis ex-ante. However, they also expect taxpayers to actively review and monitor their pricing and make adjustments to ensure that ex-post the transfer pricing result continues to be arm’s length, often notwithstanding the fact that such retroactivity is usually absent from third party dealings unless contracts are renewed and renegotiated, which does not tend to happen retrospectively.

In general we consider that the use of an appropriately constructed arm’s length range should be sufficient to demonstrate compliance with the arm’s length principle and perhaps in practice there is less of a conflict of approaches than the OECD seems to imply.

Further we consider that the OECD should not be supporting the regular expectation of ex-post adjustments except where these can be evidenced by third party behavior, or perhaps in the case of limited risk and reward entities.

- Many tax authorities take the approach that any self-assessed upward transfer pricing adjustment to profit on a tax return is evidence of significant non arm’s length behavior, whereas in reality taxpayers making such adjustments are attempting to be most compliant.

It would help shift attitudes if the OECD could encourage compliance in this manner and change tax authorities’ assumptions about the motivation behind such adjustments.

- It can be the case that taxpayers discover issues with their transfer pricing systems after the accounting year in which correcting adjustments can be made, or even after tax returns for the relevant period have been filed.

To encourage compliance and the upholding of arm’s length principles, it would be helpful if the OECD could comment on the acceptability of adjustments in later periods and the avoidance of penalties, provided there are no tax attributes that could affect the amount of tax payable in relation them.
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BACKGROUND

We welcome the publication of the discussion draft of proposed changes to (in fact replacements of) Chapter VI and the Annex to Chapter VI of the OECD Transfer Pricing Guidelines (“the Guidelines”) in respect of intangibles and the invitation for comments. We also welcome the helpful examples in the proposed revision to Chapter VI which illustrate how the provisions of the revised text of Chapter VI would be applied. We appreciate that this is not necessarily a consensus document and that the Committee on Fiscal Affairs has not yet considered the draft. We also recognise that it does not yet represent a complete draft of all the provisions which are expected to form part of the output for this project, in particular:

- any necessary modifications to Chapter VIII of the Guidelines related to cost contribution arrangements that may be made necessary by modifications to Chapter VI;
- the transfer pricing implications of various items which are treated in this draft as comparability factors rather than intangibles, including market specific advantages, location based advantages, corporate synergies and workforce issues; and
- any additional conforming changes to Chapters I-III and Chapter VII of the Guidelines required as a result of the changes to Chapter VI.

We welcome the intention to publish discussion drafts of these additional proposed changes in due course, and the wish of OECD Working Party No. 6 to receive detailed business input with regard to the proposed changes. We note the intention to hold a public consultation on this discussion draft in Paris in the week of 5 November 2012, for which participants will be drawn primarily from those providing timely written comments on this document.

WELCOME FEATURES

We agree with the following draft conclusions of the discussion draft:

- that transfer pricing definitions of intangibles should follow the practice of independent parties rather than accounting or legal definitions, or those adopted for general tax purposes (para 5);
- that important intangibles for transfer pricing purposes are sometimes not recognised for accounting purposes (para 6 - for example, when the relevant development expenditure has been expensed rather than capitalised)
that bundles of intangibles when exploited together may create more value than would be assigned to them by the accounting valuation of each separate intangible (para 6);

that an intangible is something that is not a physical or financial asset and that is capable of being owned and controlled for use in commercial activities (para 5);

that a distinction should be made between intangibles and intellectual property on the one hand and on the other market conditions that are not capable of being owned, controlled or transferred by a single enterprise (para 8). We welcome the clear analysis of the difference between market and other comparability factors (such as cost savings created by group synergies (para 23), location benefits such as low labour costs or proximity to large or affluent markets (para 24) or assembled workforce (para 25) as opposed to intangible assets (also reiterated in para 124);

the conclusion of the discussion draft that it is not helpful to explore categorisations of intangibles (para 13);

that contractual rights and commitments may be intangible assets, including where a company is able to transfer to a second party a contractual commitment by a third party to make available the services of a particular group of uniquely qualified employees (para 26);

that goodwill and going concern should not generally be considered separately as intangibles (i.e. being capable of separate pricing and transfer – para 21), but should instead be considered as part of a business’s total assets when that is the issue in point (as in the example in para 230), and should also be taken into account in the comparability analysis or adjustments – for example, in determining an appropriate royalty when reputation is transferred or shared along with a trademark licence (para 22);

that not all intangibles are valuable and not all deserve separate compensation – for example, a service using non-unique know-how where other comparable service providers have comparable know-how (para 9);

that it should not be assumed that all residual profit from transactions (net of routine returns) should necessarily accrue to the legal owner of the intangibles or the party entitled to the intangible-related returns, if different;

that some bundled transactions involving intangibles should be analysed as a single transaction because the intangibles (and sometimes services) are so closely intertwined (e.g. para 67), as with the examples of a brand in para 19 (where we welcome the analysis of what is meant by the term “brand”), a pharmaceutical product in para 68 and a software licence in para 74;
that where the discounted cash flow method is being used, a range of valuations should be developed based on reasonable variations in discount rate assumptions (para 151);

that a distinction should be made between transactions in which intangibles are used by one or both parties in the controlled transaction for sales of goods or services with no transfer of intangibles on the one hand (para 59), and on the other, situations in which the rights to intangibles are transferred as part of the controlled transaction (para 62); and

confirmation of the principle that associated enterprises do not necessarily organise their affairs in the same way as independent parties (e.g. para 78).

AREAS OF POTENTIAL CONCERN

We see certain areas in which further clarification might, however, be helpful, as follows:

regarding goodwill and going concern, further clarification may be needed as to when these can be given a value as intangible assets and when they cannot (we note the intention that reference should be made to transactions in which unrelated parties transfer goodwill and make payments for it). Guidance is also needed on how any such valuations are to be made;

similarly, while it appears that the intention of the draft guidance in para 26 bullet two is that where company A can offer company B company A’s assembled workforce this should be viewed as increasing the price which company B might pay for the transaction, but does not represent an intangible asset, this needs to be clarified;

with regard to “economic ownership” of intangibles, the proposal (box, page 12 and paras 29 and 39) is that the entitlement to intangibles-related returns should be allocated according to the performance (including having the requisite capability and capacity), control and (when outsourced to affiliates or third parties – para 40) the oversight and management responsibility of the important functions related to the development, enhancement, maintenance and protection of the intangible (and bearing the necessary cost and risk thereof). While the discussion draft explicitly takes guidance from Chapter IX of the Guidelines on control over functions and risks (e.g. references to paras 9.23 to 9.28 and more generally paras 9.10 to 9.46), it may be that the “significant people function” concept of the Authorised OECD Approach to profit attribution to permanent establishments is being implicitly adopted here in a way that was not intended by the OECD in developing and promulgating that approach (notwithstanding the use of the term “important” (e.g. in para 54) rather than “significant” in the discussion draft). We are also concerned that the reality of legal ownership combined with the bearing of the costs of intangible development is to be ignored too readily in favour of a hypothetical situation in which these are deemed to lie with the party that performs certain functions (i.e. re-characterisation as opposed to re-pricing). As noted
eventually in para 53, this is meant to happen only in exceptional circumstances;

- there might be a risk that para 177 as drafted (and see also the examples culminating in paras 265 and 268), which permits a tax administration to assume that independent parties “would have” included a price adjustment clause or would have renegotiated a contract, may be interpreted by a tax administration as providing a greater opportunity to use hindsight than is probably intended (the argument potentially becoming tautological, e.g. “the marked change in profitability proves that profitability was unpredictable and therefore that a price adjustment clause would have been inserted”). While a variable consideration might indeed represent the arm’s length position, this should be established by reference to conditions at the outset of the arrangement, i.e. firmly rejecting the use of hindsight;

- we are concerned that a form of “bright line test” is suggested (at the end of para 51 and in the examples in paras 197-201 and 209-212) in order to evaluate whether or not a party has borne costs or risks or performed functions disproportionately compared to independent parties. This, and in particular that the sales company could receive a profit split in recognition of its “entitlement to intangible related returns” in paras 200 and 212, appears to run counter to the current stance of the OECD on “safe harbours”;

- the guidance that options realistically available to both parties “must” be considered (paras 80 and 81) is perhaps too strong for every transaction involving intangibles – there are many straightforward licensing arrangements between related parties;

- similarly, while the discussion draft advises that discount rates used in valuation analyses should reflect the risks associated with the discounted cash flows (para 161), rather than say using the company’s weighted average cost of capital, more guidance may be needed as to how these discount rates should be determined. This could perhaps take as its starting point the analysis of risks in para 102;

- it is also recognised that some intangibles that have a finite life may nevertheless contribute to the creation of non-routine profits by future intangibles (para 166) and that the valuation of such intangibles should take this into consideration. Guidance could be helpful on how this should be done;

- the suggestion in para 170 (and see also the example culminating in para 258) that there should be a consideration of “how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee” could as worded give carte blanche to a tax administration to assess tax on a deemed higher sale price when intangibles are migrated to a lower tax jurisdiction. It is true that in some contexts unrelated parties take account of relative tax treatments, a classic case being where an asset transfer carries with it a deferred tax liability for the buyer if effected in one form or, if effected in
another way, leaves a tax charge with the seller; these different transactions would be priced differently. However, in many cases there will be no alternative forms of transactions. If the suggestion is that the different tax rates faced by the seller and the buyer in their discounted cash flow calculations might cause them to evaluate a transaction differently, how would one calculate a hypothetical arm’s length price when faced with a hypothetical universe of buyers?; and

- notwithstanding the conclusion that an intangible is something that is not a physical or financial asset and that is capable of being owned or controlled for use in commercial activities (para 5), the discussion draft states (para 7) that the existence of legal, contractual or other forms of protection is not a prerequisite for an item to be characterised as an intangible for transfer pricing purposes. This begs the question of how such an asset can be “owned or controlled”. We note the example given in para 16 that know-how and trade secrets may sometimes be protected by economic and technological barriers to entry but question how common this situation would be. (On the other hand, it is clear that know-how and trade secrets can be protected by non-disclosure and confidentiality agreements, in which case they would be clearly “owned or controlled”).
Dear Mr. Andrus,

Discussion draft revision of the special considerations for intangibles

We welcome the opportunity to comment on the discussion draft version of the revised Chapter VI of the OECD Guidelines issued on 6 June 2012 by the Secretariat of Working Party No 6. We are appreciative of the significant work and accomplishments of WP6 on this very difficult but important matter. This letter sets out our comments in detail.

A. Identifying Intangibles

The discussion draft rejects a legal definition of intangibles in favour of a more-general definition. There appears to be a considerable consensus among WP6 members in that regard. However, if the current definition depends on the field of economics for guidance, it is problematic. There is insufficient guidance in the economics literature that either consistently defines intangible assets, or that explains (1) how intangibles are used as inputs, (2) what role these inputs play in production or production functions, or (3) how intangible assets influence revenue or profit.

We conducted a reasonably thorough search of the economic literature. We uncovered no authority akin to, for example, Dr. Charles Berry’s work (e.g., the Berry ratio) by which the field of economics addresses intangible asset definitions. It follows that if Chapter VI adopts a general definition like the one proposed in the discussion draft, the definition lacks economic discipline, traditions, research, peer review, or authority.

Nevertheless, OECD member states, in setting prices and resolving disputes, will lack a clear, concise, and well-defined foundation by which to consider the relative ‘economic’ importance of functions, risks, market conditions, geographies, contractual terms, and other relevant factors. This concerns us greatly, as it mirrors the status quo and ‘standard operating procedures’ of daily transfer pricing discussions and analyses with some tax authorities. But isn’t advancement (not status quo) the goal of the revised guidance? And if the OECD
consensus definition survives as it currently appears in the discussion draft, the status quo will become codified in local country law. The result will be more controversies, some of which will be resolved via litigation (and perhaps ironically, under legal standards, procedures, and precedent) as transfer pricing disputes percolate from discussion and mutual negotiation to courtroom litigation. We will consequently wait some years for legal definitions from jurisprudence that will inevitably differ across countries. In this connection, a tremendous opportunity passes by to set international standards and diminish the overall number of unresolved transfer pricing controversies.

Fundamentally, multinationals identify and define intangible assets in the context of law, accounting, finance, and commercial business transactions. And the same multinational enterprises that develop, own, protect, and exploit intangibles, are those who meet face-to-face with tax authority representatives on audit and MAP matters. How is it then, that these multinationals - with their real-world legal, accounting, financial, and business experiences and language - can fully comply (and avoid or resolve any disputes) with transfer pricing rules, policies, and procedures, when the guidelines that the tax authorities utilize rest upon vague concepts and the language of false authority - 'economic' and 'economically' - in revised Chapter VI? We urge WP6 to reconsider its definition, considering the unwelcome prospect of increased disagreement if Chapter VI is written in a language that excludes taxpayers.

Moreover, the phrase ‘capable of being owned or controlled’ in paragraph 5 may create uncertainty in definition. Again, there is no help available from the field of economics on the question of ‘capable of being owned or controlled’. We understand that the standard to be applied in making this determination must be empirical, given that paragraph 5 refers to conditions either observed in actual comparable transactions or those that ‘would be agreed upon’ by independent parties in a hypothetical comparable transaction. In the case of an actual potentially comparable transaction, however, comparable transactions are generally those transactions that are recognized from a legal and commercial standpoint. The current broad definition of intangible assets presumably would open the door to a large number of hypothetical "comparable" transactions that do not see the light of day because they do not, and cannot, occur from a legal, financial, accounting, or commercial standpoint. Our resulting concern is the dim prospect of success when searching for non-existent empirical information (contracts, agreements, real-world business transactions) by which to guide multinationals and tax administrations in determining comparable transactions (and eventually arm’s length transaction norms and values) for intangibles purportedly defined or informed by the field of economics.

It is clear that an intangible asset only exists where legal protection is possible and the asset may be separately transferred in commercial transactions. We agree with the classification of market characteristics, synergies, and assembled workforce as comparability factors and not intangible assets. This brings greater certainty to multinationals when planning related-party transactions, which is a favourable development. But we disagree with the discussion draft’s definition of goodwill as an intangible for transfer pricing purposes in paragraphs 21 and 22. We will pick up the topic of goodwill as an intangible in the context of Section D.
Paragraph 11 guides multinationals in enhancing their transfer pricing documentation for the purpose of identifying intangibles (under the broad definition) and the means by which intangibles (broadly defined) create value for the organization. We would appreciate more-specific documentation guidance, in view of the expected increased documentation burden on taxpayers. Ideally, this more-specific guidance would advance the overall goal of simplifying certain aspects of transfer pricing compliance, thus increasing compliance via completeness of a taxpayer’s transfer pricing documentation.

Finally, the discussion draft abstracts from certain undefined but commonly-used terms such as ‘routine’ and ‘non-routine’. These terms have become part of the transfer pricing vernacular. For example, the term ‘routine’ is used in Annex II to Chapter II of the current OECD Guidelines, and is a well-defined concept in the context of the applying the profit split method. The term ‘premium’ is used in the context of financial return to intangible asset use in paragraph 9 – a synonym for that term in our view may well be ‘non-routine’. We would appreciate incorporating and if necessary further defining the term ‘routine’ as it is useful in quantifying the extent of the intangible return to which a related party is entitled. While this may amount to a request for a list of standard business intangibles and an enhancement of section A.4, such a list could be drawn up within the current sub-types (i) through (v) of Section A.4.

B. Identification of Parties Entitled to Intangible Related Returns

32 We are concerned with the last sentence in paragraph 32, which suggests that an intangible may be valuable even when use rights cannot be restricted by the developer or owner.

35 The wording in this paragraph appears to suggest that the Licensee is entitled to all intangible related return in respect of its licensed rights, even though the definition of intangible related return in paragraph 28 contemplates ‘business operations’ as the source of the intangible related return. This also contradicts the description of patent ownership rights in a specific geography in paragraph 15. It may be implied in this example that the licensor is receiving a portion of the “intangible related return” through the receipt of an arm's length license fee. However, this example should be more explicit in suggesting that either the owner of the intangible (the licensor) should be acknowledged as also entitled to part of the intangible related return (as this is defined in paragraph 28) in paragraph 35, or separate acknowledgement of the entitlement of intangible asset owners to intangible related returns should be added.

36 We agree with the guidance urging multinationals to document decisions concerning the allocation of rights amongst related parties. This will be particularly useful in establishing facts and intent of the contracting parties during tax authority audits.
C. Transactions involving the use or transfer of intangibles

61 The last sentence omits any comment on whether the intangibles used in performing services affect the value of the services. The concept of contribution to output value by employed intangible assets is acknowledged in paragraph 60 (which relates to tangible property transfers), but not in paragraph 61.

62 It may be helpful to indicate that certain normal business activities do not constitute a transfer of an intangible asset, or are not normally connected with transactions in which an intangible asset is transferred.

63 With regard to identification of rights transferred in a controlled transaction and the limitations placed on those rights, the identification requirement proposed is absolute and too broad. Identification should be thorough, but somehow we need to acknowledge that the level of observable terms in the market has a limit. To the extent we are not able to compare terms in a controlled transaction with terms in an uncontrolled transaction due to a lack of information on uncontrolled transactions, a practical solution must be found. This solution is acknowledged in paragraph 1.54 of the Guidelines. 1.54 also allows that certain terms may not be observable in the market via written agreements. This unqualified requirement causes concern as to the level of documentation required by taxpayers that participate in related-party intangible asset transactions. Given the proposed definition of an intangible asset in Section A, some concern arises over an increased documentation burden.

65 There is a contradiction between the interpretation of paragraph 1.52, which refers to a forward looking agreement in the future tense, “are to be divided”, and 6.64, which appears to contradict this reference to the intent of related parties when it allows that agreement terms “need not be respected by the tax authority if such specification is not consistent with the conduct of the parties”. We would welcome a reiteration of the point made in several places elsewhere in the guidelines that non recognition or recharacterization should be done in extreme cases only.

68 The meaning of the word “securing” appears unclear, as is the meaning of the term “value creation”. We find the last sentence confusing, and suggest it may not be needed. Depending on these meanings, we would ask that WP6 review paragraph 68 and consider replacing these terms to clarify meaning.

73 We find this to be a very ambiguous paragraph. The starting point for a decision concerning how and when segregation of intangibles would be required should be the actual arrangements entered into by the parties.

The paragraph appears to provide license to a tax authority not only to engage in unbundling of transactions for the purpose of determining an arm’s length transfer price, but to justify a yet higher value of unbundled intangibles through unexplored and complex cross-effects described as “interactions between various intangibles and services”. The last sentence should either be omitted or qualified by a definition of “interactions”.
Comments on Examples Illustrating the Provisions of Chapter VI.C

In general, these are broad transactional examples that could perhaps be factually narrowed to illustrate a particular point in Section C.

Example 12 We wonder if the rights of Primarni be the same if Company S had either (1) funded patent infringement suits in Asia and Africa, (2) paid to register the product in Asia and Africa but not country B, or (3) paid to market and re-brand the product in Asia and Africa for sale in a different market (where people do appreciate X’s colour and celebrity endorsement (created and paid for by Company S) more than its clever design) and sustained start-up losses while the distributors earn fixed margins? We think this is not likely. The example is perhaps overly narrow and ignores other important functions performed by owners of intangible assets.

Example 13 We cannot agree with this conclusion. Paragraph 230 states that Ilcha and not Company S developed “substantial goodwill and ongoing concern value” in country B. Company S should therefore pay nothing to Ilcha for the licensed right to use the intangibles in country B. Company S cannot logically sell an asset that it neither developed nor owned.

Example 14 We believe Company S has transfer pricing problems other than its purported illegitimate claim to a return to goodwill. Goodwill is not a valuable intangible asset, and has no meaning in the context of the related party transaction illustrated by this example. This example might more appropriately be added to Chapter IX, leaving out any mention of goodwill.

Example 15 If we retain the premise that this example has as its purpose the illustration of a principle or point of guidance set out in Section C, the only seemingly relevant portion of this example is the first sentence of paragraph 238.

This appears to be a tale of an overpriced acquisition, a poorly executed purchase price allocation, or perhaps both. The “value does not disappear, nor is it destroyed, as part of an internal business restructuring” statement tends toward a law of physics that is unwelcome in this field. The opposite is however apparently true – value is created during M&A transactions (external business restructurings). This example itself assumes $80 of business value was created as goodwill as a result of an acquisition.

Example 16 This is a very useful example.

Example 17 A good example. Highly relevant to Section C guidelines.
D. Determining Arm’s Length Conditions in Cases Involving Intangibles

83 We are generally in agreement with the incorporation of the concept of realistically available options, but would suggest that for the purpose of this paragraph the term ‘feasible set of expected outcomes’ may help make the point more clearly. We agree it is correct to say that ‘MNE groups seek to optimise resource allocations’, but it is equally correct to say that not all MNE groups achieve this goal. We would favour an amendment to this paragraph that acknowledges an MNE may not always find matches in the feasible sets of expected outcomes of transacting related parties, but should clearly explain in a functional analysis the circumstances and strategies that cause temporary departures from optimal allocations of resources.

85 The fourth sentence in this paragraph is somewhat confusing, suggesting that a tax authority may make a determination of intangible presence and use in the business of a ‘less complex’ party and as a consequence allocate the entire ‘intangible related return’ as this term is defined in Section B to the tested party. It is here that a concept of ordinary or routine intangible assets may be useful to make (what we believe at least) is the intended point. The suggestion that the entire intangible related return to accrue to the tested party appears to us to be out of line with guidance elsewhere in the Guidelines and the discussion draft.

101 On the topic of assessing the expectation of future benefit, we prima facie agree that this comparability factor is important to consider and assess and that effort should be made to evaluate this factor whenever possible. The practical problem one tends to encounter when assessing this comparability factor is the availability of information necessary to measure profit potential, especially when using the CUP method and referencing agreements for comparable data. We would ask that WP6 consider a reasonableness standard to apply to the assessment of this intangible asset attribute.

109 This paragraph neglects to include the cost and market approaches to financial valuation, both of which are well established techniques and serve to either provide a means of valuation where data required to apply one or more of the other approaches is not available. Other approaches are useful for the purpose of corroboration. We are concerned that over-emphasis of the income-based approach may result on tax authority over-reliance on this approach to the exclusion of other feasible approaches.

110 We feel that the statement in the last sentence is too strong, as reasonably applied valuation techniques applied in accordance with professional standards is not worth of this devaluation. We understand the WP6 concern over accounting valuation bias, but believe that guidance elsewhere in Section D is sufficient to hold a valuation performed for a reason other than estimating the value of an intangible asset transfer to a sufficiently high standard. While it may be necessary to revisit a prior valuation for transfer pricing purposes and verify the validity of certain assumptions, it would in our view be regrettable if Chapter VI imposed an additional layer of valuation process and cost on multinational businesses.

More specifically, we are unsure of the meaning and implication of the term “definition” in the
fourth sentence of this paragraph. We think perhaps the word “purpose” might better convey the intended meaning.

Similar views apply equally to the definition of goodwill as to the stated limited utility of a purchase price allocation. If recognized valuation techniques are applied by appropriately qualified professionals and assumptions are clearly stated and properly applied, we see no practical need to define goodwill as an intangible asset. We do not accept that an accounting concept such as goodwill should have a meaningful bearing on the determination of the value of a separately identifiable intangible asset.

112 Whereas the cost approach to valuation is recommended to be avoided, our experience indicates that the pricing of intangible assets between independent parties often references the cost of development and a particular rate of return. We would encourage WP6 to verify that the use of the cost method is not used between independent parties before concluding its guidance in such definite terms.

116 We are in agreement concerning the guidance concerning rules of thumb, but ask that some consideration be given to the use of properly documented and supported industry norms in independent transactions as a means to determine a price or the allocation of intangible related returns.

138 Some clarification on the usefulness of purchase price allocation analyses (and allocations often agreed between independent parties) in the context of using ‘the price paid’ to value an immediate intangible asset sale is needed in our view. The strong position in paragraph 110 appears to be at odds with this guidance.

143/144 These two paragraphs appear to deal with a fact pattern better handled by Chapter VIII and a cost contribution arrangement in general.

166 We are unsure of the meaning of the term ‘nonroutine returns’ that are described as attributable to intangible assets. A definition of this term in the context of an intangible asset is required, especially in view of the consistent use of the term ‘intangible related returns’ throughout Section D and the stated preference of the discussion draft to avoid reliance on categorizations such as ‘routine’ or ‘non-routine’.
**Concluding comments**

We appreciate the opportunity to contribute our comments and sincerely hope that our remarks will help WP6 move the draft forward to a point of consensus. It has been particularly helpful to be able to keep track of the emerging areas of discussion in your public comments throughout the consultation period. This enhanced communication has in our view helped focus commentary from business on those areas where work has yet to be done by the Working Party.

We wish WP6 well in the next stages of the project.

Yours sincerely,

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September 20, 2012

Mr. Joe Andrus  
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Sent via e-mail: joe.andrus@oecd.org  

Re: Discussion Draft - Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions  

Dear Mr. Andrus,

The International Bar Association would like to take this opportunity to comment on the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world’s top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.  

We are submitting our comments on behalf of the IBA Taxes Committee which has 1037 members from around the world. This committee formed a Working Group to respond to this Consultation which consisted of tax practitioners in the Netherlands, Italy, Spain, Brazil, USA, Canada and France.

The comments made in this report are the personal opinions of the Working Group members and should not be taken as representing the views of their firms, employers or any other person or body of persons apart from the IBA Taxes Committee of which they are a member.

The comments are enclosed with this letter.

Sincerely yours

Claire Kennedy  
Co-Chair of the Working Group  
IBA Taxes Committee  
Canada

Xenia Legendre  
Co-Chair of the Working Group  
IBA Taxes Committee  
France
INTRODUCTION

The IBA Taxes Committee commends the work of the OECD and Working Party 6 in preparing the proposed revision to Chapter VI of the TPG "Special Considerations for Intangibles" and related texts (the "Draft").

The IBA Taxes Committee has decided to focus its comments and suggestions on the issue of the identification of parties entitled to the intangible related return. In general, our comments follow the ordering of Section B of the Draft and, where we make comments on specific paragraphs or sections thereof, we quote in italics the relevant provisions of the Draft for ease of reading.

In summary, the IBA Taxes Committee finds that the approach taken by the Draft does not give sufficient weight to the capital deployed as opposed to the personnel involved nor does it give a sufficiently clear priority to legally binding agreements in determining the party entitled to returns from intangibles of the intangible owner. The IBA Taxes Committee also believes that where legally binding and properly documented intercompany service arrangements have not been compensated on arm's-length terms, transfer pricing adjustments for these particular service arrangements (which we acknowledge may be material) should be made as opposed to treating the service provider as the party entitled to the residual returns from intangibles, which amounts to a recharacterization of the ownership of the intangibles. Remedying non-arm's length pricing of intercompany service agreements by recharacterizing ownership will, in our view, result in less certainty and give rise to more involved and costly disputes for both taxpayers and tax administrations. This is especially true given that the approach espoused in the Draft is also inconsistent with the approach of courts in many jurisdictions, which under current law look to legally binding agreements, absent sham.

The combined impact of the Draft provisions, including the lack of weight accorded to capital providers and, the willingness to set aside legally binding agreements that are currently respected in practice, the "remedy" of attributing intangible returns to service providers rather than adjusting the transfer price for intangible related service, appears to us to be inconsistent with many existing R&D outsourcing arrangements entered into by MNEs with third parties, which reflect a variety and extent of business function outsourcing among arm's length parties that do, in fact, preserve for the provider of capital most intangible returns.
COMMENTARY ON THE DRAFT

1. List of factors to determine the owner of the intangible related returns

Paragraph 29 of the Draft indicates the factors which will be considered in determining which members of an MNE group are entitled to intangible related returns:

"...(i) the terms and conditions of legal arrangements including relevant registrations, licence agreements, and other relevant contracts; (ii) whether the functions performed, the assets used, the risks assumed, and the costs incurred by the members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns in the relevant registrations and contracts; and (iii) whether services rendered, in connection with developing, enhancing, maintaining and protecting intangibles, by other members of the MNE group to the member or members of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm’s length basis under the relevant circumstances."

Comments:

- Our general impression is that the framework that is provided in paragraph 29 draws heavily on economic principles and rather quickly departs from the legal arrangements to focus on the certain ambiguous economic factors. We want to emphasize that absent fundamental inconsistency between the contributions of the parties and the legal agreements, legally binding agreements should be accorded great weight in the transfer pricing analysis and that there should be a significant threshold that needs to be passed before the second factor and, subject to our comments below, third factor become relevant in determining which party is entitled to the intangible related returns. While we recognize that a purpose of the OECD initiative may be not just to clarify existing rules to revise them, we do note that it is our experience in practice that in the context of litigation under the existing rules, legally binding agreements that are not shams will be respected by judges in various member countries and will not be set aside in favour of the economic approach similar to that espoused by the Draft. In this respect, we refer, inter alia, to paragraphs 1.46 – 1.51, 1.64 – 1.69 and 9.21 TPG.

- We believe that the third factor referred to in Paragraph 29 should not be considered in this Chapter as one of the factors to determine the owner of the residual returns, and that the reference to intangible related returns, without further discrimination as to levels of intangible related returns, may imply that. Certainly, services that are provided by members of a MNE group to other
members of that group that are entitled to intangible related returns should be compensated at arm’s length. However, the presence of the third factor in this Chapter means that cases in which transfer pricing methods were applied incorrectly (e.g. where a distributor incurred "excessive" marketing expenses) might be remedied by way of a (future) allocation of entitlement to the residual intangible related returns with extremely far-reaching consequences and uncertainty as opposed to a (certain) direct transfer pricing adjustment. The net effect is to make ownership returns dependent on the pricing of a service transaction, resulting in circular analysis and attendant uncertainty that we believe is illustrated by the problem we highlight in our discussion of Example 11 (below).

- We also draw your attention to the decision of the Supreme Court of Canada in Canada Trustco Mortgage Co. v. Canada, 2005 DTC 5515. While this case addressed the Canadian domestic general anti-avoidance rule (GAAR), we consider it relevant in this context. In particular, the Canadian transfer pricing rules in the Income Tax Act contain their own GAAR; moreover, the Draft appears to address what the OECD considers abusive transfer pricing arrangements. The Court stated (at 5533):

  "A proper approach to the wording of the provisions of the Income Tax Act together with the relevant factual context of a given case achieve a balance between the need to address abusive tax avoidance while preserving certainty, predictability and fairness in tax law so that taxpayers may manage their affairs accordingly."

- In our respectful view, for the reasons elaborated in this submission, the Draft fails to preserve certainty, predictability and fairness in determining the party entitled to intangible returns as it ought to do if it is to be workable both for taxpayers and tax administrations.

2. Functions, risks, and costs related to intangibles

Paragraphs 37-47 of the Draft focus on the functions performed, risks incurred and assets used in relation to the intangible assets and the consequences thereof for the determination of the entitlement to intangible related returns.

Comments:

- In our view, the role of capital required to fund the activities that are performed for the development, enhancement, maintenance, and protection of the intangible property is understated in the Draft. In addition the principles espoused in this part of the Draft parallel the contents of the 2010 report on the attribution of profits to permanent establishments ("2010 PE Report"). For the reasons set out below, we do not believe that the entitlement of a separate legal entity to
intangible related returns should follow principles analogous to those governing the allocation of profits to a permanent establishment.

- **In paragraph 85** of the 2010 PE Report, the following is stipulated in relation to the determination of the economic ownership of internally created intangibles:

  "the significant people functions relevant for the determination of the economic ownership of internally created intangibles are those which require active decision making with regard to the taking on an management of individual risk associated with the development of intangible property."

- **In paragraph 91** of the 2010 PE Report, it is further stated that:

  "Again consistent with the position taken in Parts II-IV for creating financial assets, an assertion that one part of the enterprise has the capital necessary to support the risks of development would not be a relevant factor. As already noted, capital follows risks and not the other way around so the part of the enterprise found to be the economic "owner" of the intangible property would be allocated the free capital necessary to support the associated risks..."

- As we stated above, in our view the allocation of risks to a permanent establishment is not analogous to the determination of which separate legal entity in an MNE is entitled to intangible related returns. Unlike a permanent establishment, a company does or does not have capital to support its risks. Although the functions performed while developing, enhancing and maintaining and protecting the intangible are crucial for creating and maintaining the value of the intangible, the capital needed to perform these activities is in our view just as crucial or even more important in a world where you can buy everything (researchers, people managing researchers, directors instructing managers) if you have funds available. There are examples in the pharma industry of extensive outsourcing to third parties – see, for example, Albany Molecular Research Inc. (AMRI), which advertises itself as a "global contract research and manufacturing organization offering customers fully integrated drug discovery, development and manufacturing services" (www.amriglobal.com) and Evotec, a listed company that offers an "integrated approach, with all aspects of [the client's] project being managed by experienced scientists" (emphasis added) (www.evotec.com).

- We acknowledge that the "price" of the people performing these "controlling functions" may be substantial but we do not agree that it necessarily represents the main component of the value of developed intangibles nor that the proper manner of compensating it is entitlement to the intangible related returns as opposed to arm's length compensation for the service (which may or may not be an entitlement to share in the intangible related return as an owner would).
• We also note that the Draft appears to go much further than, and may even be inconsistent with, paragraphs 9.29 to 9.32 TPG, which acknowledge that if a party does not have the financial capacity to bear the associated risks, it may not be appropriate to allocate related risks to that party. In this respect, we note that Grant Thornton also raised the question of to what extent guidance analogous to paragraphs 9.29 – 9.36 should be useful in resolving uncertainty over the allocation of the right to premium returns associated with intangibles for TP purposes during the fourth OECD meeting on IP ownership issues.

• We also draw your attention to section 1.482-1(d)(3)(ii)(B) of the US Treasury Regulation, in which it is stated that the following facts are relevant to whether an allocation of risks between controlled parties lacks economic substance:

"- whether the pattern of the controlled taxpayer’s conduct over time is consistent with the purported allocation of risk between the controlled taxpayers;
- the financial capacity of the taxpayer to fund losses that might be expected to occur as the result of the assumption of a risk; and
- the extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influences the amount of income or loss realized."

Paragraph 42 of the Draft states that:

"Where the conduct of the parties is aligned with the terms of the relevant registrations and contracts, the member or members of the MNE group entitled to intangible related returns will bear and control the risks associated with the development, enhancement, maintenance and protection of the intangibles."

Comments:

• We do not agree with the Draft's statement that a member of an MNE group that is entitled to the intangible related returns must use its own employees to conduct the functions described in this paragraph, but rather believe that these functions can be outsourced under service agreements on arm's length terms and conditions, at least if the contracting group member is an entity with personnel capable of monitoring, evaluating and making high level decisions concerning the development process (as the example of the pharma outsourcing companies highlighted in the discussion above illustrates).

• Again, we have the impression that the analysis of the arm's length nature of the risk allocation for the purposes of determining the owner of the intangible related returns erroneously follows the principles for risk allocation in the context of attributing profits to a permanent establishment.
We urge the OECD to reconsider the role of capital in this context and to (more) clearly address the relevant distinction that there is between a permanent establishment and an enterprise.

Paragraph 47 of the Draft states that:

"It is important to recognise, however, that bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns."

Comments:

We agree with the notion that bearing costs alone may not be sufficient to justify intangible-related returns. We believe that indicia of legal ownership, supported by exercise through personnel of at least some level of control over the intangible, that is normal to such ownership, are also critical. That is very different from an approach that minimizes the significance of legal ownership and control and instead focuses on particular functions that may have instead been outsourced to a third party.

3. Arm’s length compensation for functions performed by associated enterprises related to the development, enhancement, maintenance or protection of intangibles

Paragraph 48 of the Draft states that:

"One condition for concluding that the contractual and other arrangements of an MNE group related to entitlement to intangible related returns are aligned with the conduct of the parties is that associated enterprises that perform functions related to the development, enhancement, maintenance or protection of intangibles, but do not claim entitlement to intangible related returns, be provided with arm’s length compensation for the functions they perform."

Comments:

We fully agree with the concept of arm’s length compensation for any services performed intragroup. However, as indicated with respect to paragraph 29 of the Draft, we do not agree that the provision of intangible related services should be an essential factor in determining which party is entitled to intangible related returns in the sense that an owner of the intangible would be, and, in particular, that the consequence of non-arm’s length remuneration of such services is an entitlement to the return thereon (i.e., qua owner).
Paragraph 51 describes the situation where a distributor bears the costs of its marketing activities. It states that:

"In general, in arm’s length transactions the ability of a party that is not the registered owner or legal owner of trademarks and related intangibles to obtain the benefits of marketing activities that increase the value of those intangible will depend principally on the substance of the rights of that party...in some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those of an independent distributor with similar rights might incur...An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles, perhaps through a decrease of the purchase price for the product or a reduction in royalty rate in order to compensate it for its functions, assets, risks and costs."

Comments:

- The contents of these paragraphs are consistent with the contents of the current paragraphs 6.36 through 6.38 TPG, which provide that excessive marketing expenses do not lead to entitlement to intangible related returns, but should be compensated at arm’s length by the owner of the intangible, for example through a decrease of the purchase price or a reduction of the royalty rate. We also draw the OECD's attention to paragraph 6.39 TPG that identifies certain key questions that must be considered in order to determine the amount of any compensation that should be attributable to the distributor's marketing activities and we encourage the OECD to elaborate on these in the Draft.

- Consistent with the views we have expressed elsewhere, we believe that so-called "excessive activities" performed by distributors (i.e., companies not owning the intangible assets) should ordinarily be treated as service to the owner of the intangible assets, which should be compensated at arm’s length, and absent a legal agreement to share of the intangible returns, should not lead to entitlement to the residual return from an intangible, unless that is the only return that would satisfy the arm's length standard (which we do not believe will normally be the case).

- We also wish the draw the OECD's attention to the approach certain courts and tax authorities have taken which is consistent with the approach we espouse and we refer specifically to the following by way of illustration:

  - the judgement of the Delhi High Court in Maruti-Suzuki India Ltd. v. ACIT-CW 6876/2008 [2010] INDLHC 3063 (1 July 2010), in which it is concluded (at para. 84) that:

    "viii. The expenditure incurred by a domestic entity, which is an Associate Enterprise of a foreign entity, on advertising, promotion or marketing of its products using a foreign trademark/logo does not require any payment or compensation by the owner of the foreign
trademark/logo to the domestic entity on account of use of the foreign trademark/logo in the promotion, advertising and marketing undertaken by it, so long as the expenses incurred by the domestic entity do not exceed the expenses which a similarly situated and comparable independent domestic entity would have incurred.

ix. If the expenses incurred by a domestic entity which is the Associate Enterprise of a foreign entity, using a foreign brand trademark and/or logo while advertising, marketing and promoting its products, are more than what a similarly situated and comparable independent domestic entity would have incurred, the foreign entity needs to suitably compensate the domestic entity in respect of the advantage obtained by it in the form of brand building and increased awareness of its brand in the domestic market."

➢ Paragraphs 500 – 508 TPG of New Zealand, in which it is stated that:

"if the subsidiary incurred expenses that are significantly larger than would independent firms under similar circumstances, expenses incurred in excess of the level incurred by independent firms should be treated as a service to the owner of the intangible (i.e. Gizmo Co), as they effectively represent a service adding to the value of owners intangible property".

4. Disregarding transactions, registrations and contracts

Paragraph 53 of the Draft states that:

"In the extraordinary circumstances described in paragraphs 1.64 – 1.69, contractual allocation of entitlement to intangible related returns may be disregarded by tax authorities notwithstanding the fact that the registrations and contractual entitlement are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles."

Comments:

• If the registrations and contractual entitlement are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles, we see no basis for a transaction to be disregarded. We do not believe that paragraphs 9.164 – 9.167 provide clear guidance on which extraordinary circumstances have to be considered in this respect and we urge the OECD to provide clear examples for such situations in this Draft. (In this respect, we also refer to our comments on Example 11.)
5. Transfer pricing adjustments in cases involving entitlement to intangible related returns

Paragraph 54 of the Draft provides a summary of the guidance on the issue as to when a member of an MNE group should be entitled to intangible related returns. It is indicated that:

"...for a member of an MNE group to be entitled to intangible related returns, it should in substance:

- Perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an at arm's length basis;[emphasis added]

- Bear and control the risks and costs related to developing and enhancing the intangible; and

- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns."

Comments:

- As stated previously, it goes without saying that parties that perform functions in relation to the development, enhancement, maintenance and protection of the intangibles should be compensated at arm’s length. If this is not the case, then a transfer pricing adjustment (which may include premium or nonroutine returns) should be made. However, no shift of the entitlement to intangible related returns that remain after such adjustment should be inferred from that. We believe the words in bold in the first bullet should be deleted as misleading.

- We further want to emphasize that in our view it should be possible to subcontract many of the functions that are mentioned in this summary and therefore that it should not be necessary that these functions be performed by the employees of the member of the MNE entitled to the intangible related returns. This should be explicitly mentioned together with the comment on the arm's length compensation for such outsourcing.
6. Examples

We welcome the examples that have been provided in the Annex to Chapter VI that illustrate how the contents of the paragraphs 30 until 55 should be dealt with in practice.

We would like to comment specifically on Example 11.

In our view, Example 11 illustrates the insufficient emphasis that the Draft places on the provision of capital (vs personnel) in determining which related party in an MNE is entitled to intangible related returns (refer to our comments on paragraph 37, above). It also illustrates the perils of the recharacterization approach espoused by the Draft in establishing arm's length transfer prices for separate transactions among MNE members.

In particular, the Example does not address the return to which Company T is entitled other than to conclude it is not entitled to intangible related returns. This Example effectively ascribes no explicit value to the purchase of the patents and other intangibles by Company T (for arm's length remuneration as assumed in the example) and to its bearing of the financial risk of R&D going forward. We find it hard to imagine that an arm's length party would pay a material amount for intangibles and undertake future financial risk associated with the further development thereof for no intangible related return from their further development.

In fact, the conclusion in the Example, that Shuyona is entitled to the intangible related returns and not Company T begs the question of what the "arm's length" compensation that Company T provides to Shuyona should be. The Example thereby illustrates the circular reasoning inherent in the recharacterization approach arising from the fact that the pricing of these transactions is now interdependent. In effect, the Example is stating that pricing for Company T in these circumstances cannot be made on a basis corresponding to a party acting at arm's length and so it in effect should not be treated as the owner of the intangible. Such an approach will increase – not diminish – uncertainty in intangibles transfer pricing, which will almost certainly lead to more frequent and more protracted disputes between taxpayers and tax administrations thereby raising the cost of tax administration for all parties.

In our view, these problems arise because the Example (and the elements of the Draft it is intended to illustrate) fail to give adequate weight to the supply of capital by Company T and to the legal agreements entered into by the parties and we do not agree with the conclusion. We request that the Example be withdrawn and the Draft revised accordingly.
REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

Comments submitted on 28 September 2012 by ICAEW Tax Faculty in response to the OECD Discussion Draft on the above subject published on 6 June 2012

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Appendix 1
INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions published by OECD on 6 June 2012.

2. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty’s Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

3. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW’s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

4. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

5. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

ICAEW COMMENTS

6. We welcome the OECD Discussion Draft which is an interim draft and was, we understand, published in this interim draft form so that it would be available at the meeting later in June in Shanghai of the Subcommittee on Transfer Pricing – Practical Issues of the UN Committee of Experts on International Cooperation in Tax Matters.

7. We appreciate the fourfold approach set out in the paper, sections A to D, which we believe is a reasonable approach:

   - identification of the intangible (section A);
   - who is involved (section B);
   - what is involved ie the use, or transfer, of the intangible (section C); and
   - the remuneration (section D).

8. We also regard as of key importance some of the statements made in the interim draft.

9. We fully endorse the statement in paragraph 28 that intangibles are not always of great value and can, indeed, have little or no value in different circumstances.

   ‘In a particular circumstance, intangible related returns with respect to an intangible may be positive, negative or zero.’
10. We note that the Discussion Draft aims for a wide definition of ‘intangibles’ but if there is not to be confusion as to what is covered by that definition then there needs to be more guidance as to what typically qualifies as an intangible.

11. For instance, we are concerned by the statement in paragraph 14 which we believe could be used by individual countries to treat intangibles in different ways and give rise, potentially, to double taxation:

   ‘The illustrations in section [A.4] should be adapted to the specific legal and regulatory environment that prevails in each country.’

12. We are also concerned by the categoric statement at the end of paragraph 22:

   ‘In most instances, accounting and business valuation measures of goodwill and ongoing concern values are not relevant for purposes of transfer pricing analysis’

13. We accept that there are different valuation methodologies, and there may be different purposes, in determining the appropriate value of the asset in question. These different valuations are all, potentially, going to be of some assistance in any other valuation, with suitable modification, to reflect the purpose for which the valuation is required and the nature of the transaction involved.

14. If there is a sale of the intangible then normal valuation principles are likely to be in point and are likely to be relevant to determine what an appropriate arm’s length value would be. If there is a licence then a valuation could be less straightforward because the proper value will be based on the use to which the licensee is going to put the related intangible and a theoretical valuation, based on an arm’s length transaction between unconnected persons, will not necessarily provide a useful answer.

15. A carte blanche dismissal of one valuation, for the purposes of another valuation, does not do justice to the similarities that will often underpin different types of valuation exercise.

16. So at the very least we would recommend that the word ‘necessarily’ should be added to the final sentence in paragraph 110 so that it reads:

   ‘In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not necessarily relevant for transfer pricing purposes.’

Identifying intangibles (section A)

17. If the notion of property is no longer going to apply to intangibles then there needs to be a complete and exhaustive definition of this new concept of intangible

Identification of Parties Entitled to Intangible Related Returns (section B)

18. We are concerned that the Section makes no reference to the observed behaviour of parties operating at arm’s length. The statement in the Box at the beginning of this section states that the Section ‘does not reflect an intention to depart from the principles of Article 9’ but we are not convinced that it has achieved that purpose which is to treat controlled transactions that operate in the same way as comparable uncontrolled transactions as being at arm’s length.

Transactions involving the use or transfer of intangibles (section C)

19. Paragraphs 1.64 to 1.69 lay down the circumstances for disregarding transactions and we believe that all re-characterisations should follow the approach and criteria laid down in these
paragraphs. Chapter VI should make clear that this approach needs to be followed when evaluating the use or transfer of intangibles.

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APPENDIX 1

ICAEW TAX FACULTY’S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person’s tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax-tax-faculty/-/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)
September 14, 2012

Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit, Centre for Tax Policy and Administration  
Organization for Economic Co-operation and Development (OECD)

Subject: Comments on the discussion draft on the revision of the special considerations for intangibles in Chapter VI of the OECD transfer pricing guidelines and related provisions.

IFA Mexican Branch (IFA Grupo Mexicano, A.C. and hereinafter referred to as IFA MX) is pleased to comment on the discussion draft of the above mentioned subject. Our comments on specific paragraphs on the interim draft are as follows:

5. In the Draft, the word “intangible”, has the purpose to address something that is not a physical asset or financial asset, and is capable of being owned or controlled for use in commercial activities.

IFA MX would like to suggest the expansion of this definition to include that some characteristics (in no way limitative and in addition to paragraph 7. of this discussion draft) to determine the existence of an intangible asset are such as being identifiable, subject to a commercial transaction, protected by the local legal framework and subject to be valued.

25. & 26. IFA MX believes that the factors mentioned in this paragraph should be further clarified. Furthermore, we would also recommend including information to clarify under which circumstances the transfer of an existing assembled work force may provide an economic benefit to the transferee and when a payment is required. In this sense, it should be taken into account the particular legal circumstances faced in different countries.

In general, any benefit that the transferee may obtain from hiring new employees such as expense savings, training, know how property of the employee, among others, should not imply a transfer of an intangible. Instead, this situation may have an effect on the salaries of the employees such as a hiring bonus rather than a payment to the former employer for an intangible.

81. IFA MX believes that from the perspective of the transfer pricing professional, it is uncommon to have enough information to run a deep comparability analysis of all the parties involved in a controlled transaction, as such we would like to suggest the following change to paragraph 81:

“Considering the available options to the parties involved, the perspectives of each of the parties to the transaction should be considered. However, a unilateral comparability analysis [COULD NONETHELESS PROVIDE] sufficiently good basis for evaluating a transaction that involves the use or transfer of intangible assets if no additional information is available”.

112. & 135. From the perspective of the transfer pricing professional, in some opportunities, the cost approach might prove to be the best methodology to value an intangible asset. We would welcome examples to this regard and would also like to suggest a change in connotation to these paragraphs as follows:
112. “In a transfer pricing analysis, the use of valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return, is generally discouraged [to mean it is APPROPRIATE ON A PARTICULAR BASIS]. There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, financial valuation techniques based on the cost of intangible development should usually be avoided.”

135. “Extreme caution should be used, however, in applying certain of the methods. Valuation of intangibles on the basis of mark-ups over development cost is unlikely to provide an accurate measure of value and is generally discouraged [to mean it is APPROPRIATE ON A PARTICULAR BASIS]. See paragraphs 112 and 113.

116. We consider that the draft discourages the use of rules of thumb; we would welcome the inclusion of examples on which the use of such rules could be allowed or recommended as a complement to a comparability analysis.

161. IFA MX considers that the wording of this paragraph might be deemed as unfortunate, we would welcome a phrasing along the following lines:

“There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. The specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.”

We would also welcome examples of different discount rates used in different scenarios.

**Final comments**

Regarding the link between this draft and the Comments on certain Transfer Pricing Timing Issues, IFA MX would welcome the inclusion of a “rule of thumb” on the validity of forecasts used in appraisals (ex-ante) and how they fare against reality and the perspective of the tax authority under audit (ex-post). For example, the US IRS rules have reasonable differences of +/-20%. We believe that the inclusion of similar rules would provide certainty to taxpayers and somehow limit the hindsight of tax authorities.

* * * * *

The members of IFA MX are pleased to provide these comments to contribute to the further development of the OECD Transfer Pricing Guidelines.

Yours sincerely,
Leiden 14 September 2012

Joseph L. Andrus  
Head of the Transfer Pricing Unit  
Centre for Tax Policy and Administration

Dear Mr. Andrus:

With this letter the International Tax Center Leiden respectfully submits comments to the Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions ("the draft").

Section A. Identifying Intangibles

We believe this section provides valuable input. In particular, we commend the part of the draft emphasizing that a thorough functional analysis will provide answer to the question: what is a valuable intangible asset for transfer pricing purposes? We think this is the right mind set as the answer to this difficult question is often industry specific, business specific and even product/service specific. A good comparability and in particular functional analysis, including an analysis of value drivers in the overall business, provides the framework to be able to answer the question about which party ought to be entitled to the intangible related returns. More than that, a thorough functional analysis in itself often provides one with a clear direction to identify a plausible answer.

Section A. 4. Illustrations

This section includes a list with categories of intangibles and several examples in the Annex. The examples are useful to illustrate the principles that the draft tries to outline. Care should be taken to avoid that the list and the examples are used as a complete check list to address specific situations and therefore miss the purpose of the draft serving as the guidelines. The list of intangibles together with the examples is quite long so one may be tempted to say: because customer list is not in the list, it is not an intangible. Or because our situation is very similar to example X, this must be the right answer.

Specific comments to the examples are included in the last section of this letter.

From the list of intangibles, the discussion about patents, know-how and trade secrets, and trademarks, trade names and brands is clear. In addition, the discussion on the licenses and similar limited rights is also clear.

However, the paragraphs on goodwill and ongoing concern are not as clear. This is because goodwill is a more slippery concept than the other types of intangibles. But this is also because the draft is trying to categorize as an intangible something that most people call by another name, namely goodwill.

Firstly, for the sake of clarity we believe that discussing in the same paragraph the features of goodwill and ongoing concern may not be beneficial. Depending on the viewpoint adopted, goodwill (as a matter of measurement or quantification) is an accounting concept deriving from an ongoing concern. It is important
to highlight that the OECD’s view on the topic has always been swinging (e.g. see the Discussion Draft on Business Restructuring of September 2008 where initially goodwill was treated as an illustration of profit potential.

The first paragraph (21) acknowledges that the term 'goodwill' can mean different things to different people. This has always added to the confusion about goodwill in a transfer pricing context, especially because there is a definition of goodwill for other tax purposes (e.g., Corporate Income Tax), accounting purposes, or for business purposes (used as synonym for reputation).

Acknowledging the confusion but not establishing a "transfer pricing" definition of goodwill (par. 22) keeps the confusion afloat. This confusion could have been eliminated if the question about how to value goodwill would come clear from other parts of the draft. After all, the most important objective of the draft is not about coming up with a list of intangibles, but rather about finding and answering to the question: what is the arm's-length return for such "intangible" and for whom is that return?

We agree with the general idea that goodwill can have value attached to it and that this value is relevant for transfer pricing purposes. However, in our view, calling goodwill an intangible only adds to the confusion. This is because, in a way, goodwill is "more intangible than an intangible", and for some people is always there and for some people is never there, and most people in the finance world do not call goodwill an intangible. Since goodwill plays a very important role in almost every business restructuring case we think it is important that these paragraphs about goodwill leave no room for interpretation.

A particular sentence in paragraph 21 "It is generally recognized that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets" is too broad and does not help clarifying the subject at hand. We believe the term going concern is misused in the referred sentence as by definition it indicates a combination of assets (and functions) under the assumption that "the assets and activities" stay together. We however can think of situations where goodwill (and again without a definition is difficult to be sure about what we mean) is not attached to any specific asset.

The traditional application of the Residual Profit Split Method assumes that routine functions are benchmarked and the residual profit is either split between the providers of “unique contributions” or the generators / owners of the intangible(s). When doing this, are we transferring goodwill? Are we saying that "routine activities" do not have any type of goodwill attached? Or are we saying that the return for the routine activities includes the return to any goodwill that those activities could have? Or do we need to adjust the residual profit and carve out the goodwill that stays locally? This is a very basic question that comes up in every business restructuring and it is answered differently depending on the specific facts and circumstances of the case.

The last sentence of paragraph 22 reads: "In most instances, accounting and business valuation measures of goodwill and on-going concern value are not relevant for purposes of transfer pricing analysis." This sentence also comes back in some of the examples in the Annex.

We understand that the full business and accounting valuation may not be relevant most of the times (e.g. because of the useful life and terminal value assumptions, or because of the accounting "test" to meet the goodwill criteria concept is different than the one suggested here). However, a valuation carried out for accounting purposes can be relevant and serve as a starting point. Please also note that some countries
(e.g. Norway, Spain, Denmark) have a specific case law that refers to business valuations when valuing intangibles for tax purposes, as such the statements in the draft will contradict that such case law.

As a conclusion to this section we agree that goodwill can have value attached to it and that this value is relevant for transfer pricing purposes. However, to avoid confusion, we would not call goodwill an intangible. If there needs to be a category, goodwill will be in a different category than intangibles. Goodwill sometimes will look-more-like-an-intangible and sometimes not. In some cases, the impact of goodwill can be taken into account with the comparability analysis: making sure that the compensation of the various functions, assets and risks of the company owning the goodwill takes into account that goodwill value. If this cannot be done because of the uniqueness of the transaction or context, in other words, because the goodwill looks-more-like-an-intangible, then we would value that goodwill separately. The important question therefore is not so much the name you give to goodwill (why not just call it goodwill?) but how do you value it.

After paragraph 22, there is a short list of things that are not considered intangibles: group synergies and market specific characteristic, as well as a discussion about workforce that is not entirely clear from the draft whether or not it should be considered intangibles.

The discussion about group synergies and market specific characteristics concludes that because "they are not owned or controlled by a single enterprise” they are not intangibles. Does this section imply that an intangible to be an intangible needs to be owned and controlled by a single enterprise? Many intangibles can be owned and controlled by several parties (like in a cost sharing context, or like a brand that has only one legal owner but several economic owners).

In this respect, we believe that un underlying contradiction is permeating the entire discussion of Section A, that is the following: the last paragraph of Section 5 stipulates that “Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”.

This sentence, might lead to the conclusion that illustrations are simply irrelevant to get to an appropriate arm’s length price for a related party transaction involving the use or transfer of intangibles. Therefore we suggest deleting this last sentence should the illustrations section be kept in the Document.

Synergies and market specific circumstances can be taken into account with the comparability analysis making sure that the compensation of the various functions, assets and risks of the company with the synergies and/or market specific circumstances takes into account those value drivers. If this cannot be done because of the uniqueness of the transaction or context, then we would value those synergies or market specific circumstances separately. For example, this could be the case for the network effect in a courier company, or in an internet services company. It could also be required for a company that has a very unique location advantage, like proximity to some natural resources or access to a well-educated workforce: there are many studies on how to measure these cluster effects.¹

The same way we say that goodwill or locational advantages can generally be considered in the comparability analysis, but may need to be valued separately sometimes, also intangibles such as know-how can be valued separately, but can sometimes be also considered in the comparability analysis. The key point to be addressed in the Draft should be to set a criterion to determine which entity would be entitled to receive the extra remuneration created by the existence of synergies or other “soft intangibles” (e.g. the parent company that triggered the restructuring etc.)

As a conclusion, we think that paragraph 14 is the most important one in Section A.4. The list of intangibles and non-intangibles needs to be an "open list" acknowledging that it is not the categorization as such that matters but the fact that "the valuable thing" needs to be accounted for in the transfer pricing analysis. This may include customer list, contracts, customer relationships or distribution network. As mentioned previously, the draft should be edited such that it prevents taxpayers or tax authorities to use the list as a comprehensive list of intangibles vs. non-intangibles. The world and especially the one of intangibles is changing very fast and what may not look like an intangible today could become the most important one in 10 years. Who knows, for example, where the practice of open innovation will lead us to?

Lastly, we would suggest the OECD Secretariat reviews the relevant part of Chapter IX, Part II, once this project will be finalized, in particular where the discussion of profit potential takes place.

Section B. Identification of Parties Entitled to Intangible Returns

The discussion that follows in B1, B2, B3, B4 and B5 is consistent with our experience and practice when analyzing intangibles.

The main difficult opened question in this section is the question about how much "control" is enough control to be able to be entitled to the intangible related returns. This is similar to the question about how many people should a principal company have to be considered the principal, and in general, the old “substance” question. There is no answer to this question other than in the facts to be interpreted in the context of a specific business model and industry practice and extreme examples like some of the examples in the Annex to this draft or like the examples in paragraphs 9.188 to 9.194 of the current version of the OECD Guidelines do not help much.

Section C. Transactions involving the use or transfer of intangibles

The purpose of this section is not so clear. If Section A concludes correctly that there is no need to "delineate various classes or categories of intangibles" (par 13), why is then necessary to categorize transactions involving the use or transfer of intangibles?

Transactions involving intangibles can be categorized in many ways. This categorization in itself does not help answering the key question about how to allocate intangible related returns.

The text also include broad statements like paragraph 70: "Similarly, it is important to identify situation where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of substance, cannot be separated." What does as a matter of substance means? This "catch all" statement is unclear and subjective, and therefore additional explanation should be added or the sentence should be removed.
Although the section is a good general information piece, we think the whole of section C can be eliminated without affecting the principles of how intangibles need to be treated for transfer pricing purposes and without affecting the meaning of the new proposed Chapter VI. Determining the intercompany transactions taking place is one of the first steps of any transfer pricing study, for goods, services or intangibles. None of the other chapters from the OECD Guidelines categorizes transactions and the general guidance given in Chapter 3 seems enough to this respect.

**Section D. Determining Arm’s Length Conditions in Cases Involving Intangibles**

The reference to “options realistically available” in paragraphs 80, 81 and 82 of the draft is not clear. This section D.1 discusses comparability criteria when analyzing intangibles, not about the specific situation when intangibles are being transferred (when options realistically available play a role) or situations where the profit split method is applied (when analyzing both parties to the transaction is required).

Paragraphs 1.33 to 1.63 (in our view the most important ones and most clear discussing comparability) do not say anything about options realistically available. Chapter III, which in our view could be improved as it confuses several times comparability in a general sense with doing a benchmark using a database, does not talk about options realistically available either. Why is this new proposed Chapter 6, Intangibles, making a bridge between an already confusing Chapter 3 and Chapter 9 which deals with the very specific situation of restructuring a business?

While we find the list of comparability factors for intangibles (rights, exclusivity, duration of legal protection, geographic scope, useful life, etc.) useful, it is just a specific example of the way the principles outlined in Paragraphs 1.33 to 1.63 should be used when analyzing intangibles. Therefore, we think that the list can be omitted. As a matter of fact, when using the Comparable Uncontrolled Price ("CUP") method for analyzing intangibles, it is going to be impossible to meet all the comparability factors when using an external CUP and very difficult when using any internal CUP. Intangibles that yield positive returns are often unique, and that is why this comparability analysis often leaves us empty handed.

**Section D.2 Selecting the most appropriate transfer pricing method**

We agree with the general message of paragraphs 106 to 108.

We do not understand the comment in par. 110 saying that “valuations of intangibles contained in a purchase price allocation are not relevant for transfer pricing purposes”. Does it mean never? It is our experience that sometimes parts of the analysis included in a purchase price allocation (for example some of the assumptions) are relevant for transfer pricing purposes. In any case it is relevant information that would need to be taken into account and dismissed as non comparable or accepted (or accepting parts of it), explaining the reasons for accepting or rejecting.

We also do not agree that the cost method is never relevant and that rules of thumb are not relevant. These methods can be useful in some contexts and also they need to be used with caution they are a tool available.

Paragraph 111 says: “Valuations conducted for business planning purposes may be either more or less relevant [relevant for what?] than valuations conducted purely for tax purposes, depending of the
circumstances.” We are not sure what valuation conducted purely for tax purposes means. Typically a valuation done for transfer pricing purposes is a valuation done for tax purposes (whether the context is a tax optimization project or not) because, in the context of art 9, transfer pricing is a tax related question.

The full section about use of valuation techniques is too detailed and in our view does not belong with the OECD Guidelines. A general reference to valuation techniques used within the finance community should be enough in our view.

There is some confusion in valuation section about the use of pre-tax versus post-tax cash flows. The examples included in the Annex refer all to after tax cash flows whereas the text in paragraphs 168 to 170 refers to pre-tax cash flows.

The examples in the Annex calculate after tax cash flows and say that "a transfer pricing analysis using a cash flow approach would have to consider how unrelated parties dealing at arm's length would take into account the cost savings and tax rate benefit in setting a price for the intangibles". We think this is correct and the most simple way to replicate what third parties would do would be to use after tax cash flows, using an after tax discount rate which can be obtained from the market, and adjusting the result for any tax amortization benefit or cost savings. This tax amortization benefit or cost saving would be split between the parties to the transaction taking into account their relative bargaining power, that, for the sake of simplicity we can assume in a group context is 50/50, unless we have arguments to use another split.

However the par 169 says:

"prices for transfer pricing purposes under a DCF analysis must typically be determined pretax [why? Is this what third parties would do? The use of "typically" is strange here.] and then appropriate adjustments may need to be made to ensure both internal consistency of the DCF model and determination of the arm's length price on pre tax basis".

From our point of view it is also possible to carry out the analysis using pre-tax cash flows and adjusting the discount rate to a pre-tax basis. However, the adjustment of the discount rate is in itself complicated. If we do need to use pre-tax cash flows, the discount rate needs to be increased. We would need more guidance on how the discount rate needs to be adjusted.

From a practical point of view and after many conversations with CFOs, finance managers and controllers about this subject, it is much easier to do an analysis after tax and then replicate what third parties would do with the savings. An analysis before tax is counter intuitive for most finance professionals and requires a lot of explanations and iteration to be able to adjust the discount rate.

The suggestion that the valuation of intangibles should be done post-tax contracts the other Chapters of the guidelines which suggest that transfer pricing is a pre-tax concept. In such case, a more specific guideline on how to adjust the post-tax discount rate to pre-tax discount rate for use in the valuation analysis should be provided, as there is no consensus on how best to adjust the discount rates.
Comments to the Examples in the Annex:

While we find the examples useful, they are very specific in facts and may not be relevant in practice. As mentioned previously, such specificities may miss the purpose of the draft being a useful guideline for the taxpayers and tax authorities in evaluating its intangibles and their arm's-length returns.

Example 1: is clear. However it is a bit of an extreme situation. What would happen if there was an arm's length payment for the rights but no control? This problem comes back later in another example but I think further guidance is required. As mentioned above, how much control is enough control is always specific to the case one is dealing with.

Example 2: no comments, clear text book case.

Example 3: no comments, clear text book case.

Example 4: Branded watches. The example is a variation of the first one, but a variation that is not very likely to be found in practice: how is one going to find comparable to determine the arm's length return for S? How would you lower the price of the watch (by how much) this is difficult to calculate unless you have CUPs. In some cases it may not be possible to lower the price (customs? Other duties?). The idea behind the example makes sense but the separation (and measurement) of the different functions is difficult, especially when functions are not clearly defined/separable as explained in the example.

Example 5: the comparison of the level of marketing expenses makes sense, however 1) it is difficult to find that level of detail in the public databases (one needs to do it manually looking at chamber of commerce filings or sec filings); 2) the companies being considered as potentially comparable need to be indeed very comparable (this is not always the case with the comparable benchmarking analysis which often includes companies that broader in functions and risks) otherwise comparing the marketing expenses does not work. The point made by the example is clear, but in practice the information available to make the analysis is of poor quality, so the result could make no sense (or not making more sense that a manual approximate adjustment). The approach proposed (as in some of the other examples) makes sense from a theoretical (and mathematical) point of view however this does not mean that this is what third parties would do. There are many things third parties would do: 1) ask for a marketing rebate 2) withdraw product from the market 3) change distributor 4) renegotiate agreement for next term.

Example 6: similar comments to the Example 5.

Example 7: How would this example work if instead of a brand (easier to separate) we are talking about technology in general? It is very difficult (if not impossible) to find reliable and comparable information about royalties paid by third parties (unless you have some internal CUTs). No breakdown of operating expenses is available for most European independent companies publishing information in the generally available databases.

What if there was a royalty agreement but the royalty was 0 at the beginning and then increases? What if sector is overall loss making? What if that particular market is persistently loss making (because of copies from local players, because monopoly situation, because of government regulations like price controls?)

Example 8: no comments.

Example 9: no comments.
Example 10: this is a very common case. A difficult question is when in country X legal ownership prevails (because of local law or case law). Does legal ownership not deserve any return at all? The answer will vary per industry/company.

Example 11: the guideline is clear. The most important question is: how much technical personnel is required? How many? Qualifications?
Mr. Joe Andrus,
Head, Transfer Pricing Unit
OECD

Comments on OECD “Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. in response to the invitation to public comments by OECD regarding “Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”. The Japan Foreign Trade Council is a trade-industry association with trading companies and trading organizations as its core members, while one of the main activities of its Accounting & Tax Committee is to develop the trade environment by submitting specific policy proposals and requests to government authorities concerning tax matters. (Member companies of the Accounting & Tax Committee of JFTC are listed at the end of this document.)

Section A. Identifying Intangibles

Overall Comments

JFTC, which consists of the member companies engaging in business operations
over the world, desires that tax administration is conducted appropriately and stably in each country or jurisdiction. We are concerned that the broadened definition of intangibles may create additional class of allegations of imposing tax by tax authorities in each country and that might lead to double-taxation on the same income and strongly concerned that tax might be imposed beyond ones calculated by the actual profits and losses resulting from the real transactions. Such taxation would not only undermine the individual company’s operations but also seriously shall hamper each country’s economic development and growth and inevitably shall cause less global growth. It is undesirable for tax authorities and taxpayers to be forced to face or get accustomed to tax disputes or to operate under the threat of such potential tax disputes in countries throughout the world.

From this perspective, we consider that the definition of intangibles contained in Section A of the Discussion Draft is too broad and provides tax authorities with excessive room for interpretation. Our most serious concern is that certainty is not assured with the broadened definitions of intangibles and in such circumstances hesitation with fear comes first and economic growth shall slow down. With the definitions broadened, various interpretations and enforcements may occur around the globe and lead to various tax consequences which at end may create double-taxation or no-point taxation and there may arise cases where double-taxation may not be eased even through the mutual agreement process with different concept of intangibles or different concept or recognition of values.

Therefore, the scope of intangibles for transfer pricing purposes should be limited to intangibles protected under law and other intangibles that are contractually or otherwise stipulated so that tax disputes on the interpretations would not arise. We also believe that intangibles should be clearly differentiated from service transactions.

Furthermore, while it is undesirable to have situations where taxes on profits from transfer of intangibles that taxpayers cannot predict and recognize are imposed by tax authorities and face double- or multiple-taxation, we strongly urge the establishment of correlative adjustment of its kind for eliminating exposure to such double- or multiple-taxation, in such a way that intangibles identified in a country is considered amortizable assets in the counterpart country through the mutual agreement process.
In line with the above, our specific comments on the Discussion Draft are as follows.

- **Specific Comments on Paragraphs in the Discussion Draft**

Paragraph 5 presents a comprehensive definition of intangibles by stating that “the word ‘intangible’ is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities.” A number of illustrations and explanations are then given following the disclaimer “rather than focusing on accounting or legal definitions.” This has resulted in a very broad definition of intangibles. **We are concerned that such broad definition would provide tax authorities with excessive room for interpretation, undermining predictability and certainty from the perspective of taxpayers.**

In particular, because goodwill has not been clearly defined, we are concerned that tax authorities would be given extensive scope for interpretation. Therefore, we consider the scope of the intangibles for transfer pricing purposes should be limited and the definition should be further clarified. In regard to this point, Paragraph 21 states, “Goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets.” Then, the paragraph continues, using the terminology of the International Accounting Standards, “Goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognized.” As can be seen from the foregoing, goodwill “cannot be segregated or transferred separately from other business assets.” On the other hand, as stated above, intangibles are defined as an asset that “is capable of being owned or controlled for use in commercial activities.” However, it is not possible for assets that are not individually identified and separately recognized to be “owned or controlled.” Thus, we consider that it is not appropriate to include goodwill in the definition of intangibles for transfer pricing purposes.

**We agree with the clarification given in paragraph 23, which states that as group synergies “are not owned or controlled by a single enterprise, they are not intangibles within the meaning of Section A.1.” However, while the Discussion Draft refers only to the positive impact of group synergies on total group income, in reality, there is no reason to conclude that group synergies will always lead to**
increased income. For example, a transfer may be undertaken not only for strengthening competitiveness but also for maintaining competitiveness. Moreover, as group synergies cannot usually be realized by transfer itself, it is possible that the input of new resources will actually result in increased cost. Therefore, we consider that the Guidelines should address that group synergies could have negative impacts on the profits. Another point that needs clarification is a multinational enterprise (MNE) group’s sales network. For instance, consider a case where a member company of an MNE group finds a seller while another member company of the same MNE group finds a buyer. In such cases of transactional matching, sales networks created by an MNE group would be categorized under group synergies because they are not owned or controlled by a single enterprise. Thus, we suggest the Guidelines explicitly indicate that such sales networks are not intangibles within the meaning of Section A.1.

We agree with the statement in paragraph 24 that market specific characteristics are not intangibles within the meaning of Section A.1., as they cannot be owned, controlled, and transferred by an individual enterprise. On the other hand, it should be noted that emerging countries in particular are raising very strong claims regarding the allocation of locational savings. Given this fact, we suggest adding illustrations and guidance regarding the methodologies of comparability analysis.

Know-how, trade secrets, and other information obtained through the experiences of an individual generally belong to the individual. Insofar as corporate ownership of these assets is not protected under law, ultimately these cannot be owned and controlled by the enterprise. Regarding this matter, paragraph 26 states: “While the transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of an intangible, as a factual matter such a transfer may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm’s length dealings.” We are concerned that the wording of the above provision may lead to the inclusion of know-how belonging to individuals (not to the enterprise) under the scope of transfer pricing taxation. We therefore propose that an explicit comment be added stating that management know-how, sales know-how, and other forms of know-how obtained by managers, employees, and teams of employees through experiences gained in corporate activities are not intangibles within the meaning of Section A.1.

The same applies to individual skills and capabilities within an assembled
workforce. That is, capabilities of individual employees are owned by the individual and do not belong to the enterprise. In particular, in the presence of highly fluid labor markets, ultimately it is very difficult for an enterprise to continue to own and control its employees as a corporate asset. Therefore, we believe that individual skills and capabilities within an assembled workforce should not be included in intangibles within the meaning of Section A.1.

Even if these are to be included in intangibles in certain special cases, they should be clearly differentiated from service transactions (including high value-added service transactions). Paragraph 26 contains the statement that “a long term contractual commitment to make available the services of a particular group of uniquely qualified employees may constitute an intangible in a particular circumstance.” However, no explanation is provided as to what “particular circumstance” may be. Because paragraph 26 does not go beyond making this very general statement, we are concerned that it may allow the scope of intangibles to be very broadly interpreted. We consider clear guidance and illustrations must be appended for this passage to effectively function as a criterion for judgment.

**Additional Comments on Section A on Matters Not Mentioned in the Discussion Draft**

The current Guidelines do not contain any explicit provisions concerning the relation between intangibles and rights pertaining to extraction and sales of natural resources. Consequently, when a party who does not own legal rights to natural resources provides services to a party who owns the legal rights, such transactions have in certain cases been recognized by tax authorities to involve the use of intangibles. However, income generated by rights to natural resources is attributed to the location where the resource has been extracted. Therefore, such transactions should be categorized under general service transactions, with the exception of specific services that utilize extremely sophisticated exploration and production technologies and other intangibles that are protected under law. Hence explicit provisions should be included to exclude such transactions from the scope of the use and transfer of intangibles.

**Section B. Identification of Parties Entitled to Intangible Related Returns**
Overall Comments

As stated in the comments to Section A, we believe it is important to ensure predictability and certainty for both tax authorities and taxpayers in all related countries. Regarding the identification of parties entitled to intangible related returns as specified in Section B, if the tax authorities are allowed to neglect or ignore the legal ownership or contractual relations and re-characterize the transactions involving intangibles based on more economically driven interpretations beyond the legal meaning, it could cause MNEs operating in countries throughout the world double- or multiple-taxation, and would present a significant obstacle to economic activities.

In addition, it is very unlikely for an entity that has no significance in functions performed, risks assumed, and assets used to become the legal owner of rights or a party to a contract.

Therefore, we consider that, in principle, legal ownership and contractual relations should be respected, and the re-characterization of transaction attributes should be limited to extreme cases where remarkable inconsistencies exist between ownership based on legal relations and ownership based on economic relations, and intent to avoid taxation can be clearly detected.

Specific Comments

In line with the above, our specific comments on the Discussion Draft are as follows.

Inconsistency between legal ownership and economic ownership is described as a situation “where the conduct of the parties is not aligned with the terms of legal registrations and contracts.” For such cases, paragraph 37 and other related paragraphs state that “it may be appropriate to allocate all or part of the intangible related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles.” However, we are extremely apprehensive that completely ignoring legal contractual relations and allowing the re-characterization of intangibles and transactions involving intangibles can result in disputes related to claims and interpretation of the rights to tax in the source country. Therefore, in principle,
legal contractual relations should be respected, and the re-characterization of transaction attributes should be limited to extreme cases where remarkable inconsistencies exist between legal ownership and economic ownership, and intent to avoid taxation can be clearly detected.

Reference has been made to the importance of “control” and “important decisions” in the identification of parties. However, no stipulation has been made concerning the specific level of “control” and “important decisions.” We consider further clarification is needed on this point.

For instance, some MNE groups stipulate, as part of their risk management and internal control systems, the procedures to be followed when a subsidiary makes an important decision on bearing risks exceeding a certain level. Such procedures may dictate that the subsidiary must check the intention of the parent company holding its shares in advance, or that in addition to its own decision making the subsidiary must also undergo a predetermined process of approval by the parent company. Therefore, it would be helpful for the Guidelines to clarify the relation between such control of a parent company over a subsidiary through equity ownership and the identification of parties entitled to intangible related returns. Furthermore, if “control” and “important decisions” are to be specified as material factors, this means that investors whose only contribution is the provision of funds (for example, a limited partner in a partnership) are not entitled to intangible related returns in spite of the fact that they bear the risk of their investment. This point should also be clarified.

Paragraph 51 states, “In some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those an independent distributor with similar rights might incur or perform for the benefit of its own distributing activities. An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate in order to compensate it for its functions, assets, risks and costs.” In this context, we believe reference should also be made to the point that an intangible asset should not be immediately recognized merely because the entity has incurred high marketing costs.

Section C. Transactions Involving the Use or Transfer of Intangibles
Section D. Determining Arm’s Length Conditions in Cases Involving Intangibles

Overall Comments

We consider the scope of intangibles for transfer pricing purposes should be limited so that the possibility of the occurrence of tax disputes can be reduced. On the other hand, even if an intangible has been recognized and the owner identified, it is impossible to uniformly assess values across borders and in accordance with individual jurisdictions. Furthermore, conflicts of interest may exist among countries. Therefore, the scope of intangibles should be stipulated in a manner conducive to mutual agreement.

If this is not ensured, the concern remains that taxpayers may suffer from exposure to double- or multiple-taxation. In particular, for MNEs where a single transaction often involves multiple countries, current arrangements for harmonization and concurrent examination by related countries cannot be said to be sufficient. If the transactional profit split method is to be applied in the current environment, it will be necessary to adopt arrangements that eliminate exposure to double- or multiple-taxation by accepting actual transactional profit and loss.

Overall, routine and non-routine intangibles have not been differentiated and, in some respects, the discussions have not taken this difference in category into consideration. In this context, if a broad definition of intangibles is to be adopted, we believe that one-sided verification would be sufficient for routine intangibles.

Finally, it should be kept in mind that the discounted cash flow (DCF) method is not based on the actual transactional profits and losses but based on hypothetical figures and the use of value measured hypothetically as a basis for taxation should be restricted.

Specific Comments

In line with the above, our specific comments on the Discussion Draft are as follows.
D.1. Conducting a comparability analysis in a matter involving intangibles

By stating that “a one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles,” paragraph 81 seems to require the use of two-sided comparability analysis at all times. However, such a requirement would face various practical problems. For instance, consider a company transacts with a related party in which the company has no majority of the voting right. If a tax system deems this to be a transaction between related parties for transfer pricing purposes, it may prove difficult to obtain information that is objective from the counterparty’s perspective. Therefore, taking into consideration the administrative burden to taxpayers and tax authorities, we consider that some form of materiality criterion should be adopted for the application of a two-sided approach. Similarly, in arm’s length transactions, it is frequently impracticable to estimate with a certain degree of accuracy the assumptions made by the counterparty. Therefore, where a two-sided approach is to be adopted, a comment should be added to the effect that, as long as analysis and/or evaluation has been conducted on the basis of information available to the taxpayer on the measurement date or on the basis of reasonably estimated information, the analysis and/or evaluation would in principle be respected.

Paragraph 104 states that “it is important to assess whether publicly available data drawn from commercial data bases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles.” Regarding this point, it is unclear how detailed the information to be obtained needs to be. The appropriate standard for the required level of detail should be one that allows taxpayers to collect practically the necessary information without incurring excessive costs.

D.2. Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

Paragraph 108 expresses concern regarding the facile application of the residual profit split method by stating, “In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled intangible related returns.” This is followed with the statement that a
transfer pricing method “should appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions.” On the other hand, regarding the adjustment of differences in comparability analysis in the process of computing arm’s length prices, it has been assumed that, as stated in paragraphs 1.33 and 3.47 of the current Guidelines, “none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences.” Therefore, we consider it would be more appropriate to stipulate that only those factors that do not “materially affect the condition” and can be quantified in the process of adjustment should be considered.

Paragraph 110 states: “In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.” In regard to this point, explanations should be added to specify points that “are not relevant.” The DCF methodology presented in Section D.4. is a commonly used valuation method for accounting purposes as well, and does not need to be completely set apart from valuation methodologies for transfer pricing purposes. Rather, it can be said that valuations performed for accounting purposes contain quite useful reference information. Therefore, except for cases that pose significant problems, we believe that the use of and reference to valuations performed for accounting purposes should be allowed.

D.3. Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services

Paragraph 124 states: “In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. While such facts may not be intangibles as that term is described in Section A.1. of this Chapter, they can nevertheless have important effects on arm’s length prices in matters involving the use of intangibles.” Thus, while having “important effects” is identified as a reason for adjustment, the foregoing provision requires numerous other adjustments or important adjustments to be made. Therefore, we consider that it would be necessary to be explicitly stated in the Guidelines that arm’s length transactions requiring such numerous adjustments may not be sufficiently comparable, and that they may not constitute valid objects of comparison.
D.4. Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles

The fair value measured based on the DCF method generally yields a range of values and a concept of “range of values” is referred to in the following wording of paragraph 148: “The calculation of the discounted present value of the streams of cash flows attributable to the intangible from the perspectives of both parties to the transaction will generally be necessary. In these cases the arm’s length price will fall somewhere within the range of both present values, after taking into account taxes required to be paid with respect to the transaction.” Regarding this point, it should be noted that ranges of values appear in the valuations conducted by both the seller and the buyer. Therefore, we suggest that the Guidelines state that the use of both ranges is allowed, on the condition that the analysis is performed based on appropriate valuation assumptions.

Moreover, in using the DCF method, the results of the valuation should be respected as long as it has been conducted on the basis of information available to the taxpayer on the measurement date or on the basis of reasonably estimated information. While, inevitably, there will be differences between projected cash flow as of the measurement date and actual cash flow at some future point, tax authorities should not use hindsight based on actual future results. We suggest that the Guidelines reiterate this point in this Chapter.

Paragraph 155 states that “it is usually the case that projections prepared for non-tax business planning purpose are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.” However, it should be noted that financial forecasts prepared for business planning are based on different assumptions depending on their intended use. Normally when preparing a business plan, an enterprise develops multiple cash-flow models by conducting a sensitivity analysis based on different sets of risk factors and assumptions. Therefore, while it cannot be said that the projections based on the single cash-flow model that the enterprise has chosen from the multiple available models is always highly reliable, we consider that the range of present values obtained from the multiple available models provides an indication of the range within which the arm’s length price will fall.
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Yuasa Trading Co., Ltd.
To: Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit, OECD’s Centre for Tax Policy and Administration

Dear Mr. Andrus

OECD Invitation to Comment on the Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”

I very much welcome this opportunity to comment on the OECD Discussion Draft and fully appreciate the tremendous effort OECD has undertaken to release the Discussion Draft 18 months ahead of the original schedule. OECD has established itself as the leading global authority on transfer pricing related issues, to the point of sometimes effectively complementing statutory law. Therefore, I find it extremely important that the guidance be amended and revised, when appropriate, in such a way that it will not lead taxpayers, tax authorities or tax practitioners to jump into conclusions based on individual paragraphs or singular observations or make this guidance on intangibles seem like a stand-alone piece that would be independent and possibly outright contradictory to established market practices.

More specifically, this commentary on the Discussion Draft is focused on valuation issues and the link between M&A market, related statutory accounting valuations, subsequent capital market reporting & investor information on the one hand and valuations for tax purposes on the other hand.1

The Discussion Draft has a fairly extensive section on valuation techniques and typical critical assumptions affecting the valuation. I fully appreciate OECD’s comments (while I recommend clarifying some of the expression used and maybe having a more structured approach) on e.g.:

- The applicability of financial valuation techniques in transfer pricing (paragraph 109). I would even say that the valuation techniques – when properly used – should normally (not just “might”) be applicable as is basically stated in paragraph 147;
- The statement that generally there may be no relationship between cost and value (paragraph 112), but that cost approach may be perfectly valid for internally developed software used in the business (but not commercially sold or licensed to 3rd parties e.g.,

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1 The views and opinions expressed in this document are those of the author alone and do not necessarily correspond to those with KPMG Oy Ab, a Finnish limited liability company or other firms of the KPMG network of independent member firms affiliated with KPMG International Cooperative, a Swiss entity.
financial institutions may typically have internally tailored or developed software). Furthermore, it may be worth mentioning that cost approach, e.g. replacement cost new, is sound and habitually used for valuing tangible assets;

- Discouraging the use of rules of thumb to shortcut proper comparability etc. analyses (paragraph 116);
- Giving the CUP, profit split and valuation techniques equal practical status in intangible valuations (paragraph 136);
- Taking into account market transactions (market approach, paragraph 138); however, even considering potential timing issues, market transactions on intangibles may provide useful guidance on transaction structuring and pricing principles;
- Recognition of excess earnings type of approach (paragraph 148; however, this established term for financial and accounting valuation purposes is not used by OECD). In accounting valuations, excess earnings (return above/below the fair market return for other assets employed) is normally used to value residual cash flows attributable to intangibles (e.g. customer relationships) for which an income stream separate from other business assets may not be recognized. Furthermore, this technique is habitually used to measure economic value added so as to e.g. value financial institutions (return on equity or ROE vs. cost of equity; financial institutions, especially banks have a highly regulated capital base and they may struggle to produce ROE above cost of equity, which explains market valuations levels close to book values);
- Furthermore, the Discussion Draft covers several key issues that should be taken into account in any commercial/financial valuation:
  i) Sensitivity and benchmarking of key assumptions and variables such as growth, discount rate and useful life of intangibles (paragraphs 149-151, 160-167);
  ii) Reconciliation of assumptions and parameters with possible non-tax valuations (paragraph 152);
  iii) Using forecasts prepared for business planning purposes (paragraph 155); and
  iv) Possible tax shield and applicable (effective) tax rate (paragraphs 168-170).

One should note that it is common best practice to take these factors into consideration, when fair market valuations for tax purposes are prepared. However, it may often be the case that business is followed or e.g. impairment testing is prepared on such a level or detailed projections into future are (understandably) limited to a few years in such a way that this information cannot directly be utilized for the specific target asset for the purposes of the tax valuation.

These are valid points. Therefore, in the context of the above and from sound and established financial and accounting valuation perspective I find it quite impossible to agree with the draft statements where it is claimed that accounting valuations (purchase price allocation or “PPA”) is “irrelevant for transfer
pricing purposes” or that accounting valuations may be “biased” towards conservative estimates of asset values.²

Based on the above, I discuss first the merits of PPA, continue with market based view on risk (reasons for market “conservatism”) and conclude with some comparability remarks, i.e. how to leverage market data to set a reasonable ballpark for intangible asset and other valuations and to overcome some of the concerns voiced in the Discussion Draft related to the possible “speculative” or “unreliable” projections in valuations.

² See e.g. paragraphs 110 and 249 of the Discussion Draft.
1 - Use of purchase price allocations as sound market benchmarks

I would find it alarming to cast aside:

i) Statutory principles set forth in the International Financial Reporting Standards ("IFRS" or similar standards such as US GAAP, which are converging to provide consistent view on e.g. valuation approaches);

ii) The established application of sound valuation methodologies from PPAs, always reviewed by the statutory auditors; and

iii) Capital market reporting on M&A deals followed by investors and enforced by regulators, who review PPA reports and subsequent impairment testing documentation.

Accordingly, rather than making overly broad conclusions for tax purposes, it should be clearly stated that PPA should be given due consideration in subsequent tax valuation analysis, e.g. in relation to following items, which are typically discussed and elaborated in the PPA reports:

- Industry and target business analysis;
- Growth, profitability and other key cash flow assumptions (one can compare this to paragraph 172 of the Discussion Draft, which basically states that income approach may be a useful tool – in a transparent way I may add – in assessing potential benefits from the subject asset);
- Risk assessment as reflected in the cash flow pattern and discount rate;
- Useful life (economic life) assumptions and related lifing analyses;
- Benchmarks derived from market data e.g. industry participants (i.e., potentially comparable firms), asset intensity (level of working capital, investments), market consensus forecasts (e.g. for growth and profitability), and royalty rates, when applicable;
- Relative allocation of fair value to different types of assets, which must reflect the key value drivers of the business and industry as well as the disclosed deal rationale.

Table 1 – Allocation of purchase price to intangible of assets by industry sector from sample European deals (source: KPMG)
It is quite understandable that PPAs may not always be directly used in connection with separate asset valuations for individual legal entities, especially if there is a significant time lag between the two transactions, but the market benchmark deals along with business value drivers documented in PPA reports certainly cannot be dismissed as “irrelevant”. Therefore, if this undue aversion relates to the fear that significant part of value is left in goodwill (example 18, paragraphs 245-249) instead of separately recognized intangibles, one should also bear in mind that:

- PPA reports typically discuss (and also measure) the elements that the goodwill consists of, such as assembled workforce (especially relevant for e.g. for project based consulting businesses), future products, trademarks and market presence;
- The current revised IFRS also encourages allocation to intangibles through removing the "reliability of measurement" criterion (rebuttable presumption that the fair value of intangible assets can be measured reliably in a business combination);
- The risk assessment is transparently showcased in the forecast cash flow pattern, which reconciles the future estimates (management business case) to the purchase price and set the framework for related PPA valuations.

The management business case may present high growth estimates, which may not be realistically achievable on an individual entity level without massive investments – and the investments require financing to which an individual entity may quite simply have no access. Therefore, while discounting ("conservatism") may transfer value from intangibles to goodwill in the projected growth case, an individual entity may never have a realistic possibility to achieve the growth and accordingly have a claim on a portion of part of the resulting goodwill from the deal to be allocated to its proprietary intangibles.
2 - Risk measurement in the capital market (financial and accounting valuation) environment

Based on the Discussion Draft, accounting valuations are “biased” towards conservative estimates. In my opinion, there seem to be perfectly sound arguments for such risk measurement: many deals may destroy shareholder value, and may eventually lead to impairments. For example, a sample of Finnish listed companies with high level of goodwill exhibit high volatility, fairly low returns on invested capital (close or below cost of capital) and fairly low valuation levels (especially price to book ratios close or below 1 may indicate possible need for goodwill impairment).

Table 2 – Nasdaq OMX Helsinki, Finland, listed companies with higher than average goodwill (Q2/2012) to market capitalization ratios (market data as of 12 September 2012)

<table>
<thead>
<tr>
<th>Entity</th>
<th>Volatility (360D)</th>
<th>WACC (Bloomberg)</th>
<th>GW m€</th>
<th>Goodwill / Book Equity</th>
<th>Goodwill / market cap</th>
<th>ROIC (market value based)</th>
<th>Current P/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOKIA OYJ</td>
<td>62,0 %</td>
<td>9,0 %</td>
<td>4 838</td>
<td>34,8%</td>
<td>57,1%</td>
<td>-39,1%</td>
<td>0,6</td>
</tr>
<tr>
<td>CARGOTEC OYJ-B SHARE</td>
<td>56,1 %</td>
<td>10,6 %</td>
<td>805</td>
<td>68,4%</td>
<td>59,9%</td>
<td>10,9%</td>
<td>1,1</td>
</tr>
<tr>
<td>SANOMA OYJ</td>
<td>39,8 %</td>
<td>5,1 %</td>
<td>2 316</td>
<td>152,0%</td>
<td>181,0%</td>
<td>2,9%</td>
<td>0,8</td>
</tr>
<tr>
<td>KEMIRA OYJ</td>
<td>44,1 %</td>
<td>8,7 %</td>
<td>606</td>
<td>44,2%</td>
<td>36,0%</td>
<td>6,6%</td>
<td>1,2</td>
</tr>
<tr>
<td>OUTFOMPU OYJ</td>
<td>59,9 %</td>
<td>5,5 %</td>
<td>478</td>
<td>22,9%</td>
<td>39,9%</td>
<td>-6,3%</td>
<td>0,6</td>
</tr>
<tr>
<td>STOCKMANN OYJ ABP-B</td>
<td>39,6 %</td>
<td>6,0 %</td>
<td>789</td>
<td>90,6%</td>
<td>73,7%</td>
<td>4,6%</td>
<td>1,2</td>
</tr>
<tr>
<td>HUHTAMAKI OYJ</td>
<td>33,1 %</td>
<td>7,4 %</td>
<td>424</td>
<td>52,6%</td>
<td>32,9%</td>
<td>7,9%</td>
<td>1,6</td>
</tr>
<tr>
<td>TIEOT OYJ</td>
<td>36,2 %</td>
<td>7,8 %</td>
<td>413</td>
<td>73,2%</td>
<td>40,5%</td>
<td>9,3%</td>
<td>1,8</td>
</tr>
<tr>
<td>ORIOLA-KD OYJ B SHAR</td>
<td>41,9 %</td>
<td>7,1 %</td>
<td>267</td>
<td>89,2%</td>
<td>90,9%</td>
<td>4,2%</td>
<td>1,0</td>
</tr>
</tbody>
</table>

Nokia and Sanoma with the highest absolute and relative goodwill, respectively, made significant impairments during Q3-Q4/2011 (Nokia from its landmark Navteq deal).

Well, how about highly valued companies then? It seems that companies with higher than average P/B ratios are somewhat less volatile, have less goodwill and higher ROIC, but their current performance may not let the companies to sustain the high valuation levels: if ROIC less than WACC, it indicates that these companies are unable to produce economic value added above the risk based return requirement.
Table 3 – Nasdaq OMX Helsinki, Finland, listed companies with higher than average price to book (P/B) ratios (market data as of 12 September 2012)

<table>
<thead>
<tr>
<th>Entity</th>
<th>Volatility (360D)</th>
<th>WACC (Bloomberg)</th>
<th>GW m€</th>
<th>Goodwill / Book Equity</th>
<th>Goodwill / market cap</th>
<th>ROIC (market value based)</th>
<th>Current P/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>KONE OYJ-B</td>
<td>30,2 %</td>
<td>10,0 %</td>
<td>1 005</td>
<td>49,4%</td>
<td>7,5%</td>
<td>5,4%</td>
<td>6,6</td>
</tr>
<tr>
<td>WARTSILA OYJ ABP</td>
<td>43,8 %</td>
<td>10,8 %</td>
<td>616</td>
<td>37,0%</td>
<td>10,9%</td>
<td>7,3%</td>
<td>3,4</td>
</tr>
<tr>
<td>NOKIANGENKAAKTA OYJ</td>
<td>47,5 %</td>
<td>11,2 %</td>
<td>64</td>
<td>5,4%</td>
<td>1,4%</td>
<td>9,5%</td>
<td>3,8</td>
</tr>
<tr>
<td>ELISA OYJ</td>
<td>21,5 %</td>
<td>6,5 %</td>
<td>797</td>
<td>94,9%</td>
<td>28,7%</td>
<td>8,4%</td>
<td>3,3</td>
</tr>
<tr>
<td>ORION OYJ-CLASS B</td>
<td>24,3 %</td>
<td>8,4 %</td>
<td>14</td>
<td>2,7%</td>
<td>0,6%</td>
<td>12,1%</td>
<td>4,5</td>
</tr>
<tr>
<td>OUTOTEC OYJ</td>
<td>49,6%</td>
<td>13,0 %</td>
<td>181</td>
<td>45,4%</td>
<td>10,7%</td>
<td>11,2%</td>
<td>4,3</td>
</tr>
<tr>
<td>KONECRANES OYJ</td>
<td>52,6 %</td>
<td>10,5 %</td>
<td>115</td>
<td>26,3%</td>
<td>7,7%</td>
<td>7,0%</td>
<td>3,4</td>
</tr>
<tr>
<td>TIKKURILA OYJ</td>
<td>30,1 %</td>
<td>7,3 %</td>
<td>69</td>
<td>35,9%</td>
<td>10,8%</td>
<td>9,0%</td>
<td>3,3</td>
</tr>
<tr>
<td>UPONOR OYJ</td>
<td>49,9 %</td>
<td>9,3 %</td>
<td>75</td>
<td>35,3%</td>
<td>12,2%</td>
<td>5,9%</td>
<td>2,9</td>
</tr>
<tr>
<td>VACON OYJ</td>
<td>38,6 %</td>
<td>9,0 %</td>
<td>9</td>
<td>9,5%</td>
<td>1,5%</td>
<td>3,3%</td>
<td>6,2</td>
</tr>
<tr>
<td>ALMA MEDIA CORP</td>
<td>27,3 %</td>
<td>7,0 %</td>
<td>31</td>
<td>31,6%</td>
<td>8,9%</td>
<td>10,5%</td>
<td>3,5</td>
</tr>
<tr>
<td>F-SECURE OYJ</td>
<td>31,1 %</td>
<td>8,8 %</td>
<td>19</td>
<td>32,6%</td>
<td>7,0%</td>
<td>9,9%</td>
<td>4,7</td>
</tr>
<tr>
<td>OLVI OYJ-A SHARES</td>
<td>27,3 %</td>
<td>7,3 %</td>
<td>17</td>
<td>13,1%</td>
<td>4,4%</td>
<td>6,4%</td>
<td>3,0</td>
</tr>
<tr>
<td>BASWARE OYJ</td>
<td>39,2 %</td>
<td>9,9 %</td>
<td>32</td>
<td>32,2%</td>
<td>11,5%</td>
<td>4,0%</td>
<td>2,8</td>
</tr>
<tr>
<td>MARIMEKKO OYJ</td>
<td>32,7 %</td>
<td>8,0 %</td>
<td>0</td>
<td>0,0%</td>
<td>0,0%</td>
<td>2,1%</td>
<td>3,6</td>
</tr>
<tr>
<td>TALENTUM OYJ</td>
<td>26,7 %</td>
<td>5,9 %</td>
<td>20</td>
<td>89,5%</td>
<td>34,2%</td>
<td>-8,0%</td>
<td>2,6</td>
</tr>
<tr>
<td>STONESOFT OYJ</td>
<td>63,1 %</td>
<td>11,6 %</td>
<td>0</td>
<td>0,0%</td>
<td>0,0%</td>
<td>-0,6%</td>
<td>27,4</td>
</tr>
<tr>
<td>ETTEPLAN OYJ</td>
<td>35,5 %</td>
<td>6,1 %</td>
<td>36</td>
<td>179,2%</td>
<td>65,5%</td>
<td>12,2%</td>
<td>2,7</td>
</tr>
<tr>
<td>TURVATIIMI OYJ</td>
<td>166,0 %</td>
<td>3,6 %</td>
<td>16</td>
<td>214,3%</td>
<td>69,1%</td>
<td>-10,7%</td>
<td>3,1</td>
</tr>
<tr>
<td>QPR SOFTWARE OYJ</td>
<td>41,5 %</td>
<td>4,8 %</td>
<td>1</td>
<td>4,8%</td>
<td>8,3%</td>
<td>3,6%</td>
<td></td>
</tr>
</tbody>
</table>

In my opinion, share prices are generally driven by growth and expected growth (e.g. companies with operations in emerging markets), profitability, payout ratio/dividend yield, sustained increase in profitability & dividends, free float, and transparent communication with good hit rate on positive and negative future risks. These elements (such as free float and investor appetite) may also strongly affect the trading volumes, price development and the betas. One can of course claim that high valuation and profitability are attributable to intangibles, but attributing such assets and especially goodwill to an individual group company in a volatile market environment may be quite subjective.

In addition to the volatile nature of goodwill, there is a significant body of empirical market research suggesting that company size is good proxy for risk. Multiple companies such as Ibbottson Associates and Duff&Phelps issue annual size premium reports that are based on market data and Moody’s credit rating methodology emphasizes company size (larger) as a risk mitigating factor. Therefore, in the context of an individual entity with a valuable intangible asset, the risk — from general debt and capital market perspective — may quite likely be higher compared to the overall group, even if the current profitability of an individual entity may also be higher (the risk may accordingly offset current excess profitability).

Given the investor/market “conservatism” e.g. related to the valuation levels subsequent to M&A deals (see price to book ratios less than 1 for companies with high level of goodwill), it seems quite bold a statement that at outset there would be less risk in individual M&A deals prospectively assessed only by management rather than subsequent realization and market consensus and as a consequence for tax purposes systematically insist on having more allocations to separately identifiable intangibles instead of...
goodwill. Moreover, the market valuation levels (with implicitly embedded market based risk and growth perception) may greatly fluctuate based on current performance and future expectations even on a quarterly or and especially on an annual basis.

Table 4 – Illustrative time series on changes in valuation levels (CAC top 40) over the past decade

The inter-quartile range used above is naturally widely used for benchmarking purposes in tax related financial valuations. Based on this statistical approach, 25% of the sample may find it hard to sustain valuations levels above the book value, and gravity seems to have a tendency to drag down the seasonal peak valuation levels. Furthermore, it seems that high profitability levels triggering increase in market values may not be sustainable over a longer period of time.

Table 5 – Relationship between profitability and market valuation levels (Nasdaq OMX Helsinki)
To conclude, the risk measurements used in accounting and financial valuations should be considered sound as they seek to take into account inherent market volatility/risks and should also provide good starting point for tax valuation.
3 - Leveraging market data to mitigate comparability issues

The Discussion Draft evokes one frequently encountered problem related to the reliability of possible benchmark transactions (Comparable Uncontrolled Transactions, CUTs or CUPs) e.g. derived from publicly available databases (paragraphs 125, 128). The problem as I see it stem from the fact that the benchmark parties to the intangible asset transaction are rarely competitors or industry peers for the subject group entity.

In the context of the above and given that many companies benchmark themselves to their industry peers, it would make sense to allow a comparison to these direct competitors. In this context, as regards reasonable intangible returns, one can basically apply a PPA type of approach or return on invested capital (ROIC) analysis on public companies so as to derive a reasonable rate of return for the subject intangible class.

Table 6 – Illustrative Return on Invested Capital (ROIC) analysis to determine reasonable returns in relation to overall profitability and other assets

<table>
<thead>
<tr>
<th>FMV balance sheet item for a Listed Peer</th>
<th>MVIC</th>
<th>% of MVIC</th>
<th>Base return (risk-free rate)</th>
<th>Premium (required, observed or implied)</th>
<th>ROIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>GW (w/o AW)</td>
<td>20.0</td>
<td>20.0%</td>
<td>3.5%</td>
<td>10.5%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Market presence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Future technology &amp; marketing intangibles</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other goodwill</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assembled workforce (AW)</td>
<td>10.0</td>
<td>10.0%</td>
<td>3.5%</td>
<td>10.5%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Customer relationships</td>
<td>20.0</td>
<td>20.0%</td>
<td>3.5%</td>
<td>7.0%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Marketing intangibles</td>
<td>10.0</td>
<td>10.0%</td>
<td>3.5%</td>
<td>7.0%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Technology</td>
<td>10.0</td>
<td>10.0%</td>
<td>3.5%</td>
<td>7.0%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Investments</td>
<td>0.0</td>
<td>0.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Tangible fixed assets</td>
<td>25.0</td>
<td>25.0%</td>
<td>3.5%</td>
<td>2.0%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Net Working Capital (NWC)</td>
<td>5.0</td>
<td>5.0%</td>
<td>3.5%</td>
<td>1.0%</td>
<td>4.5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100%</strong></td>
<td><strong>3.5%</strong></td>
<td><strong>6.5%</strong></td>
<td><strong>10.0%</strong></td>
</tr>
</tbody>
</table>

In connection with ROIC analysis, one should be able to make transparent conclusions on reasonable values and returns e.g. for intangibles based on following considerations:

i) the listed peer (or peer group) is a relevant competitor or an industry player;

ii) The total market value of invested capital (MVIC) may be reliably measured as market capitalization plus net debt;

iii) ROIC for the listed peer may directly be derived based on financial reporting metric (current or forecast EBIT) and MVIC;

iv) The book values for NWC and tangible fixed assets are normally reasonable proxies for fair values; and

v) One can leverage market estimates to derive values for technology and marketing intangibles.
If, however, such a holistic approach (as a derivative of PPA) is point blank discouraged, the fall back to independent comparables (of which no one has ever heard of outside the benchmarking context for tax purposes) or to company and asset specific – inherently subjective – considerations without a proper market context may lead to outright arbitrage and excessive administrative processes and litigation.

One additional issue that may be common in connection with tax valuations and also mentioned in the Discussion Draft (e.g., paragraph 158) is the fear that possibly “speculative” or “unreliable” projections may be used in valuations. However, scalability is a typical or even dominant feature of the financial markets, and the future growth, profitability etc. projections beyond reasonable forecast period are always speculative (and most likely “unreliable” based on hindsight bias). Furthermore, in spite of the inherent future uncertainty even in short-term and especially beyond normally applied (3-5 year) forecast periods that may not be reflected e.g. in earn-out mechanisms, it does not stop M&A deals taking place, but requires critical assessment on the assumptions for the deal value drivers, which may then be reflected high discount rates and high levels of resulting goodwill.

In the context of the above, we have a fresh example on the scalability in the financial markets, and temptation to use hindsight bias to (“reliably”) explain the outcome (with severe regress loop).

Table 7 – The top 100 of Forbes 400 (the 400 wealthiest people in the US, Source: Forbes, 2012)

In the above, the top 2 (i.e. Mr. Gates and Mr. Buffet) explain the total distribution better than any other sample (Mr. Gates is almost a 6-sigma event, i.e. 6 standard deviations from the mean and 7.5 excluding himself and Mr. Buffett). However, the key here is not that the extreme observations will explain what will happen in the market, or that the finance market follow power laws with unknown (or only after the fact known) exponent rather than normal distribution, inter-quartile range etc. or that one cannot make as accurate assumptions or projections based on the remaining 98% of the sample: when e.g. analyzing the top 100 sample in the 1970s and without prior knowledge of the accumulated net wealth by 2012 i.e. beyond any reasonable forecast period, we simply may have no clue (apart from
hindsight bias) as to why Mr. Gates (most likely out of pure luck) should come out on top with a blockbuster business and dwarf the rest of the population (and there may have been a large portion of drop-outs along the way).

In view of the above, it generally makes perfect sense that future income projections are discounted, and that this “conservatism” is then reflected in e.g. goodwill from acquisitions.

Concluding remarks

While I very much welcome OECD’s Discussion Draft and guidance on intangible valuations for tax purposes, and understand that cases should be always be assessed on their individual attributes, the guidance should be revised and amended in such a way that it does not create seeming contradictions to the existing market practices and statutory (audit and reporting) requirements as enforced by market regulators. Market data and established valuations methodologies should always be regarded as a sound platform for case specific analyses also for tax purposes.

Helsinki, September 2012

Very truly yours,

Mikko Palmu
Partner, Head of Corporate Finance
To: Joseph L. Andrus, Head of Transfer Pricing Unit, OECD’s Centre for Tax Policy and Administration  
Date: September 25, 2012

From: KPMG’s Global Transfer Pricing Services Practice  
(Clark Chandler)

cc: Stephen Blough, Sean Foley, Loek Helderman, Andrew Hickman, Matthias Kaut, John Neighbour, Kari Pahlman, Rema Serafi, Prita Subramanian, Montserrat Trape, Brian Trauman, Francois Vincent, Matthew Whipp

OECD Invitation to Comment on the Discussion Draft “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions”

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD’s Discussion Draft titled “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions: 6 June to 14 September 2012” (“Discussion Draft”).

KPMG commends the OECD for releasing the Discussion Draft eighteen months ahead of schedule despite the lack of consensus on all paragraphs. As noted in the preamble to the Discussion Draft, the OECD accepted suggestions from the business community for it to release interim drafts for detailed comment. KPMG strongly endorses this approach and hopes that the OECD will continue to use it as a model for its future projects.

The Discussion Draft segments the guidance on the transfer pricing aspects of intangibles into four parts – the identification of intangibles, the identification of parties entitled to the intangible related returns, the determination of whether the controlled transaction involves the use or transfer of intangibles, and the remuneration to the parties entitled to the intangible related returns. KPMG agrees that these four parts broadly cover the key aspects of intangibles transfer pricing.

In addition, the Discussion Draft provides twenty-two examples to illustrate the concepts presented in these four parts. The principle of providing examples to illustrate key concepts is a useful one, although as noted below some of the examples need greater clarity, and KPMG does not agree with the points made in certain of the examples. In some cases the examples are inconsistent with the text. Further, embedding some of the examples within the body of the Discussion Draft in the sections to which they relate would make it easier to identify the principles to which they relate. KPMG suggests embedding the shorter examples in the text.
The Discussion Draft makes reference to some common misperceptions related to the value of intangibles and cautions against them. For instance, the Discussion Draft says:

- “It should be emphasized that not all intangibles deserve separate compensation in all circumstances, and not all intangibles give rise to premium returns in all circumstances.” (paragraph 9)
- “In a particular circumstance, intangible related returns with respect to an intangible may be positive, negative, or zero.” (paragraph 28)
- “In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns.” (paragraph 108)

KPMG agrees with this evaluation of the realized value of an intangible. An intangible need not necessarily produce significant positive returns or be necessarily attributed all the residual profit after routine functional returns, which tax authorities have a tendency to assume.

KPMG also agrees with several other statements in the Discussion Draft. Another example is the following statement on the importance of understanding the MNE’s global business: “Indeed, in cases involving the use or transfer of intangibles, it is especially important to ground the analysis on an understanding of the MNE’s global business and the manner in which intangibles are used by the MNE to add or create value.”

While KPMG agrees with parts of the Discussion Draft, it believes that much remains to be done for the revised guidelines to provide the clarity and certainty so desired by taxpayers and tax authorities.1 However, the Discussion Draft is an important step forward towards those goals.

In the following sections, KPMG discusses its comments, concerns and suggestions on various aspects of the Discussion Draft.

**Summary of KPMG’s key recommendations:**

The key suggestions proposed by KPMG are as follows:

- The definition of intangibles should be more consistent with existing legal and accounting definitions of intangibles. There is no need to broaden the definition to capture the wider transfers that would get captured by Chapter IX anyway. The Discussion Draft’s treatment of goodwill and ongoing concern is particularly confusing, in that there is no clear definition, and it is treated inconsistently in different parts of the Discussion Draft.

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1 It is worth keeping in mind that the goals of the OECD *Model Tax Convention on Income and on Capital* (which are an offshoot of the Commentary to Article 9) are to “clarify, standardise, and confirm the fiscal situation of taxpayers”.

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• The intangible related return is defined as the residual profit remaining after costs and routine returns are deducted. This appears to be implying that the remuneration to intangibles must be measured as a residual profit, which seems to be in conflict with the discussion elsewhere in the Discussion Draft, specifically paragraph 108. KPMG suggests that this definition be modified and explicitly defined as or linked to the compensation that would have been expected, had the transaction taken place among similarly situated unrelated parties.

• The concept of entitlement to intangible related returns contains several weaknesses:
  
  o There is no reference to the role of transactions between uncontrolled parties in the discussion of which party is entitled to returns from intangibles. The examination of uncontrolled transactions should be the starting point of any transfer pricing analysis, as emphasized by Chapter IX of the OECD guidelines.
  
  o While the discussion in part B of the Discussion Draft is purportedly a discussion of entitlement to intangible related returns generally, the underlying analysis appears to be appropriate to the rewards from new intangible development. KPMG suggests revising the discussion to distinguish between the entitlement to intangible related returns from intangibles already developed and the entitlement to intangible related returns from new intangible development. As written, this section gives, at best, unclear and very likely misleading guidance with respect to entitlement to returns from fully developed intangibles subsequently transferred in an arm’s length transaction.
  
  o The “substance” requirements for determining which party is entitled to a return should be reformulated towards identification of the party bearing the risk of intangible development or enhancement. With that change this discussion should further be made parallel to the guidance on risk allocation set forth in Chapter IX. To do otherwise is to simply ignore the realities of how MNEs do business as well as how parties operate at arm’s length. It is reasonable to require that the legal entity bearing risk meet the requirements set forth in Chapter IX; the additional requirement that the entity bearing risk actually has to perform the intangible development activity itself is neither consistent with the way in which MNEs operate – capabilities and functions are often spread among a diverse group of legal entities – nor does it reflect how parties operate at arm’s length. The current guidance in the Discussion Draft effectively moves from the arm’s length standard to one that is more akin to formulary apportionment.
  
• Subject to the requirement for control over risk contained in Chapter IX, the taxpayer should be able to elect whether to compensate the provider of the intangible development activities through an arm’s length payment for its activities or a share in the outcome of the activities. While the former may include compensation for intangibles owned/controlled by the service
provider, once an arm’s length payment has been made, assigning additional value in the form of an interest in the intangible that was developed is, by definition, non-arm’s length. The taxpayer’s decision on which model to use should generally be respected by tax authorities provided that the model meets the arm’s length standard and provided that the taxpayer makes the decision clear at the outset.

- The Discussion Draft appears to give considerably more scope for tax authorities to disregard or recharacterize transactions undertaken by the related parties than does the carefully crafted guidance in paragraphs 1.64 to 1.69. Even Chapter IX makes clear that recharacterization of transactions should be a last resort to be undertaken only if an appropriate transfer pricing adjustment cannot be found. KPMG suggests that if the intercompany contract is substantially similar to a third party contract regarding functions, risks and rights, then the intercompany contract should be respected. If it is not, then guidance similar to Chapter IX’s guidance related to evaluating the arm’s-length nature of the contractual allocation of risk should be provided to evaluate whether the contractual terms are arm’s length. Paragraphs 1.64 through 1.69 refer to circumstances for disregarding transactions – the Discussion Draft should endeavor to make this discussion consistent with Chapter IX and clarify that all recharacterizations must follow the approach and criteria laid out in paragraphs 1.64 to 1.69. Chapter VI should not be introducing new ways to recharacterize transactions.

- The concept of “realistic alternatives” is defined in a very broad way in the Discussion Draft, and in a way that is likely to invite disputes not just between taxpayers and a tax authority, but among different tax authorities. As used in the Discussion Draft, “options realistically available” appears to require a detailed computation of the impact of specific options on intercompany pricing, even in cases in which there is no evidence that this would be the approach used in computing prices in a comparable transaction among unrelated parties. KPMG’s experience based on studies done to support pricing under the new US cost sharing regulations, which include a similar requirement, is that this is often a very artificial hypothetical exercise that often increases rather than lowers the sensitivity of such estimates to various assumptions used in the analysis. The original discussion of the concept of options realistically available in paragraph 1.34 envisioned a more general use of “options realistically available” – as one factor relevant to the comparability analysis. KPMG suggests that the concept of realistic alternatives be retained as a comparability criterion but not as a way to test the validity of the transaction, and certainly not as a means or reason for recharacterizing transactions.

- The Discussion Draft is essentially silent on the treatment of licensing transactions among unrelated third parties, and their implications for prices that would be expected among controlled entities. However, such third party transactions (i) often provide evidence about actual – as opposed to theoretical – pricing among uncontrolled entities; (ii) provide guidance as to the types of contractual terms that exist in agreements among uncontrolled entities; and (iii)
KPMG believes that additional guidance should be provided, and that the key points in such guidance are that (i) the arm’s length nature of licenses among controlled parties should be evaluated using the principles set forth in Chapter IX regarding respect for contractual terms (e.g., if they are the same as those that are found among uncontrolled parties, they should be respected, if not a further analysis is needed to evaluate the arm’s length nature of the terms); (ii) the licenses should be treated as a specific intangible giving the licensee and licensor specific rights that constitute a discrete intangible, and (iii) that the terms of the license established by the taxpayer should be respected unless it can be shown that these terms would not be accepted, had the agreement been negotiated among unrelated third parties and only if the criteria of paragraphs 1.64 to 1.69 are met.

The Discussion Draft does not distinguish between the value of an intangible to the multinational group and the value to specific legal entities. This is particularly apparent in the case of acquisitions, where the price paid reflects the synergy value of the group, which is likely to be greater than the value to individual legal entities. The Discussion Draft should reiterate the Chapter IX guidance that the price paid for intangibles should reflect the value of the intangibles to the specific legal entities involved, which may be different from the value of the intangibles to the group. Thus, if legal entity A owns/controls an intangible whose value is dependent upon the value of an intangible owned/controlled by legal entity B, there should be no presumption that legal entity A can capture the profits that would normally accrue to the intangible owned by legal entity B.

The Discussion Draft introduces a specific type of intangible – the “Section D.1.(vi) intangible.” The benefit of separately defining the Section D.1.(vi) intangible is not immediately evident to KPMG. We suggest that the draft simply refer to “intangibles that affect the reliability of comparisons between the controlled transaction and otherwise comparable uncontrolled transactions.” If the OECD does retain the separate definition of the Section D.1.(vi) intangible, then KPMG recommends that the OECD include a concise explanation for why the definition is important. The very odd name of the intangible underscores the lack of clarity as to its definition and scope.

The Discussion Draft in some cases goes out of its way to state that certain valuations (such as those done for purchase price accounting) have “no” relevance for transfer pricing. However, the valuation techniques used in financial statement analyses are no different in substance from valuation approaches used in economics and business generally; they are simply applied using specific assumptions that are dictated by accounting standards and which may or may not be consistent with the assumptions that should be used for transfer pricing. While it may be appropriate to state that there is no presumption that the assumptions used in financial statement valuations will carry over to the valuations for transfer pricing purposes, the Discussion Draft should provide explicit direction that the “most appropriate” method should be used, and that
the approaches used in valuation/purchase price accounting may or may not be the most appropriate method, based on the specific facts and circumstances of the intangible transfer at issue.

A general observation about our comments is that they make many references to Chapter IX. This is not because the two chapters cover the same material, although there is some overlap in that analyses of both business restructuring and investments in the maintenance and development of intangibles are very dependent upon the allocation of risk among different legal entities. Instead, it is because both chapters cover situations within MNEs where the application of third-party comparables can be very difficult. Despite this difficulty, Chapter IX provides guidance relating to business restructuring which is grounded in the fundamental concepts of the arm’s length principle and other guidance in the OECD Guidelines. We contrast this approach with that in the Discussion Draft, which seems to endorse approaches which are not referenced to commonly-understood concepts about the relevance of what happens in similar arrangements between unconnected parties, and seems to depart from other guidance in the OECD Guidelines. Therefore, we think the framework adopted in Chapter IX is a useful model. In particular, the framework invites us to start with the transaction as structured and then to compare that structure with those adopted in similar uncontrolled transactions. If the features are the same, then the arrangement is in concept arm’s length; if the features are different then the analysis goes deeper to determine whether, although there are no direct comparables, the arrangements are such that it is reasonable to assume would have been agreed by unconnected parties. That analysis, appropriate in a chapter examining restructurings involving re-allocation of risk, asks which party controls the risk. Elsewhere in Chapter IX the discussion of recharacterization is firmly rooted in the principles expressed in Chapter I. Therefore, references to Chapter IX in our comments express the need for a similar framework to be adopted in Chapter VI which is based on comparability with unrelated parties and which references existing guidance.

The following sections first present KPMG’s general comments on certain aspects of the Discussion Draft roughly in the order in which they come up in the draft. The annex to this memorandum presents KPMG’s comments on specific paragraphs in the Discussion Draft.

**Definition of intangible**

The Discussion Draft defines an intangible as “something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities.” It goes on to state that there is no requirement that the intangible be separately transferable from the business as a whole.

There is no link in the above definition to the concept of intangible property, which is a significant and unnecessary departure from the existing definition in the OECD Guidelines. Under the current version of the OECD Guidelines, the word “intangible,” even when used on a standalone basis, refers to “intangible property.” In turn, the term “property” connotes certain traits, such as being
capable of being owned, and other legal characteristics. By dropping the notion of property from
the definition of intangible, the OECD is creating a new and previously unknown concept that is not
tied to any current legal framework, although the notion of being capable of being “owned or
controlled for use in commercial activities” is present (paragraph 5).

KPMG does not believe that the expansion in the definition of intangibles is needed to protect the
interests of tax authorities. In the case of intangibles that are embedded in tangible property and
services, the Discussion Draft has identified a number of comparability criteria (location savings,
local markets) that would be taken into account (along with intangible property) in determining
pricing. In the case of a business restructuring – which is defined very broadly – Chapter IX makes
it very clear that a payment is needed if the restructuring would lead to a payment had that
restructuring taken place between unrelated parties, regardless of whether or not there is a transfer
of intangible property.

The risk of the expanded definition of intangibles is that it is likely to encourage certain tax
authorities to expect a payment for a “transfer” when no such payment would take place among
uncontrolled parties. Take the simple example of the termination of a distribution contract that has
been in place for five years. If one of the parties has the legal right to extend that contract, there
would be an intangible asset – a contractual obligation – and at arm’s length there would normally
be a payment as a result. If there is a local legal requirement specifying that the distributor must
receive two years’ notification, this may or may not be an intangible (it is not a right that can be
transferred to another and is not under the “control” of a specific legal entity), but a payment would
be required for immediate termination at arm’s length and would be required under Chapter IX.
However, if there is no ability to compel an extension to the contract, parties operating at arm’s
length can and do terminate such contracts without payment – the risk of termination is a normal
business risk. In such a situation, Chapter IX would not require a payment. However, by defining
“goodwill” as a potential transfer pricing intangible, the Discussion Draft is likely to be used by
certain tax authorities to identify an intangible, even in situations such as the one described above
where parties have no ability to compel extension of the contract, and to demand payment for that
intangible even though no such payment would take place among unrelated parties.

An additional danger of the approach adopted in the Discussion Draft is that it will preclude
reference to domestic law (which is provided, for instance, in paragraph 2 of Article 3 of the OECD
Model Tax Convention on Income and on Capital). Thus, in order for this approach to be
successful, the OECD itself must define completely and exhaustively this new concept of intangible
because none of the resources ordinarily available to understand concepts under double tax
conventions will be sufficient.

The Discussion Draft’s efforts to create a new definition of intangibles that is specific to transfer
pricing leads to inconsistencies, and there are various instances in the Discussion Draft where the
presumed definition does not fully match the definition of an intangible as “something which is not
a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities.” For instance,

- Paragraph 14 says the illustrations of intangibles provided in the Discussion Draft should be “adapted to the specific legal and regulatory environment that prevails in each country.” This seems to indicate that what is an intangible in one country might not be an intangible in another. If that is not the intent of this paragraph, then it will be helpful to have clarification on what the OECD means. It is imperative that the definition of intangible be consistent across all countries if the revised Chapter VI is to provide clarity and certainty on the transfer pricing aspects of intangibles.

- Paragraph 23 states that group synergies are not intangibles since they are not “owned or controlled by a single enterprise…” This illustration seems to indicate that control by a single enterprise is necessary for something to be considered an intangible, which is reasonable.

- At the same time, paragraph 22 says that goodwill and ongoing concern value are included in the definition of intangibles, although there is no “transfer pricing” definition of the terms goodwill and ongoing concern. This is inconsistent with Paragraph 23 because goodwill and ongoing concern value are often created at least in part by group synergies, and are not owned or controlled by a single enterprise. Presumably, goodwill and ongoing concern value that is an attribute of the group cannot be considered an intangible for transfer pricing purposes, as it cannot be controlled by a single enterprise. The failure to recognize this explicitly leads to internal inconsistency in the Discussion Draft.

- Paragraph 24 states that market specific characteristics are not intangibles since they may not be “owned, controlled and transferred by an individual enterprise.” This illustration adds transferability as an additional criterion in the intangible definition. It also seems to imply that all three criteria need to be satisfied by a single enterprise for something to be considered an intangible, i.e., it must be owned, controlled and transferrable by a single enterprise. This is different from the definition, which simply says that the intangible must be capable of being owned or controlled.

KPMG believes that many of these inconsistencies could be resolved by reverting to a more traditional definition linked to intangible property that can be owned, controlled and which is transferrable by a single entity. In this regard, KPMG notes that if a single entity can “control” an intangible, it presumably can “sell” this control to another entity, which implies that it can transfer the intangible (or at least the remuneration that can be commanded by the intangible) to a different legal entity.

KPMG recognizes the concern of tax authorities that transfer prices for intangibles may be understated based on over-attribution of value to non-compensable goodwill and ongoing concern value. However, KPMG believes that concern can be appropriately addressed without addition of
an undefined “goodwill and ongoing concern” concept to the list of defined intangibles. Specifically, the discussion of intangible valuation can make clear that arm’s length intangible values may incorporate components of value that might in other circumstances be classified as goodwill and ongoing concern. Further, KPMG believes that the Chapter IX guidance will typically be applicable to the transactions that concern tax authorities in this regard, and that chapter has appropriate guidance and protection for tax authorities on this issue.

**Links with other rules, definitions or analyses**

According to the Discussion Draft, the guidance contained in it “is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes.” (paragraph 12).

While it is understandable that the Discussion Draft is meant to provide guidance for transfer pricing purposes, it is unfortunate that the OECD would not attempt to align the concepts of royalties (which are commonly thought of as payments for intangible property) with that of the new concept of intangible.

Stating that the guidance in the Discussion Draft has “no relevance” for other tax purposes, is a simple abdication of the OECD’s responsibility for addressing issues related to double tax. By adopting a transfer pricing specific definition of intangibles, the OECD is ensuring that tax authorities will insist on a recognition of revenue arising from the use or transfer of such transfer pricing intangibles without any assurance that there will be an offsetting deduction – while there is a general recognition among countries that payments for intangible property are either deductible or depreciable, there is no similar consensus regarding payments for goodwill and going concern. While KPMG fully understands that local countries have control over the tax treatment of income and expenses, the OECD has an obligation to recognize that the use of a transfer pricing specific definition of intangibles may undermine the traditional relationship between transfer pricing and local tax rules, possibly leading to significant exposure to double tax.

The Discussion Draft’s treatment of accounting concepts and definitions is inconsistent and confusing. At times it talks about “goodwill and ongoing concern” in ways that borrow from accounting definitions, while at the same time stating that “valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.” (paragraph 110). While there are clearly differences between tax and accounting definitions, and while it is understandable that the OECD is not going to defer to specific accounting definitions, simply dismissing them seems to be problematic. Given the large volume of literature and experience that has already been developed in the legal and accounting fields related to intangibles, it seems inefficient to dismiss useful information from those areas to start afresh in transfer pricing. To the extent that these other concepts are consistent with the arm’s-length standard, there is no need to abandon them.
Finally, it is unclear that the pronouncement in the Discussion Draft that it is not intended for other tax purposes is sufficient, from a practical point of view, for it not to have any other tax impact. For instance, the practical implications on withholding taxes of the new definition of intangibles, which is different from current legal definitions of intangibles, needs to be carefully worked out. Taxpayers also face significant practical issues coordinating valuations for tax and customs duties purposes, and adoption of transfer-pricing specific definitions will create additional issues in this regard.

**Definition of intangible related returns**

The intangible related return is defined in paragraph 28 as the residual profit remaining after costs and routine returns are deducted. This paragraph appears to be implying that the remuneration to intangibles must be measured as a residual profit, which seems to be in conflict with the discussion elsewhere in the Discussion Draft. More broadly, this creates considerable confusion between the return to intangibles, and returns associated with the realization of risk not associated with intangibles. In effect, it says all profit is either intangible profit or is “routine” profit, but in fact there are a number of other sources of excess or residual profit/losses, including some of the comparability factors that the OECD has identified in the Discussion Draft (e.g., location savings), economies of scale or scope, capacity utilization during different phases of the business cycle, etc. KPMG also believes that the discussion of how to measure the intangible related return does not belong to the section discussing determination of who is entitled to the intangible related return.

The concept of “intangible related returns” should be clearly linked to the price that the intangible would command in an arm’s length transaction among unrelated parties. The use of any other standard will result in payments that are less than arm’s length in some circumstances and more than arm’s length in others. When a supplier sells accounting software to an unrelated party, it expects to be paid regardless of whether the buyer earns residual profits or not, or even whether the buyer earns positive profits or not. Similarly, one of the key reasons that uncontrolled parties enter into licenses is to shift the risk associated with the exploitation of the intangible from the licensor to the licensee. In return for accepting this risk, the licensee generally receives a share of any intangible profit arising from the successful exploitation of the intangible, and may incur losses if it is unsuccessful in exploiting the intangible. In either case, the payment made between the licensee and the licensor is not equal to total profits less routine profits.

**Identification of parties entitled to intangible related returns**

As the OECD itself has pointed out, Part B of the Discussion Draft (which discusses entitlement to the intangible related return) is probably the most in need of further clarification.

There are three key deficiencies in the approach contained in the Discussion Draft.

- The absence of reference to the observed behavior of third parties;
• The lack of any coherent discussion of the relationship between investments in intangible development and risk; and

• The failure to distinguish between intangibles already developed and intangibles under development.

Part B of the Discussion Draft provides a striking contrast to Chapter IX of the OECD Guidelines in its absence of reference to comparable transactions. For instance, in discussing the contractual allocation of risk, paragraph 9.18 says “Where data evidence a similar allocation of risk in comparable uncontrolled transactions, then the contractual risk allocation between the associated enterprises is regarded as arm’s length.” Similarly, paragraph 9.35 says “In determining whether the contractual risk allocation is arm’s length, the tax administration would examine whether there is evidence from comparable uncontrolled transactions supporting the risk allocation in the manufacturer’s controlled transactions. If such evidence exists, whether from internal or external comparables, there would be no reason to challenge the risk allocation in the taxpayer’s controlled transactions.”

In other words, Chapter IX is clearly reinforcing the bedrock principle behind Article 9 and all OECD guidance to date, which is that a controlled transaction that operates in the same way as a comparable uncontrolled transaction should be treated as arm’s length.

The Discussion Draft, on the other hand, makes no reference to comparable transactions in the context of determining entitlement to the intangible related return. (It does refer to certain paragraphs in Chapter IX in certain places; however, the application of those paragraphs is unclear.)

In paragraph 38, the Discussion Draft says “Where the parties’ conduct is aligned with the terms of registrations and contracts, the member of the MNE group contractually entitled to intangible related returns will either perform the functions related to the development, enhancement, maintenance and protection of the intangible, or arrange to have such functions performed under its control…” Further, paragraph 40 says “It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of intangibles.”

Paragraph 40 indicates that the “important” functions related to the development, enhancement, maintenance and protection of the intangibles must be physically performed, through its own employees, by the entity claiming entitlement to intangible related returns. Depending on the facts and circumstances, these important functions “would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defense and protection of intangibles, and ongoing quality control over functions performed by independent enterprises that may have a material effect on the value of the intangible.”
These paragraphs make assertions about what independent enterprises do, without requiring any comparison between the controlled and uncontrolled transactions: such presumptions should be eliminated and replaced by arm’s length principles based on comparability.

Uncontrolled parties routinely enter into contract R&D arrangements, purchase advertising services, and in general pay for services that may lead to the development of intangibles property where the level of involvement of their own employees falls well short of that implied in the OECD Discussion Draft, but which nevertheless leave the buyer of the services with the risks and rights of ownership. Indeed, one of the reasons that companies, operating at arm’s length, buy R&D, advertising and other “intangible generating” services from third parties is that they lack the capabilities to carry out these services in-house.

The OECD should also make it clear that a party that is funding risky intangible investment must have a claim on the upside of such risky investments, within a framework on risk attribution similar to Chapter IX’s. Similarly, the party funding a risky intangible investment should bear the losses that occur if the investment fails.

A typical arms’ length deal would have the owner of the intangible enter into an agreement with an investor – the owner would carry out the required development activities and would be granted an assured return by the investor, even though the investor has no employees of its own to carry out the intangible development activity. The investor must be able to expect the return to risk for this to be an arm’s length arrangement, even if the owner does all of the actual intangible development effort.

2 In this regard, while the detailed examination of the relationship between risky investments and pre-existing intangibles can be complex in practice, the relationship is relatively simply in concept. Take the case of a legal entity that is investing 100 in a project unrelated to intangible development that has a 50% chance of getting a return of 220, and a 50% chance of a return of zero. The expected return is 10% (220 * 0.50 = 110 + 0 = 110). However, if successful, the ex post profits will look to be extraordinary (220 on an investment of 100). But these profits are entirely from the assumption of risk and cannot be ascribed to any pre-existing intangible.

We can now introduce an intangible into the equation – if intangible X is used, the probability of success changes from 50% to 75%. The computation of the value of the intangible is as follows: with the intangible expected revenues are 165 rather than 110, implying a value for the intangible of 55. In case 1 (no pre-existing intangible and a 50:50 chance of success), legal entity A could expect a payment for the value of its routine services, and nothing more. (If it was paid something more, say cost plus 20%, that would imply that legal entity was entering into a bad deal in which its expected profits were 20 – 10 = -10.) In case 2 (where legal entity A has a pre-existing intangible that increases the likelihood of success to 75%), legal entity A could expect a payment that reflected both the profits on its routine activities and the value of its intangibles (e.g. 55). But, after agreeing to pay the 55 value in intangibles, the investor must be able to expect the return to risk for this to be an arm’s length arrangement, even if the owner does all of the actual intangible development effort.
Risk-bearing is an important economic activity, and the Discussion Draft should acknowledge this, and explicitly adhere to its recently issued guidance in Chapter IX on attribution of risk.

In general, the framework laid out in Part B of the Discussion Draft does not work well for licensing transactions. For example, if Company A buys an intangible asset and licenses the rights to Company B, and Company B is thereafter responsible for the performance of all functions and controls all risks, then the framework of Part B appears to imply that Company A is not entitled to the intangible related return. This seems contrary to observed third-party behavior in licensee-licensor arrangements where the licensor in such situations would receive intangible related returns.

KPMG suggests revising Part B to distinguish between the general issue of entitlement to intangible related returns, which includes the entitlement to intangible related returns from already developed intangibles, and the issue of the party bearing the risks and rewards associated with new intangible development. While the discussion in Part B is purportedly a discussion of entitlement to intangible related returns, it is really only relevant to the rewards of new intangible development.

KPMG recommends that the discussion on entitlement to the intangible related returns follow the Chapter IX guidance on attribution of risk. This approach would (a) remove the unfortunate implications of the Discussion Draft for entitlement to intangible related returns from intangibles already developed, (b) make it much more consistent with Chapter IX, (c) provide explicit recognition to risk-bearing as an important economic activity, and (c) put in place reasonable substance requirements.

KPMG proposes the following approach to determining entitlement to intangible related returns similar to the approach adopted in Chapter IX for determining whether the allocation of risks in a controlled transaction is arm’s length.

1) First, evaluate if there is reliable evidence of a similar allocation of entitlement to the intangible related return in comparable uncontrolled transactions. If there is, then the entitlement in the controlled transaction is arm’s length.

2) If there is not, then evaluate whether the allocation of entitlement to the intangible related return is one that might have been expected to have been agreed between independent parties in comparable circumstances. Apply similar standards as in Chapter IX in evaluating control over risks. Consider who controls functions or bears costs in making the evaluation on who controls risks.

In considering the role of functions and costs in determining the control over risks, the revised guidelines should address the concerns discussed above. Further, several other key aspects need greater clarity. For example, what is meant by development, enhancement, maintenance and protection of an intangible? Is each of these functions equally important in determining entitlement? If not, what factors should be considered in gauging the importance of each of these
functions? We later comment further on these points in connection with Example 1 of the Discussion Draft.

Finally, KPMG suggests that the third factor considered in the Discussion Draft on determining entitlement to intangible related returns, namely whether members not entitled to the intangible related return are compensated on an arm’s-length basis, be removed, moved or reworded. While it is important for the members not entitled to the intangible related return to be compensated on an arm’s-length basis, whether or not they are done so does not seem relevant to the determination of entitlement to the intangible related return under the principles laid out in the Discussion Draft. The compensation to parties not entitled to intangible related returns could still be discussed but it does not seem to belong to the discussion of determination of parties entitled to the intangible related return.

In essence, the structure of the transaction should be respected in determining how any adjustment is determined – the fact that tax authorities have a legitimate right to evaluate whether the compensation for contract R&D is or is not arm’s length, and to make an adjustment to bring it up to an arm’s length amount if it is not, should not also translate into the right to disregard contractual arrangements and assert entitlement to the intangible related return.

Finally, at arm’s length companies can enter into business arrangements in which the entity that is carrying out the IP development activity (e.g., R&D) is paid an arm’s length compensation for that activity regardless of whether or not it is successful, or whether the entity carrying out the activity receives payment that is contingent upon a successful outcome. They do not receive both a payment that reflects an arm’s length amount with no assumption of the risk of failure and also claim on a portion of the outcome if successful. Thus, while an arm’s length return may include a payment for the value of any intangibles that are owned by the entity carrying out the activity, once an arm’s length payment has been made any additional compensation would not be made among unrelated third parties and is, therefore, by definition, inconsistent with the arm’s-length principle. The OECD Guidelines should explicitly reject the notion that the tax authorities of a country in which a contract R&D provider resides can assert that the contract R&D provider is entitled to (i) a full arm’s length payment for the value of the R&D workforce plus (ii) an intangible related return, for instance, as a share of overall MNE profits.

**Recharacterization of transactions**

A key principle of the OECD Guidelines is the respect for transfer pricing structures put in place by taxpayers. Paragraphs 1.64 through 1.69 refer to circumstances in which tax authorities may disregard the transaction put in place by the taxpayer but they make it clear that such circumstances are rare.

Chapter IX of the OECD Guidelines builds a transfer pricing framework for business restructurings that adheres to the principles of paragraphs 1.64 through 1.69. Several paragraphs in Chapter IX reiterate the principle of respect for taxpayer structures in all but exceptional cases, without
replacing them. In other words, any recharacterization must abide by the provisions of paragraphs 1.64 and 1.69 and be limited to the cases covered or contemplated therein.

For example, paragraph 9.168 says “Paragraphs 1.64-1.69 explicitly limit the non-recognition of the actual transaction or arrangement to exceptional cases. This indicates that the non-recognition of a transaction is not the norm but an exception to the general principle that a tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them. The word “exceptional” in this context is similar in meaning to “rare” or “unusual”. It reflects that in most cases it is expected that the arm’s length principle under Article 9 can be satisfied by determining arm’s length pricing for the arrangement as actually undertaken and structured.”

To give another example, paragraph 9.171 says “The second circumstance in paragraph 1.65 explicitly refers to the situation where the arrangements adopted by the associated enterprises “differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner…” Consistent with paragraph 9.163, tax administrations should not ordinarily interfere with the business decisions of a taxpayer as to how to structure its business arrangements. A determination that a controlled transaction is not commercially rational must therefore be made with great caution, and only in exceptional circumstances lead to the non-recognition of the associated enterprise arrangements.”

The Discussion Draft, in contrast to Chapter IX, has a limited discussion of the principles of paragraphs 1.64 – 1.69. It does not reinforce sufficiently strongly its adherence to these principles and, in fact, appears to give tax authorities much greater authority to disregard the transaction as structured by the taxpayer than is envisioned elsewhere in the OECD Guidelines.

For instance, paragraphs 35, 37, 53 and 55 of the Discussion Draft appear to be creating new avenues for tax authorities to disregard or recharacterize transactions undertaken by the related parties. These paragraphs seem to imply that where the contractual arrangements are not consistent with the “conduct” of the parties, tax authorities may disregard the contractual arrangements. However, conduct is defined in a very specific manner and there is no reference either to comparable transactions (see paragraph 40 and the discussion in the last section) or to the cautionary language of paragraphs 1.64 – 1.69, leaving the door open to recharacterizations at will by tax authorities.

Similarly, the notion of “options realistically available” is currently used by some tax authorities to recharacterize transactions, without reference or recourse to paragraphs 1.64 to 1.69, under the guise of pricing them. Paragraphs 80 to 83 discuss options realistically available to both parties to the transaction, and seem to suggest that recharacterization can be applied via the comparability analysis and the review of options realistically available. While there is some reference to paragraphs in Chapter IX, their application is unclear, seemingly allowing recharacterizations that go against the spirit of paragraphs 1.64 to 1.69.
KPMG suggests that if the intercompany contract is substantially similar to a third party contract regarding functions, risks and rights, then the intercompany contract should be respected. If it is not, then guidance similar to Chapter IX should be provided to evaluate whether the contractual terms are arm’s length. Paragraphs 1.64 through 1.69 refer to circumstances for disregarding transactions – the Discussion Draft should clarify that all recharacterizations must follow the approach and criteria laid out in these paragraphs. Chapter VI should not be introducing new ways to recharacterize transactions.

**Options realistically available**

The original discussion of the concept of options realistically available in paragraph 1.34 envisioned a more general use of “options realistically available” – as one factor relevant to the comparability analysis. Chapter IX has expanded references to “options realistically available” but even there it is relevant to the comparability analysis (paragraph 9.59). The options realistically available concept is more appropriate as a comparability criterion than a pricing approach.

KPMG believes that the Discussion Draft has inappropriately broadened the application of the concept of realistic alternatives to the point where it is likely to lead to substantial departures from arm’s length pricing. While the concept of realistic alternatives has a useful role as a comparability factor and for assessing the overall reasonableness of a transaction, the Discussion Draft appears to assume that there is a specific rank order of such options that will drive not only the specific pricing of a transaction, but also whether or not a tax authority has to respect a transaction. Moreover, the Discussion Draft often appears to view the current state as necessarily one of the realistic alternatives, whereas in fact arm’s length pricing and behavior is driven by the continual need for change and adaptation. The fact that legal entity A has licensed trademark X from legal entity B for 10 years does not mean that it will always do so; at some point it may decide that the use of a different trademark is appropriate. Whether or not a payment is needed when it terminates the license agreement should be based on the principles that are the same as/consistent with those contained in Chapter IX.

The Discussion Draft applies the concept of realistic alternatives in a way that effectively ignores data from comparable transactions among unrelated parties. For example, software programs such a Microsoft Office have a positive price in the market. There are also a number of programs that may provide users with many of the same functions that are available for free or at substantially lower cost. The existence of such free/lower costs options does not imply that a purchaser of Microsoft Office has the “option realistically available” to pay a price of zero for Microsoft Office. In a similar vein, the fact that legal entity A may be the only source of a particular technology does not imply that it will always have the “option realistically available” to reap excess profits from the use of that technology in perpetuity – at arm’s length a licensee would look at the pricing of competitive intangible property and its ability to make the investments needed to shift to a different intangible property that had similar capabilities over time in order to negotiate a price that was consistent with those prevailing in third party transactions involving similar property.
The Discussion Draft’s position that options realistically available should take the specific tax attributes of the parties involved in the transaction into account (see Example 19) is particularly troubling. In this regard, while there is no question that taxes can have an impact upon price levels, it is much less obvious that the tax attributes of specific buyers and sellers necessarily impact pricing. Take the case of the interest rate deduction for home ownership in the US – while there is a general consensus that the deduction provides an overall benefit that leads to higher housing prices, a specific seller does not accept a lower price just because the specific buyer is not able to take advantage of the interest rate deduction.

Taking the tax attributes of specific parties into account in a detailed arithmetic computation, as is done in Example 19, starts with the assumption – made with no apparent need for empirical support – that a contract manufacturer with a 10 percent tax rate will necessarily charge a lower price than a contract manufacturer with a 20 percent tax rate. Using the interest rate deduction example presented above, this is equivalent to saying that a buyer that cannot take advantage of the interest rate deduction will necessarily pay a lower price than one that can take advantage of the deduction.

There are other obvious issues with the assumption that taxes are taken into account on an entity specific basis. For example, does it imply that a seller with an NOL that cushions it from capital gains recognition will be willing to accept a lower price than one without such an NOL? Or that a change in depreciation rules that allows a specific intangible asset to be depreciated over three years rather than 7 years will affect the intercompany price? In this regard, all else equal, the sale of an intangible from a jurisdiction with a lower tax rate to one with a higher tax rate may lead to an increase in taxes and therefore lower after-tax income. Does this imply that MNEs should not be allowed to make such transfers? Are withholding taxes also factored into this analysis?

Taxes are just one example of a much broader range of issues that arise when using entity-specific attributes in an arithmetically driven computation of “options realistically available.” Similar issues arise when this approach is used in the rigid evaluation of the comparability factors identified in the Discussion Draft – location savings, local market attributes – or even to more general economic attributes such as the level of capacity utilization at a plant. While such approaches are theoretically appealing and sometimes may even be used in negotiations among parties operating at arm’s length, they ignore the role of general market options and assume a level of specificity and detail that often simply does not exist.

Moreover, the Discussion Draft does not appear to acknowledge that, at arm’s length, different parties will make different decisions when confronted with the same range of options. Airline 1 may decide to buy jet fuel on a spot basis while Airline 2 may decide to enter into a long term fixed price contract. Both may have had the same options, and the decision will clearly impact profits, but neither decision is necessarily better or worse than the other at the time it is made. Similarly, one company may decide to license in a given technological capability while another may choose to develop it on its own. There may be consequences to this decision, but neither option is necessarily better or worse than the other at the time it is made. Finally, assume that trademark X is licensed to
two companies, A and B. A may decide to manufacture products that will be sold under the trademark locally, on the assumption that having manufacturing close to its market will allow it to respond to changing customer tastes more quickly. B may decide to manufacture the product in a low cost low tax jurisdiction to realize cost savings. While both are options, neither is necessarily better or worse than the other, and it is also not clear that the licensor will charge a different royalty rate, depending upon which decision is made.

In short, while KPMG believes that the concept of options realistically available may be useful in preventing abuse and as a comparability factor that governs the circumstances and assumptions used in the determination of arm’s length prices, it also believes that the rigid and formulaic use of the concept, as set forth most particularly in Example 19, will encourage tax authorities to ignore market data on pricing and the adoption of rigid approaches that will lead to results that are often inconsistent with those that would be reached by parties operating at arm’s length.

In order to stay true to the concept of arm’s-length or market pricing, KPMG believes that the concept of realistic alternatives should be defined in terms of market participants, i.e., the realistic alternatives should reflect the attributes of a likely market seller and buyer, and not the idiosyncratic attributes of the specific buyer and seller.

**Section D.1.(vi) intangibles**

The Discussion Draft introduces a specific type of intangible – the “Section D.1.(vi) intangible,” named after the section in which it is defined. The Section D.1.(vi) intangible appears to be an intangible that is unique and valuable, and which would command a positive price in a third-party transaction.

The benefit of separately defining the Section D.1.(vi) intangible is not immediately evident to KPMG. All the concepts of the Discussion Draft could well have been discussed without ever separately defining the Section D.1.(vi) intangible. We suggest that the draft simply refer to “intangibles that affect the reliability of comparisons between the controlled transaction and otherwise comparable uncontrolled transactions.”

If the OECD does retain the separate definition of the Section D.1.(vi) intangible, then KPMG recommends that the OECD include a concise explanation for why the definition is important. Paragraphs 120 and 121 include a discussion of the importance of Section D.1.(vi) intangibles. They say that if the intangible used by the related party is comparable to intangibles used in comparable uncontrolled transactions, then reliance can be placed on comparable uncontrolled transactions. However, if the intangible is a Section D.1.(vi) intangible (which means there are no comparable intangibles used in third-party transactions) reliance cannot be placed on comparable uncontrolled transactions, which seems like a tautology.

KPMG also recommends that the Section D.1.(vi) intangible be given a more descriptive name, such as “unique intangible” or “super-profit intangible” or “premium intangible” to make its
relevance clearer. It will further be helpful to see examples of intangibles that meet the definition of Section D.1.(vi) intangible (or its renamed successor) and those that do not.

**Use of valuation techniques**

The Discussion Draft provides some mixed signals on the role of valuation techniques in evaluating the transfer pricing of intangibles. The Discussion Draft spends a large amount of effort talking about discounted cash flow approaches to valuing intangibles. At the same time, the Discussion Draft goes out of its way to state that certain valuations (such as those done for purchase price accounting) have “no” relevance for transfer pricing. However, the valuation techniques used in financial statement analyses are no different in substance from valuation approaches used in economics and business generally; they are simply applied using specific assumptions that are dictated by accounting standards and which may or may not be consistent with the assumptions that should be used for transfer pricing. While it may be appropriate to state that there is no presumption that the assumptions used in financial statement valuations will carry over to the valuations for transfer pricing purposes, the Discussion Draft should provide explicit direction that the “most appropriate” method should be used, and that the approaches used in valuation/purchase price accounting may or may not be the most appropriate method, based on the specific facts and circumstances of the intangible transfer at issue. Similarly, the guidance on choosing between the income method and cost method should emphasize the need to use the method that is most appropriate, given the specific facts. Cost methods can be more appropriate than the income method, particularly when the intangible is not a key driver or profits or when reliable financial forecasts do not exist.

More attention should also be paid to traditional transfer pricing methods and the information that can be obtained from agreements among third parties. (See the more detailed discussion of licensing below.)

Overall, the guidance on valuation techniques includes a general discussion of key issues. As noted in paragraph 147, it is not the intent of the Discussion Draft to provide a detailed summary of valuation techniques, to endorse or reject specific valuation standards, or to describe in detail any particular valuation techniques. KPMG agrees broadly with this approach. Given the vast literature already existing on valuation techniques, it seems reasonable for the OECD to provide broad guidelines for the application of valuation techniques to transfer pricing situations and leave the taxpayer to customize the specific application to the given circumstances.

There are, however, some areas where greater guidance and clarity will be helpful.

One of these is the relationship of pre-tax and post-tax values, especially given that this is an area in which transfer pricing differs from traditional valuation approaches and, hence, there is not much existing knowledge related to it. There is some discussion of this issue in paragraphs 168 to 170. However, that discussion does not provide much clarity. (See the discussion above on the application of the concept of realistic alternatives for an elaboration upon this point.)
As has already been mentioned earlier, the discussion of realistic alternatives does not include sufficient restraints on recharacterization of transactions by tax authorities. This is particularly true since the entire concept of “realistic alternatives” is very broad, and may be defined very expansively by some tax authorities – does it include tax benefits, location savings, withholding and other taxes, specific synergies? It may be relatively easy for tax authorities to construct a “realistic alternative” that gives the seller a substantially higher expected price than the specific intercompany buyer can pay.

The guidance provided in the Discussion Draft on the relationship between equity compensation and the value of intangibles is incomplete, and does not take into account the need to evaluate the value of intangibles on an individual legal entity basis.

To provide a simple illustration, assume that the acquisition of Company A by Company B leads to a 100 increase in the value of intangible asset A under the control of/owned by Company A and also a 100 increase in the value of intangible asset B under the control of/owned by B, and that this entire increase is reflected in the price that Company A pays for the equity of Company B. (In essence, competition among potential buyers allows the owners of the equity in Company A to capture an increase in the value of the intangible asset owned by B.) The equity transaction may or may not be taxable, depending upon local law and the structure of the transaction. But no transfer pricing event occurs until either (i) the intangibles under the control of/owned by Company B are transferred to Company A, or (ii) the intangibles under the control of/owned by Company A are transferred to Company B. In either case, the price paid should simply reflect the value of the intangibles under the control of/owned by the transferor, which would be 100 rather than 200 in this simple example. Note that even though the price paid for the transfer of the intangibles under the control of/owned by the transferor is lower than the total value of synergies reflected in the price paid in the equity transaction, there has been no “destruction of value”. The total value remains; the issue is that only a portion of the assets giving rise to that value have been transferred. (Another way of looking at this is that it reflects the need to allocate the acquisition price among the different assets that have contributed to the synergy value reflected in the acquisition price.) Moreover, there is no “realistic alternative” issue, as the only way in which the transferor can obtain the synergy value is to gain access to intangibles that are under the control of/owned by different legal entities. An article by Clark Chandler and Sean Foley discussing this issue is attached.

**Intangibles with “highly uncertain value”**

The Discussion Draft suggests that when the valuation of an intangible is highly uncertain at the time of the transaction, then tax authorities might reasonably impute price adjustment clauses in the agreement, shorten the term of the contract, assume renegotiation, or use other approaches that they think third parties would adopt. This discussion is disturbing, in that it appears to assume that unrelated third parties frequently insert price adjustment clauses into contracts where future outcomes are uncertain. However, based on its experience, KPMG believes that:
1) Uncontrolled parties often enter into agreements where results are highly uncertain – to cite the most obvious example, there is substantial licensing activity in the pharmaceutical industry involving products that have yet to start clinical trials or which are at only the earliest phases of the clinical trials, which implies that these products have less than a 50 percent chance of reaching the market.

2) While contingent terms are relatively common in third party agreements, they generally do not involve any renegotiation based on information developed after the agreement has been negotiated. Instead, the contingencies are explicitly identified and valued.

3) It is important to distinguish between payments for intangibles and returns for risk. If there is genuine uncertainty about future outcomes, this is simply a question of risk. Chapter IX has specific guidance on the treatment of risk in the case of business restructuring; this same guidance should cover the treatment of risk in the context of investments that may create or enhance future intangibles.

4) There is the separate question of whether the taxpayer has more knowledge than tax authorities, and is using this knowledge to gain an advantage in the pricing of the intangibles. However, this is essentially a documentation issue, and tax authorities certainly have the right to insist on carefully prepared documentation around the arm’s length nature of contractual terms, the reasonableness of the forecasts that are used, etc. But the need for documentation should not be used to prevent controlled taxpayers from structuring agreements consistent with the arm’s-length standard.

Finally, the transactional structure established by the taxpayer should be respected as long as it is put in place up front and the taxpayers adheres to its up front agreement. Therefore, any adjustments to pricing should be in the context of the business arrangements established by the taxpayer. This is particularly important in the case of highly risky investments with uncertain outcomes. To illustrate this point, assume that legal entity A has an intangible that is transferred to legal entity B. The intangible has a 10 percent chance of generating profits of 1,000 and a 90 percent chance of generating profits of 0, implying an expected value/transfer price of 100. Going forward 10 years, assume that the investment is successful, and generates income of 1,500. The tax authority auditing legal entity A could potentially question whether the taxpayer should have used a 20 percent probability of success, and whether the forecast value of 1,000 was appropriate given that actual results were 1,500. This would generate a potential adjustment of 1,500 * 0.2 = 300 – 100 = 200, which is twice the amount paid, but which is likely to be in the range of adjustments that can be resolved through a mutual agreement or domestic appeals process. However, if the tax authority auditing A disregards the structure using the argument that third parties would not transfer such highly uncertain rights at arm’s length, the adjustment is likely to be 1,500 – 100 = 1,400, which is likely to be much more difficult to resolve in Competent Authority and therefore is much more likely to expose the taxpayers to the risk of double tax.
Treatment of Licensing Transactions

The Discussion Draft is essentially silent on the role and treatment of licenses and other commercial arrangements among unrelated third parties, and the role that they should play in determining the prices that would be expected in controlled transactions. This omission is particularly striking, in that one of the bedrock principles of the OECD Guidelines to date has been the reliance upon information from comparable third party transactions.

Licensing transactions are common among uncontrolled parties, and should be viewed as a key source of potential information on both the terms that are common in transactions among uncontrolled entities – which informs whether or not specific types of business arrangements are arm’s length – and specific information on pricing. This is particularly true when dealing with transactions involving intangibles that are not key drivers of profits – e.g., licenses of accounting software, the license of relatively routine technology and knowhow, the license of trademarks that are used to differentiate the goods bearing such marks from purely generic products, but which do not support unusually high profits. The OECD should reiterate that, for intangible property as well as for other property and services, prices obtained from comparable transactions among unrelated parties provide the best and most direct evidence of third party pricing.

Third party licensing transactions can also provide important insights into determining which of the legal entities participating in a transaction is entitled to returns from the use of the intangible property at issue. In this regard, a typical trademark agreement calls for the payment of a fixed royalty rate that goes to the licensor as payment for the trademark per se, with the licensee earning variable profits that are dependent upon how successfully it can exploit the licensed mark. The agreements also typically provide that the ownership rights to the trademark revert to the licensor upon expiration of the license even though the licensee is responsible for the advertising and marketing spend needed to maintain and enhance the value of the trademark during the term of the license. Finally, the terms of the licenses spell out the degree of oversight that will be carried out by the licensor, and therefore provide important information on the level of active participation on the part of the licensor in arm’s length arrangements. This should, conceptually, provide useful information on the level of oversight/review that tax authorities can reasonably expect on the part of the “own employees” of the specific legal entity that owns an intangible such as a trademark.

At one point, the Discussion Draft suggests that “intangible generating” spending in excess of that found in comparable companies may lead to control/ownership of intangibles. This concept is very similar to that used in the “cheese example” that used to be in the US transfer pricing regulations – the notion that if distributor A spends 30 percent to promote a product while comparable distributors spend just 20 percent, the 10 percentage point differential somehow implies that Distributor A is investing in the intangible and therefore should acquire an ownership interest.
The issue with this type of analysis is that companies may spend higher-than-typical amounts on advertising either to (i) invest in the development of a brand or (ii) better exploit the value of an existing intangible. Thus, if distributor A is spending 10 percentage points more on advertising than similarly situated distributors and is also incurring operating losses while the other distributors are earning 5 percent operating margins, Distributor A is probably being made worse off in the short run by its high levels of spending, and is presumably willing to accept the poor short term performance only because of expected future benefits (which could be higher returns in future years or some form of ownership stake in the intangible property). However, if Distributor A is spending 30 percent on advertising because such spending allows it to report profits of 500 while spending just 20 percent on advertising would lead to lower sales and profits of just 100, then Distributor A is better off in the short term spending on advertising, and does not need nor should it expect to receive an ownership interest in the intangible as a result.

KPMG believes that, rather than looking at spending levels, the more appropriate approach to determining rights to income under a licensing arrangement is to distinguish between the control of ownership of the underlying intangibles (e.g., trademark X) and the right to exploit that intangible in a given territory or for a given number of years (which is a separate contractual intangible.) Once this is done, both the terms of third party agreement and economic analysis can be used to evaluate the intercompany pricing that would be expected at arm’s length.

Finally, as discussed above, the pricing and other terms seen in third party transactions can provide useful insights into how the “realistic alternatives” concept works in transactions among unrelated third parties. If an examination of trademark royalty rates for 10 licensees in the food industry shows the licensees that are earning operating margins of between 15 percent and 20 percent on payment of trademark royalty rates of 3 percent to 5 percent when routine profits are perhaps 2 percent to 5 percent, this provides empirical evidence that the licensor is unlikely to capture 100 percent of residual profits in an arm’s length arrangement, and that therefore this is not an option realistically available in a licensing transaction. Similarly, an analysis of third party licensing arrangements can be used to test whether royalty rates do or do not vary with profits, do or do not vary with the geographic location of the licensee, do or do not vary with the tax rates of the counties in which the licensees operate. One way of thinking about this is that tax payers and tax authorities may have various hypotheses about how to look at and apply the concept of realistic alternatives; an examination of terms found in actual transactions among unrelated parties may provide useful information as to whether those hypotheses reflect third party behavior.

**Examples**

As noted earlier, while KPMG believes that the principle of providing examples to illustrate concepts is a useful one, several of the examples are inconsistent with the concepts they are meant to illustrate and KPMG does not agree with the points made in certain of the examples. The following section discusses KPMG’s comments on specific examples.
Examples 1 – 11: general comments

Examples 1 to 11 are intended to illustrate the application of the principles of Part B of the Discussion Draft to determine which parties are entitled to the intangible related return. The examples will be more illuminating if the Discussion Draft explains how the OECD reached its conclusions regarding entitlement to the intangible related returns by the systematic application of the principles of Part B. For instance, in Example 1 the functions related to the development, enhancement and maintenance of the intangible lead to entitlement to the intangible related return but apparently not the function related to protection.

Example 1

Example 1 describes a situation where a patent portfolio has been transferred from the entity that created the patented intellectual property to a related-party patent holding company. The example specifies that (a) the transfer was made for consideration far below an arm’s length price and (b) that the patent holding company does not perform any relevant functions with respect to maintenance or exploitation of the patent portfolio. The example concludes that the patent holding company is not entitled to the returns from the patented IP.

This conclusion is discussed as an application of the considerations of section B on functional substance requirement for entitlement to intangible returns. However, it is essentially useless as guidance in that regard because of the specification that only nominal consideration was paid for the patent transfer. Readers are provided no insight on the OECD’s view on the appropriate consideration for the patent holding company if it had acquired the patents in an arm’s length transaction. KPMG notes that there are numerous examples of arm’s length arrangements in which patents are transferred to an entity that performs no functions with regard to the patented IP other than engaging in legal defense of its property rights. Few would argue that the patent holding company in the example is entitled to the intangible related returns, but that conclusion appears to be driven more by the failure to pay an arm’s length price than by the functional profile of the patent holding company.

Example 11

According to this example, Company T is not entitled to intangible related returns since it has “no technical personnel capable of conducting or supervising the research activities.” This conclusion does not appear warranted – according to the principles of Part B, Company T is not required to “conduct” or “supervise” the research, nor is it required to have “technical personnel” capable of doing so. Company T funds the research and might well have non-technical business people making decisions about managing risks and outsourcing the research to Shuyona.

Example 18

This example goes against basic principles of market pricing by assuming that buyer specific premia should be included in the price of the intangible. Further, this example should be
strengthened to emphasize that components of the price that can be attributed to assets owned by the acquiring entity should not be included in the intangible price.

**Example 19**

In several public comments, delegates involved in the drafting of the Discussion Draft have requested comments on Example 19 in particular. This example has several issues:

- The example contains a few mathematical errors. In table 1, row 7A, the annual value of the intangible should be 175 instead of 173, leading to a total present value of 601 instead of 594. In table 2, the distributors receive more than 2 percent of sales, which is inconsistent with the assumption stated in paragraph 252. If the distributors are restricted to a return of 2 percent of sales, then the annual value of the intangible in row 42A is 275 and its present value is 945.

- The range of post-tax values that would be permissible under the principles of the Discussion Draft would be 735 to 945. Note that while this is presented as a range, it is actually equivalent to a single pre-tax value of 1,045.

- If, instead of the numbers mentioned above, the numbers presented in the Discussion Draft were used, then the lowest price that the seller would accept is greater than the highest price that the buyer would pay. The Discussion Draft concludes that the lowest price that the seller would accept is one that generates after-tax profits of 735. Dividing by one minus the 30 percent tax rate of the seller suggests that the lowest price that the seller would accept is 735/0.7 = 1,050. The Discussion Draft also concludes that the highest price that the buyer would pay would leave it with after-tax profits of 941. Dividing by one minus the buyer’s tax rate of 10 percent indicates that the highest price the buyer would pay is 941/0.9 = 1,045. Paragraphs 83-84 suggest that tax authorities could disregard the transaction.

- The example presents the relocation of manufacturing to country Y as a means to benefit from lower costs in country Y. However, there is no discussion of location savings as a comparability factor in the analysis. The example assumes a constant return for manufacturing activities of COGS plus 5 percent irrespective of where the manufacturing takes place.

- The example seems more suited to a business restructuring situation.

- It makes no reference to options realistically available as comparability criteria but instead assumes that they must be factored into the pricing.

**Additional examples**

KPMG suggests that the revised Chapter VI add an example illustrating the application of the residual profit split method.
Annex

Comments on specific paragraphs

We next discuss comments on specific paragraphs in the Discussion Draft that have not already been discussed in our comments above.

- Paragraph 30: Where no contracts exist, it would be useful to give priority to the conduct of the parties over economic principles in deducing the applicable contractual relationships.

- Paragraph 47: It would be useful to clarify this statement with an example or to elaborate to explain what situations are meant to be covered by this paragraph.

- Paragraph 51: This entire approach should be premised on what third parties would or would not do. If it is possible to demonstrate what third parties would do in given circumstances, then that approach should prevail. KPMG’s concern with the proposed wording is that some tax authorities may simply jump straight to disregarding payment of royalties (as currently occurs in some jurisdictions).

- Paragraph 55: KPMG suggests deleting the word “generally” in the first sentence. Tax authorities should respect the contractual allocations of entitlement to intangible related returns, unless paragraphs 1.64 – 1.69 apply.

- Paragraph 68: The use of the term “marketing approval” could lead to some confusion (some tax authorities may even see this as a form of marketing intangible). A better description would be “regulatory approval from health authorities.”

- Paragraph 86: It will be useful to have clarity about the level of comparability expected. Having the high level of visibility into third party comparables expected or finding industry standard norms may be difficult.

- Paragraph 93: Some trade secrets have a much longer life than any patent.

- Paragraph 107: KPMG suggests inserting the words “legal substance and resulting” before the word “economic” in the last sentence. Otherwise, it might be seen as a potential reason to recharacterize transactions based on the notion of economic consequences.

- Paragraphs 119 and 134: It would be useful to reiterate that an approach based on costs (such as a cost-plus method) should be discouraged in the remuneration for the sale or license of an intangible. Otherwise, some tax authorities will see this as allowing them to use the cost-plus method to determine royalty rates under license agreements (which is already being done in some jurisdictions).

- Paragraph 148: This paragraph mixes up the concepts of cash flows and operating income. E.g., “Estimates of cash flows attributable to business activities and/or assets other than the intangible
being valued may be deducted from the projections of operating income.” The calculations should consistently use cash flows or income measures. It will also be helpful if the OECD could indicate whether cash flows or income measures are equally appropriate.

- Paragraph 151: How many sensitivity variations would a taxpayer be expected to make?

- Paragraph 155: The last sentence of that paragraph is unfortunate. Good faith should be presumed until proven otherwise.

- Paragraph 163: It will be helpful to illustrate this point with an example or elaborate on it.

- Paragraph 178: It should be clarified that, if the original transaction was the outright sale of an intangible and if the tax year in which that transfer has occurred is statute-barred, paragraph 178 does not allow adjustment of that transaction, only of transactions continuing in open years.

- Paragraph 227: Reference to paragraphs 1.64 to 1.69 should be added in justifying recharacterization.

- Paragraph 241: What about the transfer of know-how (how to adapt the software from one bank to another)?

- We do not agree with the changes proposed for paragraph 2.9 at the end of the Discussion Draft. Originally this paragraph clarified that taxpayers do not have to use the methods outlined in the Guidelines to establish prices. The proposed changes state that tax administrations can also depart from the recommended methods. Such liberty can result in greater disagreements between tax authorities and increased uncertainty for business. If the changes are intended to accommodate discounted cash flow valuation techniques, then we recommend that Chapter VI explain how discounted cash flow techniques are part of existing methods.
Date: September 13, 2012

To: Joseph L. Andrus, Head of the Transfer Pricing Unit, Centre for Tax Policy and Administration, OECD

From: David R. Jarczyk, President & CEO, ktMINE

Subject: Comment on Discussion Draft on the Transfer Pricing Aspects of Intangibles

Dear Mr. Andrus:

The OECD requested public comments regarding the discussion draft on the transfer pricing aspects of intangibles. In its capacity as a global intellectual property business intelligence company, and as a small business with significant interests in transfer pricing matters, ktMINE humbly submits the following comments related to the discussion draft. Any questions or comments should be forward to David R. Jarczyk - President & CEO of ktMINE – at david.jarczyk@ktMINE.com or (773) 401-8962.

I sincerely applaud the quality and content of the discussion draft; especially having a great appreciation for the vast spectrum of opinions and critiques on the subjects of transfer pricing and intangibles. Specifically, I agree that transfer pricing analyses of intangibles transactions should be ‘the determination of the conditions that would be agreed upon between independent parties…” as well as dependent on “factual evidence”. Additionally, I appreciate the guidance with respect to selection of the most appropriate transfer pricing method, the use of a comparability analysis, and the use of valuation techniques. I also support the rejection of the application of a rules of thumb related to intangibles analyses; especially when solid market evidence exists to apply to such matters.

The remainder of this document provides comments related to common misconceptions related to the application of the CUP/CUT method as well as recommendations for the expansion of the comparability analysis section.

Common Misconceptions Related to the Application of the CUP/CUT Method

In my work with global tax authorities, consultants, and transfer pricing practitioners, I often encounter the following misconceptions related to the application of the CUP Method or CUT Method. Indeed, education is needed to ensure sound, prudent transfer pricing analyses. I recommend adding these following points to the discussion draft to provide an even playing field with respect to the use of the CUP Method or CUT Method.

**MYTH: The CUP Method Cannot Be Applied Because Perfect Comparables Do Not Exist**

**FACT:** The discussion draft does an excellent job referring to the OECD Guidelines’ preference for comparable uncontrolled transactions; specifically, the fact that the CUP Method is preferable over other methods. Of course, in practice, it becomes extremely difficult if not impossible to identify perfect comparables, especially when searching for comparable license agreements. This does not mean, however, that the CUP Method should be rejected. Most practitioners seem to forget that the OECD Guidelines state in Chapter II that “where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine
reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method.” Furthermore, the OECD Guidelines state that “practical considerations dictate a more flexible approach to enable the CUP method to be used...”

In fact, based on my experience with various transfer pricing matters, the practical application of the CUP Method generally provides more-than-sufficient benchmarks to act as one part of a prudent transfer pricing analysis involving intangibles. While these benchmarks may not be perfectly comparable, they do offer guidance with respect to the tested intangibles transactions and provide the professional with real-life negotiated data points for consideration.

**MYTH: Global Market Information is Not Available**

**FACT:** In many places, the discussion draft refers to the application of the CUP Method, specifically, the use of uncontrolled transactions as comparables for transactions involving intangibles. There is a common misconception that global license agreements - which may be used as comparable, uncontrolled transactions – are not available.

In fact, based on ktMINE’s research, over 60% of publicly available license agreements include territories for regions outside the United States. Indeed, the public domain contains uncontrolled license agreements for most regions and many countries.

**MYTH: Redacted License Agreements Have No Value**

**FACT:** There is a common misconception that only unredacted license agreements provide value to transfer pricing analyses involving intangibles. To transfer pricing professionals, the definition of “unredacted” generally means that royalty rate information is published within the license agreement. Based on ktMINE’s research, to date there are approximately 14,000 unredacted license agreements available in the public domain.

Unfortunately, a transfer pricing practitioner who bases an analysis on only 14,000 data points is probably missing the big picture. Based on ktMINE’s research, to date there are approximately 75,000 license agreements available in the public domain. Contained within these license agreements are various terms, deal structures, and divisions of functions and risks that can aid in the analysis of the arm’s length nature of tested transactions.

In fact, basing a transfer pricing analysis using a subset of available data (i.e., only those license agreements with unredacted royalty terms) would be a disservice to clients and shareholders as it turns a blind eye to the majority of market information available. In my experience, I have been a part of APA submissions, litigation situation, and third-party license negotiations where one expert relies on only agreements with unredacted terms, only to miss several key factors of comparability which would have been evident by reviewing all comparable, publicly-available agreements. As with any scientific approach, it is prudent for professionals to review all information available to them in order to provide a sound analysis.

**Recommendations for the Expansion of the Comparability Analysis Section**

The discussion draft rightfully cites the comparability principles from the OECD Guidelines. Furthermore, the provision of specific comparability factors is greatly appreciated. I recommend expanding this section with additional factors of comparability for the consideration of professionals. One
such example of the factors of comparability can come from a roadmap for finding and analyzing royalty rates and determining comparability that applies to all IP analyses. Exhibit 1 depicts this roadmap developed by ktMINE.

Exhibit 1: ktMINE Finding & Analyzing Royalty Rates Roadmap
These factors of comparability, in some form, are generally accepted by global analysts and lean heavily on the comparability criteria stated in the OECD Guidelines. Having a referenceable list of comparability factors developed before an analysis is a useful method for ensuring a consistent critique of each license agreement.

ABOUT ktMINE
ktMINE is an intellectual property (IP) information services firm focused on delivering IP protection and competitive advantage to IP owners and stakeholders across the globe. This is achieved by designing solutions based on three core standards: Comprehensiveness, Usability and Knowledge Transfer. By focusing on these standards, ktMINE is able to deliver solutions that provide relevant and actionable information for any type of IP analysis.

ktMINE utilizes its expertise and technology to mine data from the global public domain in order to provide Royalty & Market Rate Intelligence, Licensing Intelligence and IP Business Intelligence through its many solutions. ktMINE offers hands-on research solutions such as the Royalty Rate Finder™ database, and also collaborates with global organizations, corporations, and government agencies to provide customized research services tailored to fulfill their IP information needs.

Learn more about ktMINE at www.ktMINE.com
13 September 2012

Our ref MJZ/MJZ/MJZ

Dear Mr Andrus

We write in response to the request for comments on the Discussion Draft (Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions) of 6 June 2012.

In general, we welcome the revisions presented in the draft as providing more detailed guidance in applying the arm’s length principle in relation to intangibles. We support a principles-based approach to evolving the Transfer Pricing Guidelines and endorse the provision of further details on how the Guidelines may be applied in practice. We believe that this Discussion Draft goes a good way to providing greater clarity and certainty to taxpayers and tax administrations. In particular we welcome the Illustrative Examples provided in the Annex as an aid to understanding the concepts involved, how they may be applied and engaging with some of the practical issues consequently faced by MNEs and tax administrations.

There are some areas where we have concerns and suggestions for further consideration. For brevity, we have limited our comments to those points on which we have specific reservations or proposals which we set out below.

**Comment 1**

**Identifying an Intangible for Transfer Pricing Purposes**

We are concerned that the definition proposed is too vague and hence open to a wide a range of interpretations. This relates to the recognition, or non-recognition, of an intangible and how it is subsequently characterised for comparability purposes. We recognise the need to obtain a broad-based international consensus and we also acknowledge that too narrow a definition is undesirable. However the position should be sufficiently objective so as to minimise the risk that taxpayers and tax administrations frequently arrive at widely differing conclusions. Also, such divergence between tax administrations is likely to make mutual agreement much more difficult to achieve.

Some elements relevant to the definition of an intangible are not included in section A although they are brought up later in the Discussion Draft. As section A expressly deals with identifying intangibles we recommend that all aspects fundamental to defining an intangible in transfer pricing be brought together here. For example, the Discussion Draft refers to location as a factor that may contribute to value creation (paragraph 108) and it clarifies that locational advantages may not be intangibles for transfer pricing purposes, although they may have important pricing implications.
With regard to location advantages, we believe these are not intangibles in themselves but represent factors to be considered in applying the arm’s length principle and the comparability analysis. A clear statement to this effect belongs in any guideline which defines intangibles. It should explain that, according to the arm’s length principle, the way in which independent parties would price any division of comparable location savings should determine the transfer pricing treatment; adding that a major determinant would be their respective bargaining powers, deriving from their functions, assets and risks. This should be contrasted with the up-front determination of location savings as an intangible attributable to the low cost location.

We are concerned that divergence between tax administrations, whereby some treat location savings as a comparability issue while others treat it as an intangible, is likely to present taxpayers with significant and intractable problems of double taxation, discouraging international trade.

We note, from the preamble (page 3), that the Working Party still intends to address some topics not currently addressed in this draft and that this includes location-based advantages, now treated as comparability factors. We commend the above approach for inclusion at this stage.

Comment 2

Mark-Ups and the Resale Price Method

Paragraph 135 seems to rule out mark-ups and the resale price method. We are concerned that the statements in paragraph 135 may be interpreted to rule out mark-ups and the resale price method entirely in this context. Consideration of these methods, especially in a corroborative analysis or to provide contextual economic background, may be helpful in some cases.

Comment 3

Transfers of Intangibles or Rights in Intangibles

Section D4 distinguishes between two categories of transaction, in terms of applying the arm’s length principle. The first category comprises those transactions for which reliable comparables exist, while the second category is where no comparable uncontrolled transactions can be found (paragraphs 139 to 144). This distinction is useful in that it draws attention to the situation where reliable comparables cannot be found and highlights that this is a common outcome for intangibles. We feel that more detailed guidance is needed in how to deal with the second category in practice. This should go beyond suggesting suitable transfer pricing methods and should also suggest how these methods might be applied in practice, beyond the examples provided in the Annex. In particular where allocation keys or other forms of apportionment methods are applied in a profit split further guidance would be helpful.

Allocation keys are sometimes considered somewhat arbitrary. While it would not be useful to specify predetermined keys for particular allocations, it would be helpful to explore those factors taxpayers might be expected to demonstrate in the economic analysis. Greater consensus in what constitutes an objective analysis, balancing evidence of correlation with the compliance cost of collating additional metrics, should lead to less uncertainty. Taxpayers may reasonably expect to understand which approaches are likely to meet with agreement among tax administrations. In particular the relative emphasis placed on capital and labour factors and the treatment of risk might prove to be a good starting point.

Comment 4

Bilateral Analysis

We are concerned that, in paragraph 148, the suggestion that an analysis should be conducted from the perspective of both parties to a transaction can be too burdensome. Although the Discussion Draft does qualify this, noting that it should depend on the facts and circumstances of the individual case, we feel this requirement for bilateral analysis may be interpreted overzealously. This may put smaller and
medium sized international enterprises at a disadvantage placing a disproportionate compliance cost on relatively lower value cross border transactions.

Additionally, information may not be equally available in respect of both parties’ perspectives to the transaction. Such asymmetric information constraints may render such a bilateral approach impractical. Considering this in conjunction with the point made, in paragraph 150, with regard to the reliability of assumptions and estimates, it may be more appropriate to estimate the range itself, rather than attempting to determine its maximum and minimum. Comparable peer group analyses, game theory and behavioural models may lend themselves to this approach for transactions significant enough to merit it.

Comment 5

Underlying Assumptions and Valuation Parameters

Paragraphs 150 to 153 raise the issue that the same factors that can be viewed differently in two different analyses. Where the two parties are a taxpayer and a tax administration the consequences for the former of different underlying assumptions create the risk of suffering double taxation. Both sets of assumptions may, in fact, be reasonable. This underlines the need for more specific guidance and further willingness for tax administrations to consider up front clearances and improvements to the mutual agreement process.

Comment 6

Financial Projections

Paragraph 155 discusses the source and purpose of financial projections used in valuation techniques for in transfer pricing. We cannot agree that financial projections for non-tax business purposes are more reliable than those prepared purely for a transfer pricing analysis. Nor can we accept the inference that such “transfer pricing business projections” are less reliable and likely to be suspect. Rather, the matter will depend on the diligence and rigour with which the transfer pricing analysis has been undertaken. We note that in some cases “non-tax business projections” will not be available or they will not be available for the perimeter of operations or at the level of the intangible concerned. Moreover, business planning often involves setting motivational targets to promote behaviour to achieve business strategies. These will represent desired outcomes rather than objective expectations and adjustments to such business projections for transfer pricing will be justified.

Comment 7

Member State Positions

It would be helpful if OECD member states that disagree with any aspects of the revised guidance publish their position or indicate their reservations, both on the text and the illustrative examples, explaining the reasons why. Those states co-operating with the OECD as Observers on the Committee on Fiscal Affairs may be asked to set out their positions similarly.

Comment 8

Summary Comments

In summary, we welcome the Discussion Draft as it provides more guidance on an area of considerable uncertainty. We also value the continued approach of expounding underlying principles of guidance rather than attempting to specify overly detailed guidance. However, in some cases, we have noted that deeper guidance would be helpful. We feel that taking the guidance in those areas to the next level of depth would improve interpretation and implementation without becoming too constricting. We see this approach as consistent with the evolution of the OECD transfer pricing guidelines to date and also in keeping with the work undertaken in recent years on the attribution of profits to permanent
establishments under Article 7 of the OECD Model Tax Convention. In the latter initiative, parts II, III and IV of the report examined the application of the principles set out to specific industries. We suggest that a similar undertaking could be helpful for the project on the transfer pricing aspects of intangibles. This might select one or more industries in which the intra-group provision of intangibles is prevalent and has proved to be a contentious transfer pricing matter.

We understand that the OECD will hold a public consultation, in Paris on 12 – 14 November, on the three transfer pricing Discussion Drafts that were released in June 2012 including this Discussion Draft on transfer pricing aspects of intangibles. We would be pleased to attend the consultation and would be ready to address any of the issues we have raised as requested.
Please contact the undersigned with any questions or comments.

Yours sincerely

Martin Zetter
Head of Transfer Pricing
on behalf of Macfarlanes LLP

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Dear Mr. Andrus,

Comments on June 2012 Intangibles Discussion Draft

We are writing in response to the request of the Centre for Tax Policy and Administration of the Organisation for Economic Co-Operation and Development (“OECD”) for comments on the discussion draft entitled Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (“Discussion Draft”).

We thank Working Party VI and everyone who contributed to development of Discussion Draft, which is a significant step forward in the transfer pricing of intangible assets. Please note that the comments presented in this letter are solely our personal opinions and not those of GlaxoSmithKline.

1. Comparability

In transactions involving IP transfers, a thorough comparability analysis should be performed for the transaction involving IP, especially when considering CUP method. Although the Discussion Draft helpfully provides a number of features to consider, we believe that an additional essential comparability factor needs to be added: an analysis of the comparability in the contractual arrangements and the allocation of risks between the parties.

There are usually fundamental differences in the contractual terms and the allocation of risks between the transacting parties in third-party transactions involving transfers of the IP, compared with transactions involving transfers of IP between related parties. In the pharmaceutical industry:

1 Paragraph 90-102
a. Whereas a typical third-party IP seller/licensor will have all of the economic rights relating to an asset (e.g. to research, develop, manufacture, distribute & sell) and will sell/license those rights in full to the purchaser/licensee and, after the transaction, the licensor/seller will generally have little or no participation in the future development and commercialisation of that asset;

b. In contrast and as a consequence of transfer pricing, a typical licensor of IP between two entities in an MNE transaction will ordinarily only have the residual economic rights relating to an asset (i.e. the rights to residual income after the deduction of returns for functions and risks – e.g. manufacturing, sales and distribution – earned by other members of the multinational enterprise). An intra-group licensor of IP may also continue to participate in the development of the asset, albeit with a different risk profile (e.g. under limited risk service contract arrangements).

In the above example, the third party licensor/seller and licensee/buyer would transact on the enterprise value of the asset, which would include all the returns associated with functions and risks performed by the enterprise. If the inter-company transaction were priced on the same basis, this would lead inevitably to double taxation: the MNE would be taxed on the full value of the enterprise in the hands of the IP seller/licensor and the value associated with the returns for functions and risks performed by entities other than the licensor/seller and licensee/buyer. This is a common issue for MNEs and we strongly recommend that this comparability factor is explicitly recognized in the revised Guidelines.

2. Relationship between commercial valuations and transfer pricing valuations

The differences highlighted in (1) above translate directly to differences in typical commercial valuations of IP on one hand, and valuations of IP for the purposes of transfer pricing on the other. Whereas a commercial valuation of IP (e.g. in third party transaction valuations or purchase price allocations) ordinarily seeks to determine the total value of the asset for the enterprise, a valuation for the purposes of transfer pricing looks at the allocation of that value among entities within an MNE. To do so, the valuation must also take into account the existing and expected intra-group contractual arrangements for returns attributable to functions and risks performed by group entities other than the transferor and transferee.

In other words, transfer pricing valuations are not valuations per se; rather, they are the allocation of such valuations between entities within an MNE according to the functions, assets and risks of each entity. The value for routine functions performed can be estimated using TNMM/CPM comparables, while only the residual profit (or proportion thereof) can be attributed to IP value for transfer pricing purposes. The value may need to be further reduced if other entities take more risks and/or own additional IP, in comparison to TNMM comparables. The resulting IP value may have very different result from IP valuations done for any other purposes. We strongly recommend that this point is clarified (in paragraphs 145-153 or other sections as deemed appropriate).

3. Relationship between Discounted Cash Flow (“DCF”) and other transfer pricing methods
We applaud that the Discussion Draft recognizes that valuation techniques such as Discounted Cash Flow ("DCF") analysis can be useful for determining the value of IP. However, it would be beneficial to expand the guidance on the relationship of DCF to other methods, including CUP, profit split method, and other unspecified methods, such as acquisition price methods. Specifically, the guidance should recognize that:

- The reliable use of a CUP method (or profit split method) for the pricing of an intangible requires an analysis of the future expected benefits (or profit potential) of the intangible of a controlled transaction against comparable uncontrolled transactions; and

- The only reasonably precise way in which to perform such an analysis is to examine the value of cash flows relating to both the controlled transaction and the comparables, taking into account other comparability factors (including the differences to account for functional transfer pricing returns among members of an MNE discussed in 1 above)

In other words, a reliable use of CUP and other transfer pricing methods depend upon reliable DCF analyses. Given the dependency of other transfer pricing methods on DCF, and given the difficulty of establishing comparability correctly discussed in the Draft Guidelines, we believe that the revised Guidelines should establish the primacy of DCF over other transfer pricing methods, or at least give DCF parity with other methods, in the case of intangible property. To that end, we recommend amending language in the Draft Guidelines that suggests a lower preference to DCF as compared to other transfer pricing methods, for example, the statement in Paragraph 136, “valuation techniques can be useful in some circumstances”.

4. Uses and corroboration of valuations

We concur with Discussion Draft that it is essential to consider the purpose for which a valuation is performed; and that the projections prepared for non-tax business planning purposes are more reliable than other projections. There is also an acknowledgement that for sound accounting purposes, some valuation assumptions may be biased in favor of conservative estimates.

In business practice, projections often tend to be optimistic, possibly because of the positive bias exerted on projections by those closely involved and interested in the success of the projects in question. Additionally, certain fixed costs may not be considered for business planning purposes. As the Discussion Draft mentions conservative nature of valuation for accounting purposes, it would be useful to mention optimistic and incremental nature for business projections that are often used for non-tax decision making, and to make the recommendations to seek external, corroborative evidence of values, wherever appropriate.

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2 Paragraph 136
3 Paragraph 111
4 Paragraph 155
5 Paragraph 110.
In our experience, an appropriate and useful corroboration of projections, of assumptions used for valuation purposes, and of valuations has been to reconcile these to market capitalization and to the projections and estimates by independent analysts, where these are available for publicly traded companies. Reconciling overall value estimated as net present value of DCF to market capitalization and/or analysts’ reports will provide some comfort level as to reasonableness or projections and many assumptions used, allaying some of the valid concerns raised in D.4.(v).

5. Allocation of residual profit

We support the Discussion Draft in warning against adopting a method that “too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns.” 6 It would be useful to add further explanation on this point. It may be helpful to illustrate that a transferee of IP would demand returns in excess of those expected from a routine function, if the transferee will be obliged to incur additional significant costs and risks of further development and/or commercialization; therefore, not all of the residual profit for the partially developed asset should be attributed to transferor/licensor.

Transactional market evidence or target Internal Rate of Return (“IRR” or “hurdle rate”) of the taxpayer may be useful to further develop support as to the price the transferee would accept at arm’s-length given the requirements for future funding. In other words, if licensee can invest capital into other projects and earn certain IRR, it would not enter into the intercompany deal that provides it with lower IRR based on routine returns alone. In view of this example, we believe profit split (supported by DCF analyses) are very often used for the transfers of partially developed intangibles in third party pharmaceutical transactions and should be clearly recognized as potentially appropriate method.

Although we agree with the arguments in paragraph 143-144 in terms of irrelevance of past spending to current IP value, we encourage additional language to recognize that other types of analyses (such as evidence from third party transactions splitting the profits, or IRR analysis) could reliably support the use of profit splits for partially developed intangibles.

6. Taxes

We would welcome further clarification on treatment of taxes when using DCF and other methods for transfer pricing purposes. Paragraph 169 and 170 may contradict each other, with 169 stating that the transfer prices should typically be pre-tax while 170 that specific tax situations of transferee and transferor need to be taken into account. We question why a specific tax situation would be important if the pre-tax valuation implies irrelevance of taxes.

Moreover, the Discussion Draft acknowledges that acquisition prices, which are typically developed on after-tax basis, can be useful for determining IP value for transfer pricing purposes. We recommend that OECD guidelines further clarify use of pre-tax vs. post-tax valuations, and reconciliation of such statement to the methods based on acquisition prices and market capitalization. It will be beneficial if

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6 Paragraph 108
examples also highlight how taxes have impact on determining the arm’s-length price for IP in acquisition price method (example 18) and DCF scenarios (example 19).

We very much appreciate the opportunity to comment on the Discussion Draft and would welcome a chance to participate in meetings on this subject with the OECD and participating countries.

Yours Sincerely,

Olga Manziy & Kullervo Maukonen
a. **Disregarding Transactions and Realistically Available Options:** These are understandable provisions from a tax administration standpoint, as in the Chapter 9 Guidelines. My only suggestion is that a brief comment be made about how we can do TP documentation that addresses these matters without having to essentially document the negatives (i.e., the transactions are not to be “disregarded” or there are no “realistic alternatives.” In Member countries, one approach would simply be to make a laundry list of the issues and opine that the chosen methodology is the most appropriate methodology. It seems important to me from all sides that documentation at least address the issue, which would not be inconsistent with the requirements in any Member country.

b. **“Alignment”:** Same comment.

c. **Profit Splits:** As with safe harbors, it seems to me that the WP # 6 view of profit splits is evolving. As you know from the CA world, two-sided methodologies are common when we have major intangibles disputes. It would be helpful to have a brief comment identifying WP # 6’s views when there is a MAP matter where one-sided methodologies have been used on one-side. Perhaps an illustration would be appropriate.

d. **Timing (¶ 8. above):** One element that could be helpful to the WP # 6 deliberation with respect to timing is the U.S. experience in its “commensurate with income” provision (Section 367(d). The U.S. struggles with how to apply these provisions, even after almost 30 years on the books.

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20 August 2012

Mr. Joseph L. Andrus
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France

Re: Discussion Draft, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, issued on 6 June 2012

Dear Mr. Andrus,

I am pleased to respond to the OECD’s request for comments. I share your interest in building consensus among the OECD member countries and other participating countries. Respectfully, the attached comments are provided with the best intentions to help with this difficult process.

I am a Chartered Accountant and Chartered Business Valuator who has specialized in transfer pricing since 1996. My career and practice at MDW Consulting Inc. regularly deals with intangibles, business restructuring and other transactions. I have appeared in the Tax Court of Canada as a transfer pricing expert in Alberta Printed Circuits Ltd. v. The Queen, which dealt with these issues and concerns. MDW is a member of the Altus Alliance, an international association of transfer pricing professionals.

Please contact me should you wish to discuss my comments in further detail. I am available and interested in attending the public consultation to be held during the week of 5 November 2012.

Sincerely,

Matthew Wall CA CBV

Cc: Ms. Michelle Levac, Chair of Working Party No. 6 and of its Special Session on the Transfer Pricing Aspects of Intangibles
A. Identifying Intangibles

A.1 Definition of intangibles

Respectfully, section A.1 in general needs a clearer definition of intangibles than what is provided in paragraph 5. It is not enough to define an intangible as something *it is not* such as a physical asset or financial asset, or something *agreed upon between independent parties for a comparable transaction*.

Please consider using the definition below, based on the first part of paragraph 6.2 (with minor edits) from the existing guidance on intangibles, which might need to be edited but is easy enough to understand, and links well with the illustrations provided in paragraphs 14 to 26 of the Discussion Draft.

Intangibles include: rights to use assets such as patents, trademarks, trade names, designs or models; and intellectual property such as know-how and trade secrets.

A.1 Intangibles that should be compensated

I would also suggest moving paragraph 105 (shown below) into section A.1 in general, which would link the definition of an intangible with specific criteria for when an intangible is considered to be valuable. This is an important definition, pertinent to the whole of Chapter VI and should be at the beginning.

An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would be remunerated in dealings between independent parties, will be referred to as unique and valuable intangibles that should be compensated.

A.1 Intangibles that should not be compensated

I agree with the principle in paragraph 9 that says “not all intangibles deserve separate compensation”. Building on this, it would be helpful to include this principle and more guidance under a new section in or near A.1 in general to reduce the burden on a taxpayer from the more detailed analysis required by the remaining sections of the Discussion Draft if, after reviewing the facts and circumstances, the taxpayer has reached a conclusion that documents why their intangibles should not be compensated.

This section should include a new paragraph defining when intangibles should not be compensated. For example, to be consistent, I have edited paragraph 105 for intangibles that should be compensated to provide a sample definition for intangibles that should not be compensated, as shown below.

An intangible (i) that is *not* similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is *not* expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would *not* be remunerated in dealings between independent parties, will be referred to as a routine intangible that should not be compensated.
The example in paragraph 9 (shown below) helps illustrate the above principle and definition, although it would have greater authority and usefulness if this became Example 1 in the Annex to Chapter VI.

“... consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns to the functions it performs.”

These changes will help the OECD “simplify transfer pricing rules and compliance where possible.”

This could constitute a safe harbor for taxpayers that use intangibles that should not be compensated. The objective being to: simplify compliance for eligible taxpayers in determining arm's length conditions for routine intangibles that should not be compensated; providing assurance to a category of taxpayers that this transaction will be accepted by the tax authority without further review; and, relieving the tax authority from the task of conducting further examination and audits of this transaction. The benefits would include compliance relief, certainty, administrative simplicity, etc. for the taxpayer and tax authority.

A.2 Relevance of Chapter VI for other tax purposes

Contrary to paragraph 12, the guidance contained in Chapter VI for transfer pricing is relevant for other tax purposes in Canada. Please reconsider this paragraph and withdraw it, if possible.

Canada's Federal Budget in March 2012 made changes to its transfer pricing rules that will link transfer pricing adjustments directly to the secondary adjustments for deemed dividends subject to withholding taxes, all within Section 247 of the Income Tax Act. Taxpayers should expect the Canada Revenue Agency will use the same characterisation of the transaction for the reassessment of the (i) transfer price and (ii) withholding taxes on the deemed dividend, but possibly a different tax treaty and withholding tax rate depending on which party is deemed to receive the dividend (e.g., the parent or sister company). This will concern the taxpayer and tax authority in other countries.

A.3 Categorisation of intangibles

While I recognize the Discussion Draft is trying not to use labels, the term “routine intangibles” is widely recognized and understood and less cumbersome than “intangibles that should not be compensated”. Please reconsider and include some or all of the terms used in the existing guidance on Chapter VI. These are important and necessary characteristics for defining, characterising and pricing intangibles.

Many Chapters in the OECD Transfer Pricing Guidelines use the terms “unique”, “valuable” and “unique and valuable” intangibles. For clarity and consistency, these same terms should continue to be used in the Discussion Draft for Chapter VI. To avoid misunderstanding, since these terms are not yet defined in the OECD Transfer Pricing Guidelines, please consider the definitions shown below, which I used and the Tax Court of Canada accepted for assessing the intangibles in *Alberta Printed Circuits Ltd. v. The Queen*. The court also recognized the impact of intangibles on certain transfer pricing methods.

Intangibles are “unique” if they are a creative endeavor that provides the recipient with: (i) a competitive advantage over other companies; (ii) savings in time, cost or both regarding the technology, manufacturing, delivery process, or commercial sale of a product or service; or both.
Intangibles are “valuable” to the extent they generate sales and profits in excess of a normal return, can be licensed or sold to independent third parties, or both depending on the facts and circumstances.

The presence or absence of “unique and valuable” intangibles will have significant influence over the appropriate selection and reliable use of the transfer pricing method or methods.

The Discussion Draft should also include a definition for when intangibles do not have value. Please consider the definition below used in *Alberta Printed Circuits Ltd. v. The Queen*.

Routine intangibles are those intangibles that do not distinguish the taxpayer from its competitors.

Unique and valuable intangibles can diminish in value and become routine when, for example, other companies acquire or develop intangibles similar to the intangibles used by the taxpayer, resulting in the taxpayer losing the competitive advantage, savings, or both that the intangibles once provided.

The above changes provide greater definition and purpose in paragraph 128 when it refers to “unique and valuable contributions” for the application of profit split methods, and in paragraph 166 when it refers to the “non-routine return” for the useful life of intangibles at the time of valuation.

**A.4 Illustrations**

The Discussion Draft is particularly useful when it concludes what “are intangibles within the meaning of section A.1” including patents, know-how and trade secrets, trademarks, trade name, licenses and similar rights in intangibles, and goodwill and ongoing concern value. However, since paragraph 14 states this is not a complete list of all possible intangibles, one or more paragraphs need to be inserted to include some of the relevant facts or circumstances for establishing the criteria for what are intangibles.

The Discussion Draft is particularly useful when it concludes what “are not intangibles within the meaning of section A.1” including group synergies and market specific characteristics. However, since paragraph 14 states this is not a complete list, one or more paragraphs need to be inserted that includes some of the relevant facts or circumstances for establishing the criteria for what are not intangibles.

To avoid confusion and dispute, the Discussion Draft needs to state if or when an assembled workforce is, or is not, an intangible. From my perspective, I am not aware of any arm's length example to license or sell an assembled workforce, although there are many examples of a license or sale of the intangibles created by an assembled workforce. This suggests an assembled workforce can contribute to intangibles, but is not an intangible. Understandably, if the Working Party is unable to reach a consensus, it would be better to exclude the discussion of an assembled workforce from Chapter VI on intangibles.

Finally, it becomes overly complicated if the Discussion Draft suggests or implies we should attempt to value other factors that contribute to intangibles – e.g., group synergies, market specific characteristics, assembled workforce. For greater clarity and compliance, it would help to state:

The facts and circumstances need to be considered to determine if the presence of other factors contribute to an intangible; and, (ii) preliminary analysis is required to determine if this is a routine intangible that should not be compensated; or (iii) additional analysis is required to determine an arm’s length compensation if this is a unique and valuable intangible that should be compensated.
B. Identification of Parties Entitled to Intangible Related Returns

B. Introduction

To simplify the transfer pricing rules and compliance, it would help for the start of section B to say:

Unless otherwise noted, Section B provides guidance for those intangibles that should be compensated, and does not apply for those intangibles that should not be compensated.

B. Terms and phrases

Section B of the Discussion Draft might be placing too much emphasis on the inclusion or omission of certain activities in the phrase “development, enhancement, maintenance and protection of intangibles”. It would be better to refer to “activities that contribute to intangibles” wherever this term is used in the Discussion Draft. The facts and circumstances will define and determine the activities that are relevant to the contribution of intangibles, recognizing the relevant activities can vary by industry, company or both.

The phrase “is consistent with” is used throughout the OECD Transfer Pricing Guidelines and, for greater clarity and consistency, should be used in place of “in alignment with” throughout the Discussion Draft, unless the OECD is trying to define “in alignment with” as something different from “is consistent with”.

B. Factors to consider for sharing intangible related returns

Paragraph 29 is important for determining which members of an MNE group are entitled to intangible related returns. However, the wording in this paragraph is awkward and can be easily misunderstood, misused, or both. For greater clarity and usefulness, please consider the revised text shown below.

29. In determining which members of an MNE group are entitled to intangible related returns with respect to an intangible, the following factors should be considered:

(i) the terms and conditions of the legal registrations and contractual arrangements for the intangibles;

(ii) whether the terms and conditions of the contractual arrangements on the date of execution, revision or renewal are consistent with the conduct of the parties during the period in use;

(iii) whether the conduct of the parties using the intangibles contribute to the value of the intangibles that are owned by another party or parties within the MNE group; and

(iv) whether the parties contributing to the value of the intangibles are entitled to share in the intangible related returns of the intangibles owned by another party or parties within the MNE group.

If paragraph 29 sets the rules, paragraph 35 is for those who break them – e.g., for when the economic substance differs from the form of the taxpayer’s transaction. See below. For example, the tax authority may disregard and recharacterise the transaction, allocating a share of the intangible profits to the licensee as compensation for their contribution to the value of intangibles.
35. Except as otherwise provided in this section B. or in section C., below, where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity entitled to use the intangible and to exclude others from using the intangible, under applicable law and under relevant contracts, is the entity entitled to intangible related returns with respect to that intangible for transfer pricing purposes. In the case of a licence or similar arrangement, the licensee will be the entity entitled to intangible related returns attributable to its licenced rights, subject to its obligation to provide arm’s length compensation for the grant of the licence.

Although I am not a lawyer, it appears paragraph 35 contradicts a legal principle entitling the licensor to all of the benefits from their intangibles without any expectation or obligation to share this with the licensee other than what their legal agreement provides. Although many license agreements have terms, default clauses, and obligations to provide upgrades and enhancements, these rights are defined by the contract and generally end when the contract term expires.

Paragraph 35 might also contradict paragraph 1.64 of the OECD Transfer Pricing Guidelines which says:

In other than exceptional cases, the tax authority should not disregard the actual transactions or substitute other transactions for them. Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax authority does not share the same views as to how the transaction should be structured.

Please reconsider, withdraw if possible or edit paragraph 35. Otherwise, paragraph 35 will increase the level of uncertainty and dispute over difficult issues including, for example:

(a) When does the conduct of the parties differ from the contractual arrangements?
(b) When is the licensee judged to contribute to intangibles owned by the licensor?
(c) How do you distinguish the licensee’s contribution to the value of the intangibles separate from the licensee’s activities and costs to use the intangibles?
(d) Does the licensor, licensee, or both own the next generation of intangibles?
(e) How do you determine, and what is, the fair market value of the licensee’s contribution?
(f) Can a party pay for this at a point in time to avoid sharing profits over a period of time?

It might interest you to know the Tax Court of Canada dealt with the above questions in Alberta Printed Circuits Ltd. v. The Queen, which it decided based on my report and testimony.

Below are a few more points to consider, if the licensee was to share in the intangible profits:

(g) Are there any legal principles, contracts or examples between arm’s length parties where the licensor would, has or will provide the licensee with a share of the intangible profits?
(h) If the licensee receives a share of the intangible profits year-after-year, at some point the licensor will have paid - and continue to pay - more than the fair market value of the licensee’s contribution.
(i) Should the licensee pay its share of the annual costs to maintain, protect, etc. the intangibles?
(j) Should the licensee pay its share of intangible losses, if and when intangible losses occur?

(k) Should the parties follow the guidance in Chapter VIII for Cost Contribution Arrangements?

If the above meaning and interpretation for paragraph 35 remains in the Discussion Draft, then in fairness to the taxpayer this section should also include the following statement:

If the related parties have a legal agreement governing the intangibles, and the conduct of the parties is consistent with the legal agreement, then the tax authority should not recharacterise the taxpayer's transaction to, for example, share intangible related returns with the licensee of the intangibles.

B.2 Functions, risks and costs related to intangibles

Paragraph 40 will concern any company that outsources their research, development or manufacturing to related parties, or relies on related parties to market and distribute their products and services.

The first part of paragraph 40 says it is not essential for the owner of the intangibles to perform all of the functions related to the intangibles, and it can outsource some functions to related or unrelated parties.

The second part of paragraph 40 says the owner is expected to perform through its own employees the important functions related to the development, enhancement, maintenance and protection of intangibles with particular emphasis on the design, control, management, decisions, etc. for these functions. This suggests or implies there are very few functions left, if any, the owner of intangibles can outsource.

Paragraph 40 can be easily misunderstood, misused and lead to more disputes where, for example, the taxpayer relies on the first part to justify why the owner of the intangibles outsourced some of the functions to a related party, while the tax authority relies on the second part to claim the related party performed important functions that contributed to the value of intangibles which deserves a share of the intangible profits. It might take years to resolve this, with many of these disputes left for the tax court to decide, which creates uncertainty for all taxpayers and tax authorities until a final decision is rendered.

Please reconsider and edit paragraph 40, and include in section B.2 clearer guidance, examples or both to illustrate the responsibilities of the (i) owner of intangibles, (ii) related party service provider, (iii) and the overlap between them, to comply with the first part and avoid the second part of paragraph 40.

It would help if section B.2 stated “not all functions, risks and costs contribute to valuable intangibles that should be compensated” and went on to explain with examples the functions, risks and costs that can be substantial but not significant, significant but not substantial, or substantial and significant. This would provide the guidance needed to identify the functions, risks and costs that contribute to routine intangibles that should not be compensated vs. unique and valuable intangibles that should be compensated.

Finally, it would help if Section B.2 took the next step to explain the importance for some of its guidance. For example, part (ii) of paragraph 43 discusses types of risks including “the possibility that technological advances of competitors will adversely affect the value of the intangibles” but fails to explain – which needs to be included – this suggests the intangible was once unique and valuable but might now be routine. Similarly, what is the next step or importance of the types of risks noted in parts (i), (iii) and (iv)?
OECD Draft Memoranda of Understanding (MOUs) for low risk services

The consultation process needs to consider the relationship between section B and the draft MOUs for low risk services issued on 6 June 2012, and the importance each section has on the other. Section B will need to be revised to reflect any changes in the draft MOUs, and vice versa. Please consider MDW's letter and comments to the OECD on Safe Harbours and the Draft MOUs.

It appears section B imposes strict guidelines and expectations on those taxpayers that outsource functions related to intangibles, and taxpayers should anticipate scrutiny of these transactions when audited by the tax authority unless the transactions are structured in compliance with the draft MOUs for low risk (1) manufacturing services, (2) distribution services or (3) research and development services.

The draft MOUs for low risk services clearly state what functions the related party can and cannot do in performing the services. For example, a low risk manufacturer must perform the manufacturing in its country and using a certain percentage of assets dedicated to manufacturing plant, equipment, raw material inventory, etc. but "shall not engage in advertising, marketing and distribution functions, credit and collection functions, or warranty administration functions with regard to the products it manufactures."

Further, the draft MOUs include restrictions (expressed as a percentage of net sales) on the amount of "annual research, development, and product engineering expense", on the amount of "total marketing and advertising expense", or both as is required by the MOU for each low risk service.

There are other terms, conditions and restrictions for each MOU that need to be considered.

Ultimately, it is reasonable to expect the tax authority will rely on the terms and conditions defined in the MOUs for low risk manufacturing, low risk distribution and low risk research and development to determine if a taxpayer has outsourced important functions, or if a related party service provider has contributed to the value of unique and valuable intangibles by performing important functions.

Although the memoranda of understanding (MOUs) for limited risk services might help the Competent Authorities resolve issues of double taxation, they might also be used by the tax authorities to dispute a taxpayer’s position – i.e., creating more double taxation for the Competent Authorities. It might happen that the MOUs create more cases of double taxation than they resolve.

B.3 Arm’s length compensation

Respectfully, paragraph 49 has gone too far when it states:

One important issue is whether the marketer/distributor should be compensated as a service provider, i.e. for providing promotion and distribution services, or whether the marketer/distributor should share in any present and future intangible related returns attributable to the trademarks and related intangibles.

Paragraph 49 contradicts the existing OECD Transfer Pricing Guidelines which generally accepts (i.e., not questions) business transactions as they are structured by the parties, focuses on the price paid for the transaction (i.e., not the profits earned), and restricts (i.e., rather than allow) the tax authority from disregarding the actual transaction and substituting other transactions for them.
This increases the uncertainty and dispute over “marketing intangibles” when in paragraph 51 it states:

In some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities. An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles …

Paragraph 52 applies the above principles to the performance of research, development and manufacturing services which increases the uncertainty and dispute over “trade intangibles”.

It is reasonable to anticipate the tax authority might, after a series of queries, find the related party distributor incurred marketing expenses at a higher rate than its comparables or the limit stated in the MOUs for marketing and advertising expenses, and claim the related party distributor contributed to the value of intangibles which deserves a share of the intangible profits.

Respectfully, I am concerned the tax authorities might misunderstand and misuse section B.3 and the draft MOUs as a mechanical test to recharacterise and allocate a share of the intangible profits to the related party service provider if they incur a high amount of certain expenses. This could and would diminish the relevance and authority of the OECD Transfer Pricing Guidelines to enforce the arm’s length principle using a comparability analysis based on the facts and circumstances.

Please edit section B, the draft MOUs or both to address the above concerns.

If the above meaning and interpretation remains in the Discussion Draft, then in fairness to the taxpayer this section should also include the following statement:

If the functions, risks and costs of a related party is consistent with the terms of their agreement, and does not exceed the functions, risks and costs of an independent party in comparable circumstances, or has a reasonable explanation for it, then the related party has not contributed to the value of intangibles.

Finally, section A.3 Categorisation of intangibles needs to be revised to include (i.e., not omit) the existing guidance in Chapter VI for “marketing intangibles”, “trade intangibles”, etc. since section B.3 and other sections include scenarios that show these are relevant terms that can lead to the recharacterisation of a transaction and allocation of intangible profits to a related party.

**B.4 Disregard of transactions, registrations and contracts**

It might not be enough for section B.4 to refer to paragraphs 1.64 – 1.69 of the OECD Transfer Pricing Guidelines for guidance on the “extraordinary circumstances” that might justify recharacterising the taxpayer’s transaction in order to allocate a share of the intangible profits to a related party.

To avoid misunderstanding, misuse, increased uncertainty and the likelihood of dispute, please consider:

(a) Including in Section B.4 the statement from paragraph 1.64 that says:

A tax administration’s examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II.
(b) Including in Section B.4 the following excerpts from paragraph 1.65 that says:

However, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction.

The first circumstance arises where the economic substance of a transaction differs from its form.

The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

(c) Including in Section B.4 any other examples of exceptional circumstances.

(d) Edit all other sections of the Discussion Draft to be consistent with the above terms.

Finally, in the absence of these changes, it is reasonable to anticipate prolonged disputes where the tax authority relies on selected paragraphs within the Discussion Draft to recharacterise a taxpayer’s transaction, while the taxpayer relies on paragraphs 1.64 – 1.69 and 9.164 – 9.167 of the OECD Transfer Pricing Guidelines to argue why the tax authority should not recharacterise the taxpayer’s transaction. It might take years to resolve this, with many of these disputes left for the tax court to decide, which creates uncertainty for all taxpayers and tax authorities until a final decision has been rendered.

B.5 Transfer pricing adjustments

The above concerns, comments and recommendations for “important functions” under B.2 Functions, risks and costs related to intangibles and “recharacterising transactions” under B.4 Disregard of transactions, registrations and contracts also apply for paragraph 54 and 55 of this section.

B.6 Illustrations

In general, Examples 1 to 11 will need to be revised to reflect any changes in the Discussion Draft.

Example 1 is unclear in its use of the word “assign” and favours the tax authority by narrowing the discussion of, and consideration for, possible adjustments depending on the facts and circumstances.

The word assign might mean Premiere is the owner of the patent and has given Company S an exclusive, royalty free, license to use it. This scenario might result in a transfer pricing adjustment. Although Example 1 provides only one conclusion, which is to reduce the profits of Company S to an arm's length compensation for its services, it omits the alternative of charging a royalty over the period of the license.

Alternatively, assign might mean Premiere has transferred and sold the patent to Company S. This scenario might result in a valuation adjustment. Example 1 overlooks or omits this, which would adjust the amount paid to its fair market value based on the available information at the time of the transaction.
It would help to revise Example 1 to include both meanings for assign and all possible adjustments, with the qualification that any adjustment, if required, depends on the facts and circumstances in each case.

It would also help to state in the example that the terms and conditions of their agreement (written or verbal), and the conduct of the parties, will be very relevant for deciding the outcome in this case.

**Example 2** can be easily misunderstood, misused or both to suggest there is a choice of adjustments. The appropriate adjustment in Example 2 would be an allocation of the recall and product liability costs.

However, it is not appropriate to state an alternative may be to adjust the product pricing for all years on the suggestion that Company S was not actually a limited risk distributor. Example 2 fails to mention this would recharacterise the taxpayer's transactions, omits the facts and circumstances that would need to exist, and is missing the relevant sections from the Discussion Draft that would apply.

**Examples 3 to 8 deal with marketing intangibles**

These examples assume too much by suggesting Company S can or should recharacterise the taxpayer's transaction, unbundle and segment the transaction to test the price paid for watches separate from the compensation for marketing, expect to find reliable comparables in sufficient detail for both transactions, check if Company S contributed to the intangibles, make a claim for local marketing intangibles if it does, and issue a reassessment giving Company S a share of the intangible profits.

**Example 11** describes a taxpayer that appears to follow the guidance in Chapter IX of the OECD Transfer Pricing Guidelines to restructure their business among related parties, transfer and sell assets including intangibles, and enter into new agreements for contract manufacturing.

It appears unfair that the tax authority accepts the price paid by Company T to purchase intangibles from Shuyona, recognizing Shuyona sold its valuable intangibles to Company T, but then claim that Shuyona, not Company T, deserves the intangible related returns from the new R&D funded by Company T.

Although the tax authority disputes the intangible profits reported by Company T from the new R&D, it appears their real concern is the “business purpose” for the restructuring and Company T. If this is true, then it would help to include more guidance in section C and more details in this example to provide a clearer illustration of when the tax authority considers a transaction or series of transactions (i) would not have been entered into between persons dealing at arm's length, and (ii) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

**C. Transactions Involving the Use or Transfer of Intangibles**

**C. Introduction**

To simplify the transfer pricing rules and compliance, it would help for the start of section C to say:

Unless otherwise noted, Section C provides guidance for those intangibles that should be compensated, and does not apply for those intangibles that should not be compensated.
C. Terms and phrases

Section C can be misunderstood and misused when it uses the term “transfer pricing” in reference to the “use or transfer of intangibles”. While transfer pricing methods can be used reliably for transactions involving the use of intangibles, it is difficult to use transfer pricing methods for the sale of intangibles. However, valuation methods are relevant and more reliable for the sale of intangibles.

For greater clarity, please edit the Discussion Draft to refer to the “transfer pricing methods for the use of intangibles” and “valuation methods for the sale of intangibles”. Alternatively, if the Discussion Draft intends for valuation methods to be listed as an “other method” within transfer pricing, the Discussion Draft will need to be edited to clearly indicated if it is referring to transfer pricing methods, valuation methods, or both each time it mentions “transfer pricing” in respect of the “use or transfer of intangibles”.

C.1 Transactions involving the use of intangibles for goods or services

Please include paragraphs 6.17 and 6.18 from the existing guidance on intangibles in section C.1. These paragraphs provide clear and useful guidance for these transactions.

6.17 The compensation for the use of intangible property may be included in the price charged for the sale of goods when, for example …

6.18 In some cases, intangible property will be bundled in a package contract including rights to patents, trademarks, trade secrets, and knowhow. For example, an enterprise may grant a licence …

C.2 Transactions involving transfers of intangibles

The word “transfer” is confusing since it refers to two kinds of transactions and analysis. For greater clarity and usefulness, please separate this guidance into the two parts shown below.

Transactions involving the license of intangibles

Paragraph 62 refers to the transfer of limited rights – e.g., a licence or similar transfer of rights to use an intangible which may be subject to geographical restrictions, limited duration, restrictions with respect to the right to use, exploit, reproduce, further transfer, further develop.

Generally, these transactions are valued (i) using transfer pricing methods, (ii) to determine the arm’s length price, (iii) for the use of the intangible, (iv) over a period of time.

Transactions involving the sale of intangibles

Paragraph 62 also refers to the transfer of all the rights in the intangibles (e.g. a sale of the intangible).

Generally, these transactions are valued (i) using valuation methods, (ii) to determine the fair market value, (iii) for the sale of the intangible, (iv) at a point in time.
It would help for this section to have a general introduction to business valuations with a reference to the International Valuation Standards Council (IVSC) which has 74 member bodies from 54 countries including the Canadian Institute of Chartered Business Valuators and American Society of Appraisers.

Respectfully, transfer pricing professionals should consider the valuation courses and designation offered by the organizations named above before engaging in the business valuations part of a larger assignment that involves tax, transfer pricing and other issues. Alternatively, transfer pricing professionals should involve and work with business valuators that have the appropriate qualifications and experience.

This is an important distinction. In Canada, there are separate sections of the Income Tax Act for transfer pricing versus valuations and, because of this, the Canada Revenue Agency has two different departments. One department deals with transfer pricing and another deals with business valuations. These departments can and will work together on certain audit issues – e.g., business restructuring.

C.3 Illustrations

In general, Examples 12 to 17 will need to be revised to reflect any changes in the Discussion Draft.

Examples 12 and 14 appear correct for using transfer pricing, not valuations, in these examples.

Example 13 is unclear in its use of the word “transfer” and misleading in the analysis that is required.

Please edit this example to clearly indicate this is a sale of a business segment consisting of tangible assets, intangibles and goodwill. The transaction occurred at a point in time, likely on the same date Company S was incorporated. Valuation methods should be used to determine the fair market value of the business segment. It would be inappropriate to use transfer pricing methods for this transaction.

This is a difficult issue for most tax professionals, knowing when to use valuations vs. transfer pricing. The Tax Court of Canada dealt with this same issue in Alberta Printed Circuits Ltd. v. The Queen, which the court decided was a valuation issue, not transfer pricing, based on my report and testimony.

Example 15 involves valuations and transfer pricing in a series of transactions including (1) Company T acquiring another company, (2) the sale of the newly acquired intangibles to Company S (valuation), and an agreement for the acquired company to provide contract R&D for Company S (transfer pricing).

Respectfully, the example is wrong to say the purchase price allocation from transaction (1) is irrelevant for transfer pricing purposes. On the contrary, it is very relevant for transaction (2), particularly if the taxpayer relied on it. The question remains is it reliable for valuing this transaction? It is unfair to say the purchase price allocation is not relevant without explaining what information is relevant.

Example 15 becomes overly complicated with a high chance of dispute once it names the workforce separate from, and in addition to, the tangible and intangible assets that were sold to Company S. For example, some of the OECD member countries do not yet agree that the workforce is an intangible and, even if it was, there is no guidance in the Discussion Draft on how to value a workforce.
It is worth repeating, if the Working Party No. 6 is unable to reach a consensus, it would be better to exclude the discussion of an assembled workforce from Chapter VI on intangibles.

Respectfully, Example 15 defines many of the relevant issues, but fails to provide the appropriate guidance in sections A, B, C and D that is needed to resolve the uncertainty and dispute.

Example 16 raises the difficult question as to who owns the second generation of intangibles.

The facts and circumstances, legal interpretations, etc. are needed to decide who owns the second generation of intangibles. It might be Zhu which owns the first generation, Company S which developed the second generation, or both. Without knowing more details, it is not appropriate to conclude in this example that Company S should compensate Zhu for the rights of the software. If compensation is required, it is unclear if the intangibles were sold (valuations) or are in use (transfer pricing).

From my perspective, there are a few possibilities as to who owns the second generation of intangibles, and the right answer will depend on the facts and circumstances in each case. This is one of a few issues where the Discussion Draft cannot provide a clear and simple answer for all situations. For greater clarity and usefulness, it would help to state this in section B and Example 16 of the Discussion Draft.

D. Determining Arm’s Length Conditions Involving Intangibles

D. Introduction

To simplify the transfer pricing rules and compliance, it would help for the start of section D to say:

Unless otherwise noted, Section D provides guidance for those intangibles that should be compensated, and does not apply for those intangibles that should not be compensated.

D. Terms and phrases

Section D of the Discussion Draft uses the phrase “section D.1. (vi) intangibles” which is not very descriptive. For greater clarity, please substitute the phrase “unique and valuable intangibles”, unique and valuable intangibles that should be compensated” or “intangibles that should be compensated”.

D.1 Conducting a comparability analysis

Please edit paragraph 88 as follows for the reasons mentioned below.

88. Where the tested party and the potential comparable have similar routine intangibles that should not be compensated, no comparability adjustments will be required. However, if either of them have and use in their business section D.1.(vi) unique and valuable intangibles that should be compensated, then the Transaction Net Margin Method cannot be used. It may be necessary either to make appropriate comparability adjustments or to revert to a different method to consider another transfer pricing method or methods. (See section D.1.(iii) for matters to be considered in evaluating comparability of intangibles).
In the first sentence of paragraph 88, it appears the tested party and comparables own or use routine intangibles that should not be compensated. In this instance, routine intangibles should not interfere with the comparability if using, for example, the Transactional Net Margin Method (TNMM).

In the second sentence of paragraph 88, it is misleading to suggest “it may be necessary to make appropriate comparability adjustments” if either the tested party or comparables have unique and valuable intangibles that should be compensated. If the intangibles are truly unique and valuable, it is unlikely you will be able to make a reliable adjustment to improve the comparability. The rest of the sentence is correct when it says it will “be necessary to revert to a different transfer pricing method.”

It might interest you to know the Tax Court of Canada dealt with this same issue in *Alberta Printed Circuits Ltd. v. The Queen*, and agreed with me when the judge said in his decision “TNMM is less likely to produce reliable results where the tested party contributes to valuable or unique intangible assets.”

**D.2 Selecting the most appropriate transfer pricing method**

**(ii) Use of valuation techniques**

Paragraph 109 is misleading when it says:

> 109. Some valuation techniques drawn from financial valuation practice may have application both in cases involving the use of intangibles in connection with sales of goods or services, and in cases involving transfers of intangibles or rights in intangibles …

Generally, the transfer pricing methods described in Chapter II of the OECD Guidelines are relevant and reliable for determining the arm’s length price of transactions involving the use of intangibles over a period of time. Valuation techniques should not be required, but if they are to be considered, the Discussion Draft should allow this in “limited circumstances”. Without this, there is a concern that taxpayers and tax authorities might misunderstand and misuse valuation techniques in place of transfer pricing methods.

Further, valuation methods described by the IVSC and other professional bodies are relevant and reliable for determining the fair market value of transactions involving the sale of intangibles at a point in time. Transfer pricing methods should not be required, but if they are to be considered, the Discussion Draft should allow this in “limited circumstances”. Without this, there is a concern that taxpayers and tax authorities might misunderstand and misuse transfer pricing methods in place of valuation methods.

Paragraph 110 is misleading when it suggests the valuation assumptions are “biased in favour of conservatism” and “can lead to definitions that are too narrow for transfer pricing purposes”. To clarify, it is the generally accepted accounting principles that cause this, not the valuation assumptions.

Respectfully, paragraph 110 is wrong to say the purchase price allocation is not relevant for transfer pricing purposes. On the contrary, it is very relevant, particularly if the taxpayer relied on it. The question remains is it reliable for valuing this transaction? Finally, it is unfair for the Discussion Draft to say the purchase price allocation is not relevant without explaining what information is relevant.

Please delete these comments from paragraph 110 and, in its place, include the following caution:
The taxpayer and tax authority should inquire and consider the purpose of the valuation, the definition of value used, and the level of assurance provided before using the valuation for transfer pricing purposes. Adjustments might be required before using this information for the valuation of intangibles sold to a related party.

For example, a valuation for financial reporting purposes based on the “fair value” defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date” is not the same as a valuation for tax purposes based on the “fair market value” defined as “the highest price available in an open and unrestricted market between informed and prudent parties, acting at arm’s length and under no compulsion to act, expressed in terms of cash.”

The Tax Court of Canada also dealt with these issues in *Alberta Printed Circuits Ltd. v. The Queen*.

### D.3 Determining arm’s length prices for the use of intangibles

Paragraph 131 is misleading when it says:

> 131. In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions may be utilised to determine arm’s length conditions for the sale of goods or services where intangibles are used in connection with the transaction.

The comments and recommendations above for paragraph 109 also apply for paragraph 131.

### D.4 Determining arm’s length prices for the transfer of intangibles

Please consider structuring section D.4 so that the guidance is moved within one of the following headings for: (i) in general; (ii) transactions that involve the license of intangibles; and, (iii) transactions that involve the sale of intangibles. This should help make this section easier to use and might help prevent or resolve certain misunderstandings, misuse and disputes.

The comments above for sections C.2 and D.2 also apply for section D.4 – e.g., using transfer pricing methods for the arm’s length price of transactions involving the use of intangibles, and valuation methods for the fair market value of transactions involving the sale of intangibles.

To clarify, if third party transactions exist and are reliable, this would be a comparable uncontrolled price or transaction for transfer pricing purposes, or the “market approach” for valuation purposes.

Respectfully, paragraph 142 is misleading, possibly wrong. Although the profit split method is an appropriate and reliable method for pricing transactions involving the use of intangibles, it is not the most appropriate or reliable method for valuing the sale of intangibles. Valuation methods should be used for this transaction. Using profit splits in place of valuation methods for the sale of intangibles will lead to greater uncertainty and disputes between the taxpayer and tax authority.

I agree with paragraph 147 when it says:

> 147. It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one
or more sets of valuation standards utilised by valuation or accounting professionals or to describe in detail
one or more specific valuation techniques or methods that may be especially suitable for use in a transfer
pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these
Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate
consideration of the validity of the assumptions underlying the valuation and the consistency of those
assumptions with the arm’s length principle, such techniques can be useful tools in a transfer pricing analysis
where reliable comparable uncontrolled transactions are not available.

However, contrary to paragraph 147, paragraphs 145 to 170 appears long and detailed, which gives the
false impression of setting out a comprehensive summary of valuation techniques, and appears to focus
on the discounted cash flow method to the detriment of other valuation methods that might apply.

Therefore, to be consistent with paragraph 147, and to avoid any misunderstanding or misuse, please
reduce paragraphs 145 to 170 to only a few paragraphs with less detail. Finally, please encourage
transfer pricing professionals to consider the valuation courses and designation offered by the
International Valuation Standards Council and its 74 professional bodies before engaging in the business
valuations part of a larger assignment that involves tax, transfer pricing and other issues. Alternatively,
transfer pricing professionals should involve and work with business valuators that have the appropriate
experience and qualifications. Working like this will lead to better answers and fewer disputes.

Finally, for countries seeking more guidance on business valuations, please consider moving this
guidance and examples into an Annex to Chapter VI or a new chapter in the OECD Guidelines.

The chart below summarizes the most reliable methods for each type of transaction involving intangibles.

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Type of Intangibles</th>
<th>Most Reliable Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangibles in connection with the sale of goods or services</td>
<td>Routine intangibles that should not be compensated</td>
<td>Transfer pricing methods including the TNMM</td>
</tr>
<tr>
<td>License of intangibles</td>
<td>Routine intangibles that should not be compensated</td>
<td>Transfer pricing methods including the TNMM</td>
</tr>
<tr>
<td>License of intangibles</td>
<td>Unique and valuable intangibles that should be compensated</td>
<td>Transfer pricing methods i.e., CUP or residual profit split, but not the TNMM</td>
</tr>
<tr>
<td>Sale of intangibles</td>
<td>Unique and valuable intangibles that should be compensated</td>
<td>Valuation methods</td>
</tr>
</tbody>
</table>

**OECD Draft on Timing Issues Relating to Transfer Pricing**

The consultation process needs to consider section D.4 and the OECD draft on timing issues as it
relates to the use of information after the fiscal year of the transaction – i.e., hindsight. Section D.4 will
need to be revised to reflect any changes in the OECD Draft on Timing Issues, and vice versa. Please
consider MDW’s letter and comments to the OECD on Timing Issues Relating to Transfer Pricing.
D.5 Illustrations

In general, Examples 18 to 22 will need to be revised to reflect any changes in the Discussion Draft.

**Example 18** involves valuations and transfer pricing in a series of transactions.

The comments above for Example 15 and paragraph 100 also apply for Example 18 – e.g., the purchase price allocation is relevant, the question is it reliable, and what would be more relevant and reliable?

**Example 19** involves the restructuring of a business where Pervichnyi (1) sells the patents and trademarks to Product F for a lump sum to a newly incorporated subsidiary, Company S, and (2) transfers all of its production of Product F to Company S. This example “seeks to identify an arm’s length price for the transferred intangibles by utilising a discounted cash flow (DCF) valuation technique.”

There are concerns with the facts, assumptions and analysis in this example. For example, transactions (1) and (2) represent the sale of a business segment for Product F at a point in time, which requires valuation methods (not transfer pricing) to determine its fair market value (not arm’s length price).

Respectfully, the example is vague in using the term “lump sum”, suggesting or implying this is inappropriate, unreliable or both. It does this in order to discuss the DCF analysis without mentioning, or comparing, the DCF with other valuation methods. Depending on the facts, lump sum might refer to a valuation report that determined the fair market value of the business segment, which should be reliable.

It is inappropriate and misleading to assume the patents and trademarks have a useful life of five years because, if this was true, it is very doubtful Pervichnyi would have restructured its business in the manner described. It is more likely the patents and trademarks have a much longer useful life. For this and other reasons, the DCF is not the most appropriate valuation method to use. This example should consider all of the valuation methods before selecting the most appropriate one given the facts and circumstances.

The example omits and overlooks the actual facts that Pervichnyi and Company S considered at the time of the transaction in order to propose alternatives using a DCF analysis based on a list of assumptions.

It appears the tax authority’s real concern is the “business purpose” for the restructuring and Company S, which operates in a low tax jurisdiction (i.e., 10%). The comments and recommendations in Example 11 for this point also apply for Example 19.

**Example 20 and 21** raises difficult questions regarding the second generation of intangibles.

The facts and circumstances, legal interpretations, etc. are needed to decide the issues. This is one of a few issues where the Discussion Draft cannot provide a clear and simple answer for all situations.

**Example 21 and 22** include adjustments using a “price adjustment clause” on the assumption there is evidence that independent enterprises would have insisted on protection in this form.
These examples can be misleading and might be misused if tax authorities begin using the theory of a price adjustment clause without first finding relevant and reliable evidence to support this claim.

For the same reasons stated in paragraph 116, which deals with rules of thumb, the application of a general rule or theory about second generation intangibles, price adjustment clauses and possibly other issues "does not provide an adequate substitute for a complete comparability analysis conducted under the principles of Chapters I through III. Accordingly, application of a rule of thumb ... is discouraged."

Please consider MDW's letter and comments to the OECD on Timing Issues Relating to Transfer Pricing.

Please reconsider and edit examples 20, 21 and 22 to reflect this concern and guidance.
Subject: MEDEF Comments on the OECD Discussion Draft: Revision of Special Considerations for Intangibles in Chapter IV of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Pascal,

MEDEF is pleased to respond to the OECD request to send comments on the Discussion Draft on the revision of Chapter VI of the Transfer Pricing Guidelines published 6 June 2012 (hereafter referred to as “the Draft”).

We welcome the work that has been undertaken by the OECD and the opportunity that has been given to the business community to comment on the current Draft. We know from experience that the OECD Guidelines are used as an international standard for related party transactions, and that not only member States, but also non-member States follow them. This is why we consider consensus among Member states and the business community on as many sections as possible essential to the success of the Draft. It would also help enhancing the application of the Draft for non-member States.
Direction des Affaires fiscales

Please note that we are providing only general comments in this letter, as we have been working very closely with BIAC, as a BIAC member. We therefore concur with all the conclusions, comments, redline draft and reservations contained in the BIAC comments on the Draft. Also note that we will provide you with comments on the examples included in the Draft, as well as potential additional “real life” examples, after the November meeting. We will then be in a better position to interact on such examples in a more effective way. We would like, for example, to include situations where expenditure does not result in the creation of an intangible or where intangibles do not produce benefits at all or not immediate benefits.

In the meantime, we would like to specifically highlight the following:

- **Transfer Pricing analysis should be process driven.** The Draft shall articulate the process that needs to be followed in order to analyse (i) the ownership, (ii) the income deriving from the ownership and (iii) the valuation of intangibles. This might sound very basic, but concepts without processes are not always helpful. In practice such a step-by-step analysis may read as follows:
  1. Does an intangible exist?
  2. Who owns it and is therefore entitled to the intangible related return?
  3. What is the value of such an intangible asset if it is used by or transferred to another entity within the Group?

- **Does an intangible exist?** The current definition of an intangible (“something” that has commercial value), is way too vague. An intangible should be defined as an “asset” that is recognized by legal and accounting principles as being subject to ownership, control and transferability. An entity cannot own an intangible if it does not simultaneously (1) own legal protection of the intangible (2) perform functions in relation to the ownership, the maintenance or the management of the intangible and (3) incur costs in relation to the intangible.

- **Who owns it and is therefore entitled to the intangible related return?** It is crucial that this analysis does not mix two different concepts: the ownership of an intangible, giving right to the intangible related returns and the performance of certain functions and the incurring of expenses in relation to an intangible that gives right to an arm’s length compensation. We suggest the following articulated approach in order to secure analysis of who is entitled to the intangible related return:
  1. Comparable uncontrolled transactions analysis
  2. If no such transactions exist, functions, costs, and control risks analysis coupled with contractual entitlement analysis
What is the value of such an intangible asset in case of use by or transfer to another entity within the Group? A distinction should be made between complex cases requiring very sophisticated methods and simple cases with standard valuation and documentation requirements. We trust the Draft does not set the profit split method or the DCF method as the only appropriate methods in assessing the arm’s length compensation or valuation of any intangible. It is also very important that non-OECD recognized methods are not used by the tax authorities in substitution for standard methods nor for “sanity check” purposes.

Last but not least, we would welcome a redraft of some of the paragraphs that relate to abusive transactions or situations. Whilst MEDEF recognizes that such transactions or situations may exist in isolated cases, we have concerns that the Draft can be read as assuming an anti-abuse standpoint, which would be inappropriate as not reflecting the reality of how companies behave.

We hope our contribution will give you a clearer insight into our expectations and will be pleased to answer any questions you may have regarding these comments.

Sincerely yours,

Vanessa de Saint-Blanquat
COMMENTS SUBMITTED BY THE MEXICAN CHARTERED ACCOUNTANTS INSTITUTE

COMMENTS TO THE REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

Intangibles in development process

In general terms, the discussion draft that OECD published regarding the revision of the special considerations for intangibles refers mainly to intangibles already developed.

Since intangibles have different levels of development, such provisions should also include specific considerations for intangibles in its different levels of development.

Assembled workforce

Paragraph 25 “Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or the efficiency with which services are provided or goods are produce by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.”

Although the document presents certain examples regarding the treatment of what the assembled workforce should receive, the Revision should include additional guidelines in this subject, specifically with respect to the comparability analysis.

Cost Approach Method

Paragraph 112 “In a transfer pricing analysis, the use of valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return is generally discouraged. There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, financial valuation techniques based on the cost of intangible development should usually be avoided.”

In certain cases, the application of the cost approach method is reasonable since the future economic benefits to be generated by the intangible are uncertain. In order to estimate the fair market value of an intangible with an uncertain economic future, it is considered that the cost approach method must provide reliable results; therefore the Revision should consider this method as an alternative option.
Valuation methodologies

In order to have more Guidelines regarding valuation methodologies, the Revision should include the different approaches used for valuation purposes, such as:

- The cost approach
- The market approach
- The income approach, including the following categories:
  1. Methods that quantify higher levels of economic income.
  2. Methods that quantify lower levels of economic cost.
  3. Methods that estimate a relief from comparable royalty.
  4. Methods that quantify the before and after difference in value of the overall business enterprise as a result of owning versus not owning the intangible property.
The aim of this paper is to discuss the legal framework that currently regulates the transfer pricing of intangible assets in Mexico. As a result of this study, we would emphasize the very low level of regulation on this issue and the need to create an appraisal and valuation system for uniformly taxing these transactions, given their importance for the national economy.

1. The importance of trading with intangible assets for developing countries

With the advances in communications, the problems of transfer prices have intensified as business transactions are becoming more complex. Moreover, simultaneously with the proliferation of multinational companies, cross-border transactions have increased sharply. Thus, as a result of globalization, transfer prices have gained relevance for effectively taxing the income of related companies.

As per the recommendation of the Organization for Economic Cooperation and Development (OECD), which has been adopted by Mexico, the principle of market prices should be used for transfer pricing, i.e., the subsidiaries of a multinational company operate as independent entities despite belonging to the same business. Based on this approach, subsidiaries belonging to multinational corporations are treated as independent parties, and therefore, which raises the issue of whether agreements between these parties are different from those executed for comparable uncontrolled transactions. This comparison between controlled and uncontrolled transactions is precisely the basic principle of market prices.

It is important to emphasize that as technological development advances, transactions between related companies have also become more complex as they trade with tangible assets traded, but also with high yield intangibles such as patents, copyrights, designs and models, software, and business secrets (unpatented formulas) that are not usually transferred between independent companies.

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1 Researcher at the Institute for Economic Studies of the National Autonomous University of Mexico.
2 Professor and researcher at La Salle University, Business School
3 Torre Delgadillo, Vicente (2010) Problemas de precios de transferencia de bienes intangibles en la empresas multinacionales, Mexico, Boletín Mexicano de Derecho Comparado, new series, no. 128, May-August 2010.
While the application of the principle of market prices for trading with tangible assets is often problematic, in the case of the trading with intangibles this is even more so, among other reasons, because of the difficulty in finding information on the prices of comparable intangibles that would allow for this principle to be applied. Therefore, the appraisal of intangible assets becomes subjective.

This situation leads to the easy manipulation of transfer prices between related companies when they are located in countries with different tax rates. Given the lack of information on the bilateral trade in intangible assets, countries such as Mexico find it particularly difficult to estimate the market price of specific services that are bought and sold to other developing countries, making it impossible to conduct a comparative study. Indeed, the lack of information in the market on an intangible asset is the greatest problem in determining its value.

The problems

According to the specialists, one of the handicaps for estimating the transfer pricing of intangible assets involves their exploitation, which can be undertaken directly or indirectly. In the former case, the individual or entity using the intangible asset is that which created and protected it in their favor. In the case of indirect exploitation, all or part of the rights of the intangible asset are transferred to companies of the same group or third parties.

The difficulty occurs when the tax treatment is different. If the transfer is complete, the corporate profits should be taxed only in the recipient location; if the revenue derived from the exploitation of the intangible asset is partial, it should be taxed in the country where the income is generated and in the recipient location as well.

Thus, to determine the tax to be paid, it is necessary to take into account the particular circumstances and the extent of the transfer of rights on the intangible asset. In Mexico, this situation is dealt with in Article 170 of the Income Tax Law (LISR).

A second difficulty arises from the degree of linkage between the parties involved in order to be subject to the regulations on transfer pricing. A commodity or tangible asset that is accompanied by an intangible asset represents another scenario that complicates the assessment of market prices to determine taxable income. In this case, in order to appraise the appropriate tax, both assets should be separated from each other and, in addition, it is necessary to determine to what extent the value of the tangible good is influenced by the intangible asset.

4 Alvarado, Héctor, “Valuación de intangibles”, in several authors, Precios de transferencia. Marco jurídico y práctico, Mexico, IMCP, 2008, p. 331.
This situation is particularly complex in the case of intangibles trading, which according to the Transfer Pricing Guidelines (TPG), include registered trademarks, brand names, lists of customers, distribution channels, specific names, and symbols, among others. For example, it is very difficult to separate a product from the trademark and thus determine the revenue attributable to each. The criterion used is the following: if the tangible asset includes rights to use intangible property, it must establish a payment at market prices for the intangible asset. Hence, the already mentioned problem of lack of information fosters the tampering with transfer pricing.

The previously alluded to difficulties are coupled with the high functional specialization of multinational enterprises (increasingly intensive use of business private networks within the multinational corporations) and the dissimilar control that these operations are subject to in each country. This situation has favored the manipulation of transfer prices when intercompany operations are undertaken in different countries. Such transactions do not have a market price nor are they fully comparable.

This also affects the competition that occurs in many countries to attract foreign investment. The absence of coordination can lead to several side effects, among them a reduction in tax collection income in the competing countries and a deficient distribution of resources. The result has been the use of manipulated transfer prices, whereby transactions end up being taxed in countries with low tax rates.

2. Intangible trading legislation in Mexico

The LISR has regulated transfer pricing in Mexico since 1997. Other legal provisions that affect the operations of related companies are the Financial Reporting Standards (FRS) and the Industrial Property Law. However, legislation for the transfer pricing of intangibles is very new, so much so that fiscal laws do not define specifically the concepts involved in the marketing of intangible goods and assets.

Article 215 of LISR stipulates that all transactions undertaken by resident taxpaying companies with related parties residing in the country or anywhere else should be agreed to at market value, including those involving intangible assets. The same article states that, for the interpretation of this provision, the Transfer Pricing Guidelines for Multinational Enterprises will be applied.

According to Article 38 of LISR, intangible assets can be goods or rights and fees that allow for a reduction in operating costs, improve the quality or acceptance of a

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product, exploit a good, as well as the rights and fees that allow for the exploitation of assets in the public domain or for providing a public service concession.

Financial Reporting Standards (FRS)

According to the Financial Reporting Standards (FRS), intangible assets are those that are saleable though not material or physical. Their main attribute, in addition to being incorporeal, is that they provide specific economic benefits to a company's operations for periods extending beyond the timeframes for which they were incurred or acquired. In other words, they allow businesses to reduce costs or increase revenue in the future. These economic benefits can correspond to revenue from the sale of products or services, savings in costs, or increased productivity.

Intangible assets are identifiable when purchased individually or in a business acquisition (when the buyer is the controlling entity, i.e., when it has the power to decide on the financial and operating policies of a company), or when these intangibles are internally generated. These intangibles can be sold, leased, transferred, exchanged, or licensed by the purchaser. These intangible assets are also considered as identifiable when they arise from contractual or legal rights regardless of whether or not they may be transferable or separable from the company. This is the case with some concessions, trademarks, patents, certain knowledge, and the like.

An intangible asset is identifiable if it is separable, that is, if it can be separated out in order to be sold, transferred, licensed, leased, or exchanged, either individually or together with a contract for another identifiable asset or liability. This means it can be traded in the market, just like a patent that can be licensed or a customer or client list that is used by a third party for sending out advertising. Meanwhile, an intangible asset is identifiable if it arises from contractual or legal rights, regardless of whether these rights are transferable or separable from the company or from other rights and obligations.

Some intangible assets can be defined as having a tangible essence, such as software, legal documentation (patents), or a movie. Given this panorama, the intangible asset should be treated as stipulated in the legal standard concerning property, physical installations, and equipment, or as an intangible. This requires a professional judgment to assess which of the two elements has a more significant weight.

An intangible asset that falls into the category of legal or contractual ownership must be recognized separately even if it does not fit the bill for separability, since the condition of legal or contractual ownership bestows it with an individual value, such as a leasing contract in a shopping mall; concessions, permits or rights; and patents licensed to third parties. When acquiring an intangible asset, which can be obtained along with a group of other assets, the transaction must involve the transfer of legal rights that enable an entity to identify the intangible asset.
An entity controls an asset if it has the power to obtain future economic benefits that flow from the asset and that, in addition, if it can restrict access to such benefits on the part of others. This capacity to control the asset is provided by legal rights or know-how, if it is protected by law, as well as by restrictions through accords, trade treaties, or legal agreements with employees to maintain confidentiality. In the absence of legal rights, the entity may or may not have control over the economic benefits. Thus, it is necessary to show that there is some form of control to meet the definition of an intangible asset, such as client relationships in effect for a considerable time and which will continue in the business and generate future revenue.

Internally generated goodwill is not recognized as intangible because its economic benefit cannot be controlled and its cost cannot be reliably assessed. At the same time, goodwill that arises from the acquisition of a business is recognized, and is subject to impairment tests for considering its lifespan to be indefinite. Goodwill represents the excess of the cost of acquisition over the fair or specific value of the acquired net assets. Particularly in the acquisition of businesses, these assets are not individually identified nor separately recognized.

The valuation of an intangible asset must be at its acquisition cost, either in cash or its equivalent. In the case of the acquisition of a business, the cost is the fair value of each identifiable intangible asset that does not exceed the percentage of the consideration paid to which it is attributable. When the intangible asset is generated internally, its cost is determined by the disbursements undertaken for its development. The acquisition cost of an intangible asset encompasses its purchase price and import duties and taxes, and any expenditure attributable to the preparation of the asset for the purpose for which it is intended.

**Industrial Property Law**

The individual or entity that produces an invention, utility model, or industrial design, or his or its successor, has the exclusive right to its exploitation for his or its benefit, for himself or for others with his or its consent. This right is granted through a patent in the case of inventions, and registrations for utility models and industrial designs. The right to obtain a patent or registration can be transferred through inter vivos or by succession. The rights conferred by a patent or registration can be taxed and transferred wholly or partially provided that they are registered with the Mexican Industrial Property Institute. The patent is valid for 20 years, with no possibility of extensions.

An invention is any human creation that allows for the transformation of matter or energy that exists in nature, for use by people and to satisfy our needs. To be patentable, the inventions must be new, the result of an inventive activity, and susceptible to industrial application. The exceptions involve processes that are
essentially biological for the production, reproduction, and propagation of plants and animals, biological and genetic material as found in nature, animal species, the human body and the living parts that compose it, and varieties of plant life. In terms of legislation, theoretical or scientific principles will not be considered inventions, nor are discoveries to disclose or reveal something that already exists in nature, even if it were unknown to humankind. This is also the case with schemas, plans, rules, and methods for performing mental acts, games or businesses, and mathematical methodologies; computer programs; ways of presenting information; aesthetic creations and artistic or literary works; methods involved in surgical, therapeutic, or diagnostic treatment applicable to the human body and to animals; and the juxtaposition of known inventions or mixes of known products, their variations in use, form, dimensions, or materials, except when this really involves their combination or fusion so that they cannot function separately or that their inherent qualities or functions cannot be modified to obtain an industrial result or a use that is not obvious to skilled professionals in the field.

The Industrial Property Law defines as utility models those objects, utensils, equipment, or tools that as a result of a change in their disposition, configuration, structure, or form, provide a different function with respect to the parts that comprise them or advantages in terms of their usefulness. The registration of the utility models is valid for ten years.

3. Research and development

In some cases, the intangible can be generated internally. Given these circumstances, it should be evaluated whether the intangible asset qualifies for recognition as such. To do so, it is necessary to identify the existence of an intangible asset and the time when it will generate probable future economic benefits, as well as reliably determine the cost of the asset. An entity should classify the generation of the asset in two phases: the research phase and the development phase. If the entity has no way to distinguish the phases, all expenditures made will be treated exclusively in the research phase.

In the research phase, all costs should be recognized as an ordinary expenditure in the period when they are incurred, given that there is no certainty that future economic benefits will be obtained. Activities can occur at this phase that are aimed at obtaining new know-how; searching for alternatives for other materials; evaluating an finally selecting applications of research findings or other knowledge; searching for alternatives for other materials, tools, products, processes, systems, or services; and training, designing, evaluating and finally selecting possible alternatives for improvements to materials, tools, products, processes, systems, or services.

The costs in the research phase are related to the use of internal and external personnel participating in the research project; materials consumed and services received; equipment and facilities to be used in the project, including the depreciation of assets; indirect costs, other than administrative expenditures,
related to operations; and other expenses such as the amortization of patents and licenses.

In order for intangibles to be recognized in the development phase, in addition to identifying the four previously mentioned attributes, the feasibility of completing the production of the asset should also be demonstrated so that it shows that the entity intends to use or sell the intangible. Such feasibility can be demonstrated through a business plan that indicates the resources necessary to develop the intangible asset.

Activities in the development phase include the design, construction, and testing of pre-production models and the testing of prototypes and models; the design and manufacture of tools, templates, molds, and dies that involve new technology; the design, construction, and operation of a pilot plant that is not attached to an intangible asset; the design, construction, and testing of materials, tools, products, processes, systems, or services, either new or improved.

4. Definition of certain intangible assets as per the Financial Reporting Standards

Patents are a right granted by a government for the exclusive use of a manufacturing process or for selling or exploiting an invention. There are two categories of patents.
1. Process patents, which control the process by which products are made.
2. Product patent, which cover current physical products.

The holder of the patent or registration may concede through an agreement, licenses and permits for its use or exploitation. The license must be registered so it can have legal bearing and rights. For example, this would be the case with cable TV, radio and television broadcasters.

Registered trademarks involve a word, phrase, or symbol that distinguishes or identifies a particular product or entity. The right to its exclusive use is obtained through its registration. Registered trademarks involve the rights that can be acquired, sold, or leased.

The appraisal of a trademark is grounded in an approach based on revenue, a methodology known as the quantification method based on royalties. For accounting standards in Mexico, it was felt that the range of percentages of royalties in relation to sales is, on average, 4%.

A franchise exists when the license to use a trademark also involves the transmision of technical knowledge or when technical assistance is provided to those to whom the license has been granted so that they can produce or sell goods or provide services uniformly and with the operating, marketing, and management methods established by the holder of the trademark. These methods are aimed at
maintaining the quality, prestige, and image of the corresponding goods or services.

5. Definition of certain intangible assets as per the Industrial Property Law

Industrial designs include industrial drawings, which are any combination of images, lines, or colors that are incorporated into an industrial product for decorative purposes and that provide it with a unique and specific appearance of its own, and industrial models, consisting of any three-dimensional shape that serves as a model or pattern for the manufacturing of an industrial product and which gives a special appearance that does not involve technical effects.

An industrial or trade secret is considered to be any information of an industrial or commercial application that an individual or entity may hold as confidential, and which involves obtaining or maintaining a competitive or economic advantage vis-à-vis third parties in the carrying out of economic activities and with respect to which sufficient measures have been adopted to preserve its confidentiality and restricted access to it.

A trademark can be represented by a visible brand name and patterns that are sufficiently distinctive and capable of identifying goods or services to which they are applied or attempted to be applied, as compared with those of the same type or category; tridimensional shapes; commercial or trade names; the name of an individual as such. The trademark registration is valid for ten years and can be renewed for the same length of time.

Commercial advertising involves the phrases or slogans whose purpose is to inform the public of establishments and business, industrial or service activities, products or services, to distinguish them from others of its kind. As with trademarks, their registration is valid for a period of ten years and may be renewed for the same amount of time.

6. Concluding remarks

In establishing the transfer pricing of intangible assets, up until now the OECD methodology has prevailed, which is based on market principles. However, this method is not effective in this case due to the absence of comparable transactions to serve as benchmarks for establishing a market price.

As we have pointed out, assessing the value of the trade in intangibles involves a high degree of subjectivity. Therefore, it is difficult to impose a single methodology for determining transfer prices. To begin with, this requires an analysis of each of the factors that are present, and based on this study, the method that best suits the economic reality of the transaction is applied.
Under these conditions, subsequently it will be necessary to create a valuation system for uniformly taxing these transactions. If countries do so on an individual basis, no one will benefit from different standards and valuation methods whose application could be a source of conflict between the fiscal authorities and corporate taxpayers, with the aggravating circumstance that the latter will seek to be taxed in countries with a lower tax burden with the resulting deficient distribution of resources.
September 7, 2012

Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Mr. Joseph L. Andrus
2, Rue André Pascal
75775 Paris, France

Re: Comments on OECD Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Mr. Andrus,

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Discussion Draft published June 6, 2012, and referenced above. The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we commend OECD Working Party No. 6 for providing the opportunity for business input on this important project.

The Discussion Draft includes a proposed revision of Chapter VI of the OECD Transfer Pricing Guidelines as well as a proposed revision of the Annex to Chapter VI providing examples illustrating the application of these provisions. These aspects of the Transfer Pricing Guidelines address the transfer pricing aspects of intangible assets. Our comments on the Discussion Draft are based on several overarching principles, which we believe to be widely shared by business enterprises and other stakeholders. First, it is absolutely critical that any revisions to the Transfer Pricing Guidelines provide more clarity and certainty for businesses and governments with respect to the issues addressed. The goal of revisions to the Transfer Pricing Guidelines should be to further the consensus among governments and taxpayers as to the application of the arm’s length standard, thereby minimizing the risks of double taxation, consistent with the tax treaties under which the Guidelines are relevant. Second, this project should not be used as a platform to reopen issues that were resolved in the recent guidance on business restructurings included in the Transfer Pricing Guidelines in 2010; rather, any further revisions to the Transfer Pricing Guidelines should incorporate and build upon the consensus reached in the business restructurings project.

The Discussion Draft is divided into five parts: (1) identifying intangibles; (2) identification of parties entitled to intangible related returns; (3) transactions involving the use or transfer of intangibles; (4) determining arm’s length conditions in cases involving intangibles; and (5) an annex with examples
illustrating the principles of parts (2) – (4). We provide comments on each of parts (1) through (4), with comments on the examples provided in context.

**Identifying Intangibles**

The Discussion Draft provides guidance on what constitutes an “intangible” for transfer pricing purposes. The Discussion Draft rejects definitions from other contexts. Instead, the Discussion Draft in paragraph 5 provides a two-part definition of “intangible”: “something” (1) “which is not a physical asset or a financial asset,” and (2) “which is capable of being owned or controlled for use in commercial activities.” A guiding principle to determine whether an asset constitutes an intangible asset for transfer pricing purposes is whether, in a transaction between independent parties, compensation would be provided for the asset. The Discussion Draft provides that accounting and legal descriptions of existing intangible assets should not control the determination of whether an intangible asset exists given the constantly changing modes of doing business and intellectual property laws. To provide clarity and an analytical framework, however, legal and accounting definitions of intangible assets should serve as the reference point for defining an intangible asset. The Discussion Draft emphasizes, however, that even if an item constitutes an intangible asset, it will not necessarily deserve separate compensation or give rise to a premium return under all circumstances. To illustrate this point, the Discussion Draft identifies non-unique know-how as an intangible that might not, under particular circumstances, warrant a premium return. The Discussion Draft then provides illustrations of items that would be considered intangible assets under this framework. It concludes that goodwill and ongoing concern value may be intangibles under some circumstances and discusses assembled workforce. The Discussion Draft concludes that items not owned or controlled by a single entity, such as group synergies or market-specific characteristics, are not intangibles.

The NFTC applauds the efforts in the Discussion Draft to define the scope of the term “intangible,” to clarify that not all intangible assets generate premium returns, and to clarify that group synergies and market characteristics are not intangibles. In this regard, we recommend that the Discussion Draft further limit the scope of the term to items that are proprietary – that is, items that are legally protectable such that the associated enterprises party to a transfer can exclude others from using the assets. In the absence of such proprietary interest, an independent transferee would not pay to acquire the item. Indeed, as other commentators have recommended, it may be helpful to retain the terms “intangible assets” or “intangible property” in the current Chapter VI to prevent confusion or misinterpretation. We therefore recommend that paragraph 5 of the Discussion Draft be revised to state that the term “intangible” is to be defined as “an asset which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and which is capable of being transferred.”

Our recommendation is guided by the primary purpose for which classifying an item as an “intangible” is relevant, namely to determine whether a compensable transaction has occurred between associated enterprises. The definition of “intangible” for transfer pricing purposes is important in the context of determining whether a valuable intangible asset has been transferred between associated enterprises, and therefore whether compensation is due. It is not significant in determining the compensation due among associated enterprises in ongoing transactions that may involve the use or exploitation of intangible assets and similar items because such items may be taken into account regardless of any label in a transfer pricing analysis through a comparability analysis. This observation is consistent with recent revisions to the Transfer Pricing Guidelines; for example, the recent revisions to the guidance on the
profit split methodology provides that residual profits or losses are allocated in accordance with unique and valuable contributions of any type, not only in accordance with contributions of intangible assets.

Our recommendation is best illustrated in the context of goodwill, ongoing concern value, and assembled workforce. The Discussion Draft concludes that goodwill and ongoing concern value are valuable intangibles that should be taken into account under appropriate circumstances, namely when some or all of the assets of an operating business are transferred. But goodwill and ongoing concern value do not constitute interests in property in their own right, and it is not possible for one enterprise to transfer goodwill or ongoing concern value to another independent of a transfer of the entire business to which they relate. There is no purpose to defining these items as “intangibles,” and such a classification may create a misimpression that such items can be independently transferred or that such items automatically attach to collections of assets. In cases where some or all of the assets of an operating business are transferred, then all attributes of those assets and that business should be taken into account regardless of whether they are classified as intangibles or not. Example 13 of the Annex illustrates this point. In that example, the goodwill and ongoing concern value associated with a parent company’s operations in country B should be taken into account in evaluating the transfer pricing for the transfer of all of the parent company’s country B business operations to a new associated enterprise without regard to whether the goodwill or ongoing concern value are classified as intangibles.

Similarly, assembled workforce can be thought of as a particular subset of ongoing concern value. An assembled workforce is not an interest in property, and it is not possible for one enterprise to transfer such an attribute to another independent of a transfer of the entire business to which the workforce relates. There is no purpose to defining this item as an “intangible.” The Discussion Draft is correct of course that the existence of a uniquely qualified or experienced workforce may affect the arm’s length price for services and should be taken into account in a transfer pricing comparability analysis. But it is not necessary to classify assembled workforce as an “intangible” to achieve this result.

Regarding market specific characteristics and group synergies, the NFTC commends the language of the Discussion Draft. These characteristics cannot be owned, controlled, or transferred and therefore should not be regarded as intangible assets within the meaning of the Chapter VI and the Transfer Pricing Guidelines. These characteristics may, however, affect transfer prices and should be taken into account through the required comparability analysis.

Our recommendation is consistent with the objectives of providing more clarity and certainty for businesses and governments and with building on the work done with respect to business restructurings. The definition of “intangible” is most relevant in the context of determining whether there has been a transfer, and in that context, a definition that goes beyond proprietary interests has the potential to lead to uncertainty and disputes. This is consistent with the guidance on business restructurings, which emphasizes that compensation is due as a result of a business restructuring only where tangible or intangible assets, as distinguished from profit potential, are transferred.

Finally, while we generally agree with the Discussion Draft’s conclusion that the definitions of royalties in Article 12 of the OECD Model Tax Convention should not be relevant for the definition of intangibles for transfer pricing purposes, we believe that the Commentary on Article 12, regarding transfers of certain non-tangible items that generate business profits, should be relevant for the classification of intangible assets in the Discussion Draft. For example, consistent with the Commentary, user transactions in software and digital products should not be treated as transfers of
intangibles for transfer pricing purposes, even though no physical property is involved in the transfer. See Organisation for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, Commentary on Article 12 ¶¶ 12-17.

Identification of Parties Entitled to Intangible Related Returns

The Discussion Draft next addresses how to determine which members of an MNE group are entitled to returns from the use of intangible assets. The Discussion Draft identifies the concept of intangible related returns and provides that such returns should follow the contributions made by associated enterprises to the value of the intangibles. Comments are requested as to whether this formulation successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns attributable to intangibles should be determined on the basis of relevant functions, assets, and risks. The Working Party No. 6 delegates expressed consensus that the transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain intangible related returns without more. In paragraph 41, the Discussion Draft illustrates these principles by treating legal registrations and contractual arrangements as a starting point for the analysis, but places considerably more weight on whether a person physically performs through its own employees the important functions related to the development, enhancement, maintenance, and protection of the intangibles. To merit intangible related returns, the functions performed by an entity “would generally include, among other things, the design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, and important decisions with respect to defence and protection of intangibles and ongoing quality control.”

The NFTC is concerned that the approach suggested by the Discussion Draft could undermine the arm’s length principle by failing to give due regard to actual transactions and arrangements undertaken, to legal and economic ownership rights, and to the bearing of economic risk with respect to the development of intangible assets. A fundamental tenet of the Transfer Pricing Guidelines is that the arm’s length principle can be satisfied by determining the arm’s length price for an arrangement as actually undertaken and structured, except in rare or unusual circumstances. Rare and unusual circumstances include cases in which the transaction undertaken is inconsistent with the underlying economic substance, as evidenced by the conduct of the parties. We recognize the need for this exception to address arrangements lacking in economic substance. However, legal and contractual arrangements between associated enterprises should, in general, be respected. The conduct of the parties may be consistent with a broad range of potential legal or contractual arrangements and therefore cannot determine the entitlement to intangible returns without considering the structure of the arrangement. The conduct of intangible development functions by an associated enterprise, for example, may be consistent with the provision of contract R&D services for the economic owner of the intangible asset for a cost-plus fee or with the performance of R&D functions by the owner on its own behalf. The best way to determine which arrangement is intended is by examining the relevant legal, financial, or contractual arrangements. The Discussion Draft should clarify that the transaction or arrangement actually undertaken, as evidenced by legal rights under contract or otherwise, typically will drive the entitlement to intangible related returns.
In addition, the Discussion Draft appears to apply a different standard to determine an entitlement to an intangible related return than to other elements of a traditional functional analysis, unduly emphasizing certain functions over assets or risks. Under a functional analysis, the returns to an associated enterprise depend on the functions performed, assets used, and risks assumed by the parties. In the context of intangible assets, the assets themselves may be legally and economically owned by an associated enterprise. Indeed, the legal right to exclude others from exploiting intangible assets is what gives such assets their value. Similarly, because of the speculative nature of many intangible development activities, bearing the costs related to intangible development often constitutes a significant risk assumed by an associated enterprise. It is not clear why the Discussion Draft dismisses legal ownership and bearing of intangible development costs as insufficient to attract intangible related returns. The Discussion Draft essentially asserts that an associated enterprise is entitled to intangible related returns only if it physically performs, through its own employees, the “important” functions related to the development of the intangibles without regard to legal or contractual arrangements or who bears the costs of intangible development.

The standard proposed by the Discussion Draft is unwieldy, inconsistent with the manner in which many MNEs operate, and likely to lead to significant uncertainty and controversy. At the margins, determining whether an associated enterprise is engaged in enough of the important functions related to intangible development may be difficult and uncertain for both taxpayers and tax administrators. More fundamentally, MNEs increasingly conduct intangible development activities in regional centers in multiple jurisdictions, as well as in manufacturing sites or other facilities. Where multiple associated enterprises are engaged in activities involving the same or related intangible assets, identifying the enterprises that perform the functions identified by the Discussion Draft will be intensely challenging both for MNEs and tax administrators. Presumably, this circumstance would require an allocation of intangible related returns among the associated enterprises that perform such functions. Yet the draft provides no guidance on the methodology that parties should use to make such an allocation. The uncertainty created by the proposed standard will increase compliance and enforcement burdens and will also likely increase the number of controversies in this area.

A preferable standard would focus on who funds intangible development costs where the funder is intended to be the economic owner of the intangible assets. We believe that funding intangible property development efforts, coupled with a legal or contractual indication that the funder is intended to be the economic owner of the intangible assets vis-à-vis associated enterprises, should be regarded as a strong indication that the funder is entitled to an intangible related return. If necessary to address abusive cases, the funder could be required to oversee the activity, at least at a high level. This standard is more consistent with the arm’s length principle because it gives effect to a range of economic arrangements that could be entered into among independent parties. It would also bring the guidance in conformity with Chapter VII of the Transfer Pricing Guidelines, which provides for the use of cost contribution arrangements to develop intangible assets. In a cost contribution arrangement for the development of intangible assets, each participant is entitled to exploit its interest in the intangible assets developed separately as an effective owner thereof, and therefore entitled to the returns from the assets, because it bears the costs and risks of such development. The same should be true outside of the cost contribution context when only one person bears the costs and risks of funding intangible development. Further, NFTC’s preferred standard would lead to far more certain and predictable results for taxpayers and tax administrators.
Finally, we note that the use of the “intangible related return” concept seems unnecessary as a general matter and even within the framework developed in the Discussion Draft. This concept is axiomatically defined as the residual return once returns to all other assets (including intangible assets other than those being considered), business functions, and risks are considered. It is not clear why it is necessary to take this step rather than to determine the returns to which one or both associated enterprises may be entitled based on their functions, assets, and risk in accordance with a traditional functional analysis. While there may be circumstances in which the isolation of intangible-related returns may be illuminating, in general, this step strikes us as unnecessary. Further, in many cases it would be difficult or impossible to determine the intangible related return for any particular intangible asset. Any framework that depended on the determination of such returns would be difficult to administer and would lead to considerable uncertainty.

**Transactions Involving the Use or Transfer of Intangibles**

The Discussion Draft recognizes two general categories of transactions involving intangible assets: (1) transactions involving the use of intangibles in connection with the sale of goods or services, and (2) transactions involving the transfer of intangibles. The Discussion Draft provides additional guidance and considerations for cases where intangible assets are transferred in combination with other intangible assets or in combination with other business transactions and contains several illustrative examples.

Example 15 is noteworthy. In that example, Birincil acquires all of the shares of an unrelated company, Company T, for 100. The purchase price allocation performed for accounting purposes attributes 20 of purchase price to tangible and identified intangible assets, and 80 to goodwill. Company T then transfers all of its intangible assets to Company S, a subsidiary of Birincil. Company S then enters into a contract R&D arrangement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of intangible assets on behalf of Company S on a cost plus basis. Company S has a large research staff, including management personnel, and assumes full management responsibility for the conduct of intangible development. The example states that the allocations of purchase price for accounting purposes are not relevant for transfer pricing purposes, and that the purchase price reflects the arm’s length price for the business of Company T. It concludes that, under arm’s length transfer pricing principles, Company T should be entitled to compensation from Company S for the value allocated to goodwill, either as part of the compensation for the transfer of intangible assets or as compensation for the long term contract R&D arrangement.

In general, we applaud the use of examples to illustrate general provisions and provide concrete guidance, and we understand that it is not possible to provide examples that account for every factual variation or nuance. However, the analysis in Example 15 seems too facile. The 100 of purchase price reflects the value of Company T to its purchaser, Birincil, and not the value to Company T of its own assets and other attributes. There may be reasons why, at arm’s length, Company T would not be expected to extract returns commensurate with the purchase price from its transactions with Company S or the exploitation of its own current assets. For example, the purchase price may reflect expected synergies between Company T and Birincil assets and attributes, including Company S’s research and management staff and the capital with which it will fund ongoing intangible development. This example should be eliminated or at a minimum substantially redrafted to reflect alternative analyses.
Determining Arm’s Length Conditions in Cases Involving Intangibles

The Discussion Draft provides substantial guidance on how to determine the arm’s length price of transactions involving the use or transfer of intangible assets. The Discussion Draft outlines considerations for conducting a comparability analysis of intangible assets, sets out a list of comparability factors specific to intangible assets, and identifies certain intangible assets that would be difficult to benchmark (so-called “D.1.(vi) intangibles”). The Discussion Draft then provides more specific guidance on the determination of arm’s length prices using the five OECD transfer pricing methods and other valuation techniques, in particular discounted cash flow methods.

The NFTC is concerned with some aspects of the Discussion Draft that could be read to disparage the applicability of the comparable uncontrolled price (“CUP”) method. While the Discussion Draft acknowledges that the CUP method may be appropriate in certain cases, the overall thrust of the Discussion Draft is to discount the applicability of the CUP method by highlighting the difficulty of finding comparable intangible assets or making sufficient adjustments. Other commentators have noted that a substantial percentage of cases involving intangible assets have been resolved in various jurisdictions on the basis of the CUP method. While it is not perfect, particularly where internal CUPs are not available, the use of observed royalty rates or other prices may be more indicative of the true arm’s length result than a profit split, and simpler to apply than a discounted cash flow analysis. We agree with the concerns expressed in the Discussion Draft regarding some of the weaknesses of the discounted cash flow method, in particular the reliance on financial projections and the uncertainty of the discount rate determination. We believe that the CUP method, where applicable, often provides the most reliable and predictable indication of the arm’s length result.

The NFTC is also concerned with the increasing prominence of the realistically available options principle and the potential for this principle to undermine the arm’s length principle. As noted above, the arm’s length principle generally requires a determination of the arm’s length price for an arrangement as actually undertaken and structured except in rare or unusual circumstances. The realistically available options principle should not be used to circumvent the ability of taxpayers to structure their arrangements. While in some cases a realistically available options analysis may be useful as a check on prices, it is not appropriate to use this analysis to support a conclusion that a transaction should be disregarded or reconstructed by tax administrators. Further, though the reasonably available options principle might be appropriate in the business restructurings context, which focuses on significant one-time transactions, the great majority of transactions involving the use or transfer of intangible assets do not involve the issues that appear to be addressed by the principle. Accordingly, the realistically available options principle should not be used as a substitute for the arm’s length principle.

The NFTC is concerned, moreover, with some of the guidance relating to intangible assets whose valuation is highly uncertain and whether it is realistic to hold taxpayers to the suggested standards. Paragraph 177 and Example 21 suggest that in some circumstances some independent parties involved in a transfer of intangible assets whose valuation is highly uncertain might insist on a term requiring the renegotiation of terms or might insist on short-term arrangements. It is not clear how taxpayers or tax administrators are to implement this guidance. For the behavior of unrelated parties to have an impact on the agreed terms (rather than the pricing of transactions), must there be unanimity in the observed behavior? Is it appropriate to limit the analysis of the behavior of unrelated parties to the industry involved, or is the behavior of independent parties with respect to any intangible asset whose profit potential is uncertain relevant?
Finally, we note that since the development of Chapter VI, there has been a proliferation of transfer pricing documentation and penalty regimes. Given these regimes, it is even more important that the Transfer Pricing Guidelines provide guidance that can be complied with up front as books of account are prepared and tax returns are filed. The realistically available options principle and the guidance related to intangible assets whose valuation is highly uncertain both make it more difficult for taxpayers to have confidence that their reporting position ultimately will be acceptable to tax administrators when examined.

Sincerely,

Catherine Schultz
Vice President for Tax Policy
We wish to start our comments by expressing our appreciation for the Discussion Draft that was issued on June 6th. It represents a very good starting point for further discussion, in particular by trying to steer clear of limits that are inherent to the strict use of legal or accounting definitions. Our comments are the following.

1. The scope of the definition of “intangibles”

In the Discussion Draft (par. 5), intangibles are defined as “something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities”. The draft therewith approaches an intangible as an asset, to be used in commercial activities. First step is the identification of such intangibles in a specific case. Inevitably, although not limited by them, such identification is informed both by legal concepts and by accounting conventions. The party that can claim ownership and/or control is supposed to be entitled to an “intangible-related return” (IRR), which ultimately needs to be established at arm’s length.

It is our suggestion to broaden (or at least complement in relevant cases) the definition of intangibles, and lift the focus of arm’s length analysis from an “asset” basis to an “enterprise” basis. In the broadest sense, an intangible can be defined as an entitlement to current and/or future economic profits. Intangibles as defined in the Draft represent only part of the intangibles universe.

The asset-based approach (which could also be called a “deterministic” or bottom-up approach) may well fail to identify all intangible issues at stake in a specific case and thus, ignoring the elements not-identified, lead to an over-attribute of value to the intangibles identified or, as the case may be, to an understate of value of a transaction. The broader definition can be
seen, not necessarily as an alternative to the one proposed in the Discussion Draft, but as a complement.

An enterprise-based approach (some might prefer to call it a “holistic” or top-down approach), starting from the context of the total enterprise (sector or business line, business unit etc. whatever is relevant), would allow us to develop a view of the total value creation of the relevant enterprise, and of the contribution thereto of the individual parties (ultimately entities) involved. This insight in how value is being created, and in what the role of each of the relevant parties is in the joint value creation, can then serve as the input for an assessment of the relative bargaining positions of the parties involved. The bargaining analysis can be used, either to suggest to which extent parties involved can claim a part of the jointly generated economic profit, or to serve as a sanity check on conclusions reached using the asset-based approach.

The necessary view of the total process of value creation can be developed by way of a value chain analysis (VCA), rather than that it follows from a functional analysis as defined in the current Chapters I - III. The current approach of those Chapters concentrates on a “tested party” and the (intangible) assets that we can identify when looking at that tested party. In that sense, it perfectly matches the analysis of intangibles based on the asset-based definition of the Draft for Chapter VI. Problem is that it may very easily miss part of the intangibles universe. Is that a serious problem?

2. The missing transactions

It can reasonably be defended that the approach of the Discussion Draft, and the current one of Chapters I - III, can very adequately serve as effective guidance for the large majority of intercompany transactions. Point is however that a (relatively small) number of transactions is not covered, while precisely these transactions usually connect with considerable entitlements to future profits.
In this respect, the Draft creates an interesting opening in par. 105, where it introduces a rest category of intangibles, the “Section D.1.(vi) intangibles”. “An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or
transfer would be remunerated in dealings between independent parties, will be referred to as a Section D.1.(vi) intangible.” An open use of this category however is blocked by the basic definition of par. 5, which excludes intangible issues like goodwill, going concern value, group synergies etc. beforehand.

It is obvious that in asset transactions per se these last mentioned issues can not be listed. They can only be transferred in transactions that concern a (part of a) business. But does that mean that we should simply ignore them, as does also the overview of section C., because they are not visible in the asset-related approach chosen by the Draft? The narrow definition of intangibles inevitably leads to the absence of this category in the list of transactions in Section C. It is therefore imperative in our view to extend the list with a category “C.2.(iv), Transfers of intangibles in the context of the transfer of (part of) a business.” Once we do that, it becomes evident that the definition proposed in the Draft is too narrow, and that Chapter VI needs to go a step further in its scope. Without it, Chapter VI also falls short of its mission in respect of Chapter IX.

For all these reasons we propose to complement the asset-based approach, in case of reasonable doubt that all relevant intangible issues have been successfully tracked, by an enterprise-based approach. Creating the new category of intangibles (i.e., Section D.1.(vi) intangibles) may help in case of transfers, but it still leaves untouched and unidentified the entitlements to future profits that these intangible issues relate to outside the context of a transfer. This means that the current approach of the Draft will tend to ignore the value of intangible issues in the course of normal, ongoing business. These issues risk to remain undiscovered in cases where comparables exist that are deemed reliable, but they are likely to stay in the dark in cases where “reliable comparables do not exist” (Section D.3.(ii)).

For good order’s sake, we note that in the latter cases the application of the arm’s length principle does not, as is sometimes defended, imply that transactions for which comparables do not exist can be ignored and/or re-characterized to “what actually happens between unconnected parties”. Re-characterization is only at issue when the economic substance of a transaction (we would prefer to say “of commercial and financial relations”) differs from what was contractually defined.
3. The context of an arm’s length analysis

The Transfer Pricing Guidelines (TPG) elaborate on the application of the arm’s length principle (ALP), which is defined in par. 1 of article 9 of the OECD Model Tax Convention: “[Where] conditions are made or imposed between […] [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The guidance in the TPG leads directly (Chapters I – III) in the direction of transactions between the associated parties, with additional testing methods that are based on benchmarking entity results. Transactions are manifestations of a relationship indeed, but looking at individual transactions and comparing them with uncontrolled transactions without sufficient attention for the broader commercial and financial relations between the parties concerned can lead to flawed conclusions on what is arm’s length in respect of the transaction concerned. E.g., an incidental transaction will take place at conditions that can be very different from those at which the same transaction would take place as part of a long-term, cooperative relation between the parties.

Using benchmarks from parties with comparable functional profiles may lead to the identification of what is an average performance in that sector of activities. It gives orientation, but does not directly indicate what is an appropriate, i.e. arm’s length, outcome for the tested party in its specific circumstances, i.e., relations with associated parties. Invariably, these analyses rely on comparison with what independent parties do apply as transactional conditions, and what they do realize as results. Nevertheless, these approaches in practice allow companies to deal with their transfer pricing challenges in respect of most of their related-party transactions.

Still, there is the outlying transaction that we can not manage with those approaches. The understanding and explanation of what is arm’s length in those cases requires more. It is in these cases that it is for good reason that the ALP is defined as it is in article 9, MTC. It speaks of “commercial and financial relations” and what independent parties would agree on as conditions. This means that the arm’s length principle itself prescribes a contextual approach, such as the one we have suggested in our first comment.
Remains the question what to do in cases where no reliable comparables can be identified, whether that is because we can’t access the information of similar relations between independent parties or because there are no similar transactions identifiable. This is the field where economics can help by way of delivering the elements necessary to apply a bargaining analysis that informs how independent parties would behave in similar circumstances. The focus on the relationship and the analysis of value creation as mentioned above are essential element in these cases.

4. The intangible issues outside the proposed definition

Section A.4. of the Discussion Draft finishes with a series of illustrations of what falls within and what outside the definition chosen. One of the examples given is that of market-specific characteristics (A.4.(vii)). Such items “should be taken into account in a transfer pricing analysis through the required comparability analysis.” Reference is made in this respect to Chapter III. This is an interesting illustration indeed, but not necessarily of the adequacy of the current Chapter III.

In an economic sense a premium market allows the enterprise to realize profits above the average. The question that is to be answered in transfer pricing is not so much whether or not the market premium is an intangible in the sense of Section A.1. of Chapter VI, but who of the related parties involved in serving that market and realizing its potential is (or are) entitled to (a part of) that excess profit. It is highly doubtful that the traditional transfer pricing methods as applied according to Chapter III give the necessary guidance. When using the complementary definition, suggested in comment 1. here above, the issue enters into the field of Chapter VI. It is about entitlement to future profits and there is no reason to avoid this question in Chapter VI.

5. “The economic principles at issue”

Section B. is preceded by a declaration: “Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties.”

It then specifies that “Section B., below, identifies a concept of intangible related returns and suggests that such returns should follow the contributions to the value of the intangibles.”
It ends with the request to business “to comment as to whether the formulation contained in section B. successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks.”

We respectfully offer the following comment. In the first place we see the view of Working Party No. 6 as not incorrect but rather as incomplete. We refer to what is explained above in respect of the “assets-based” versus the “enterprise-based” approach. The conventional functions, assets and risks (FAR) analysis typically generates a partial insight in what happens inside a business (due to its specific focus on one of the parties involved, the tested party) and in what functions etc. need to be remunerated. Which intangibles (in the narrow definition of the Draft) play a role is not always correctly or fully identified, and what role the different related parties play in relation to each other does not become clear. As explained, this FAR analysis needs (in cases where the conventional approach fails to deliver satisfying or relevant answers) to be complemented by a value chain analysis (VCA). This use of the concept of value creation ultimately connects with the entitlement to future profits.

This means that the statement that “returns should follow the contributions to the value of the intangibles” is not necessarily incorrect, but may be taking the bend a bit sharp. As such, section B. does not successfully communicate the economic principles at issue. Where a FAR does, as a rule, not generate an insight in the value creation, it requires a leap of faith to directly link that to value of intangibles and of relative entitlements to (part of) future profits. This becomes even worse when using a narrow definition of intangibles. What we suggest is, in cases where this is necessary, to complement the traditional FAR by a VCA. Such value chain analysis generates an understanding of how value is being created inside the relevant business, and of the relative role of group entities involved in the joint value creation. The contribution of each of those entities to the joint value creation can serve as the input necessary to map relative bargaining positions and to carry out a bargaining analysis. That then is the basis for conclusions with regard to the relative entitlement to current and future profits, which allows us to conclude on the value of intangibles.
6. The examples

The examples represent welcome attempts to illustrate and clarify certain views. Inevitably however, they create an oversimplified context and therefore offer limited orientation. In practice, the challenge is to identify, map and analyze the whole relevant context of a specific case and then draw conclusions. In the more complex cases, the relevant conclusions can only be drawn while applying the analytical approach described and suggested above. For this reason, it may be helpful to refer to real-life cases from jurisprudence. In those cases, facts have to be established in a broad sense and economic factors recognized in the context thereof. It is interesting to compare e.g. the careful way facts are established in cases like DSG Retail (UK) or Glaxo Canada with the way the examples are built up. In each of a large number of real-life court cases it appears unavoidable to base final conclusions on some kind of a bargaining analysis. In each challenging, usually more complex case, the economic principles at issue that we have tried to capture in the previous point are essential for reaching relevant and sustainable conclusions.

Paris / Chicago, September 12, 2012

Pim Fris
Harlow Higinbotham
Emmanuel Llinares
1. Comments in relation to the OECD Discussion Draft - REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

Introductory Comment

The purpose of the OECD Guidelines is not to provide anti-avoidance legislation but to provide guidance to taxpayers and tax administrations on how to avoid double taxation.

Unfortunately, the general tone of the current draft, no doubt in a reflection of governments under domestic political pressure to increase tax yields from corporates, seems to emphasise the preconception of, certain, tax administrations that the OECD Guidelines are an avoidance tool used by multinationals to avoid (or evade) taxation which is their due.

That is not the purpose of the OECD Guidelines.

The purpose of the OECD Guidelines, at least from this individual’s perspective, is to provide a common framework, acceptable in its principles to both business and tax administrations, and within a multilateral global environment insofar as practical and possible, to provide a reasonable and informed manner to minimise the risk and incidence of double taxation.

I would go further and note that as much as tax administrations are concerned with less than single taxation, businesses are just as worried about more than single taxation. A business seeking to pay its taxes where they are due via reference to its functions performed, assets utilised and risks borne and particularly one with operations in Emerging Countries is far more likely to suffer more than single taxation due to a disparate individual tax authority than the contrary.

The OECD Guidelines should therefore continue to be based around what independent parties would do in unrelated transactions – i.e., it must reaffirm the arm’s length principle.

The risk of seeking to use the OECD Guidelines for purposes other than establishing a framework mechanism for applying the arm’s length principle is to render the consensus weakened for increased international trade which has been so important in helping deliver economic growth and reducing global poverty.

The current financial crisis will, eventually, pass - it is far from historically unique. If, however, its legacy is to retrench international trade via reducing opportunities for profitable gain by institutionalising double taxation its legacy will be much further reaching.

It should also be noted that, as it has always done, the OECD Guidelines do not and should not compensate for domestic anti-abuse legislation – such legislation is the prerogative of domestic legislatures and tools exist for authorities. These tools should be used for their relevant purpose and the OECD Guidelines should solely pertain to how to apply the arm’s length principle.

Specific comments – Part A

- Paragraph 15

As per the comments on Paragraph 16 below, the recognition that intangibles of material value may not be patented is often under recognised by tax administrations. To this end, I feel that it would be useful to further emphasise that the choice to or not to patent does not detract or in fact necessarily bear relation to the economic value of something that is “potentially patentable”. To this end, suggested additional wording of the nature below would be extremely welcome:

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[“In certain circumstances businesses may, and do, choose to protect information that is patentable by other means than the patent system. The fact that a process or invention is patentable, even if it is not patented, should and may influence its eventual value, irrespective of whether legal protection is actually sought.”]

- **Paragraph 16**

Frequently, know-how and trade secrets can be extremely material in terms of their value to businesses.

Notwithstanding this, and particularly when the recognition of this fact is unfavourable to them, tax administrations tend to concentrate only upon those intangibles with legal protection. In audit situations, in Europe at least, US patents are also considered to have less value.

In this context, this paragraph is extremely welcome as to have know-how and trade secrets so expressly discussed may help provide useful counter-weight to this, erroneous, impression.

However, I believe that it would be useful to increase the current emphasis on the importance of know-how and trade secrets and suggest additional emphasis could be added in relation to this. To this end, an additional sentence could be added to the end of Paragraph 16 as follows:

[“In certain industries the disclosure of information necessary for patent protection would allow competitors the ability to develop alternative solutions to the same issue using information necessarily disclosed in the patent application. In these cases, know-how and trade secrets may represent a significant proportion of a business’ intangibles, often far outweighing the elements of patentable knowledge actually patented.”]

- **Paragraph 20**

In this paragraph, the inclusion of the word “implied” in the first sentence feels likely to trigger significant debate.

Potential alternative proposed wording would be,

[“…whether written, oral or [as could be inferred by the actual practice of the parties concerned.”]

**Specific comments – Part B**

- **Paragraph 28**

For preference, and to avoid potential confusion on the point in tax audit situations, it might be useful to indicate that economic return expressly does not necessarily mean an accounting or normal return.

This could be achieved by the following change:

“..is the economic return [(as opposed to an accounting or normal return)] from business operations…”

It is, however, recognised that such a change might render this key paragraph less easy to read.

- **Paragraph 47**

Whilst the intention of this paragraph is clear, it would be of use were the following to be added at the end of the paragraph to counter the implicit negative connotation of this paragraph:
“create an entitlement to intangible related returns. [The bearing of such costs, with due regard to the relevant facts and circumstances, however, is likely to be strongly indicative of such an entitlement to intangible related returns.]”

- **Paragraph 54**

This is a core paragraph – however, its provisions currently appear to deviate, materially, from the arm’s length principle. Furthermore, at no point is reference made to what might or could be acceptable in theory or in practice between unrelated parties.

The current criteria in the second part of the paragraph, based on a series of consecutive subjective fail criteria, would appear to greatly increase the risk of double taxation. Other than a domestic single legal entity business, it is hard to imagine all of these tests being met to the conclusive satisfaction of two interested tax authorities if the amounts were sufficiently material.

In this context, a rebalancing of tonality between the interests of MNEs and tax administrations would be extremely useful. Reference to the arm’s length principle in this key paragraph would also be of high value. Potential proposed wording changes might be:

“54. In summary, with due regard to the relevant facts and circumstances and what unrelated parties might or would agree to in comparable conditions, for a member of an MNE group to be entitled to intangible related returns, it should:

- Perform or control functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis;
- Actually bear the risks and costs related to developing and enhancing the intangible; and,
- Actually bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

Where a party receives intangible related returns, but does not perform or control relevant functions, does not control other related functions performed by independent or associated enterprises, or does not bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks might be entitled to part or all of the intangible related returns, [if in an equivalent arm’s length situation they would have been so entitled].”

**Specific comments – Part D**

- **Paragraph 78**

Recognition that,

“for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate.”

is very welcome. Whilst the reference to 1.11 also adds detail, further reference to the fact that such a situation need be done for reasons wholly unrelated to tax would be welcome. If possible, strengthening this sentiment with wording of the nature below would be highly welcome,

[“Such a situation should not give rise to a presumption that such a structure is for tax reasons.”]
• **Paragraph 95**

The usefulness of this already important paragraph could be emphasised if the following wording were to be added after the first sentence:

“Many intangibles have a limited useful life. [Particularly, if a company were to fail to continue to invest in them, its intangibles might well quickly decline in economic value.]”

• **Paragraph 101**

The last sentence in this paragraph risks causing debate given its broad nature. Particularly, the last sentence, whilst welcome in its flexibility, risks that any factor not identified (even after reasonable analysis) could trigger *ex-post* discussions.

Suggested change could include:

“…average profits. Any [identified] factor [that could] materially [affect]…”

• **Paragraph 127**

It might be advantageous in this context to refer back to the comments made in paragraph 78 and furthermore to paragraph 1.11 to emphasise that, whilst it is clearly relevant to take into account the effect of the structure on the pricing applied, the use of a structure dissimilar to what might have been agreed between unrelated parties should not create a presumption that the intention is not for “wholly legitimate business reasons”.

The advantage of simplicity in intercompany transfer pricing arrangements, given that the primary aim of business is first and foremost to generate societally beneficial profits, is frequently underestimated by tax administrations in their consideration of how transfer pricing arrangements are determined.

• **Paragraph 145**

Whilst this is necessarily likely to be difficult to achieve, stronger support for the arm’s length nature of an appropriately structured valuation would be most welcome.

To this end, if any changes could be made in this paragraph to suitably reflect the importance of valuation techniques in terms of estimating an arm’s length outcome this would be of material value to business. Valuation techniques and not comparable uncontrolled transactions are what are used when performing this type of transaction between unrelated parties and the OECD Guidelines should seek to reflect this reality.

Potential wording might that would be extremely welcome could include:

“In situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified [or, despite potential reliability are not considered as most pertinent,] it may be [useful] to use valuation techniques [in order to most appropriately and accurately determine] an arm’s length price for intangibles transferred between associated enterprises. [It is relevant to note that in transactions of this nature between unrelated parties, valuation approaches based on estimated discounted value of future cash flows are currently the norm. Such approaches are, however, frequently cross-referenced to other analyses, such as via refer to comparable uncontrolled transactions as well as industry standards, in order to provide stronger overall comfort of the appropriate validity of a discounted cash flow form analysis.]
**Paragraph 147**

The tension inherent between the interests of MNEs and tax administrations in this context is clear.

Notwithstanding this, and whilst the value of recognition in the OECD Guidelines of current economic valuation techniques should not be underestimated, the paragraph remains very negative in relation to their use.

Given that businesses buy and sell assets, tangible and intangible, whole businesses and parts, on a day-to-day basis, recognition of the tools that they use to assess what prices they would be willing to pay in third party market situations is important and necessary in order to maintain the validity and usefulness of the OECD Guidelines and the arm’s length principle.

However, the potential asymmetry of information between parties should be recognised and MNEs could do more to recognise that this fact represents an obstacle to achieving an equitable and arm’s length outcome in discussion with an interested tax authority by seeking to increase transparency on such issues.

Specialised financial valuation resources within tax administrations would also be of great assistance in this context. In their absence, it is difficult to see, even in an entirely arm’s length situation, an MNE and a tax administration that are in dispute easily or equitably being able to achieve an economically relevant outcome.

Specific comments on wording are:

“…where reliable comparable uncontrolled transactions are not available…” – here the use of the word “available” seems to disadvantage MNEs.

During a tax audit situation, it could well be imagined that a sufficiently interested tax authority might be tempted to search with substantial vigour for transactions in order to seek to reject a valuation. Information in relation to these transactions might not be available to an MNE or might not be found even if available even when acting both in good faith and with due care and attention.

To help deal with this issue, a suggested alternative wording might be:

“…where reliable comparable uncontrolled transactions are not available [, were not identified or were not considered as reliable an arm’s length outcome as the application of a suitably prepared valuation]…”

Issues related to the use of hindsight, in that tax administrations must recognise that its use is not relevant in such a situation, should also be expressly taken into account to help redress balance.
Mr. Joseph Andrus  
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OECD - Centre for Tax Policy & Administration  
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France

Discussion Draft – Revision of the special considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions

Dear Mr. Andrus,
Dear Joe,

PwC welcomes the review of Chapter VI of the OECD Transfer Pricing Guidelines (“Intangibles chapter of the OECD TPG”) and wishes to thank the OECD’s Working Party No. 6 for the opportunity to provide our comments. In light of the current overall uncertainty and disputes on intangible-related issues, this Project will certainly go a long way in clarifying and providing guidance on the interpretation and application of the arm’s length principle when dealing with intangibles.

In this context, PwC respectfully provides this submission in response to the request for comments in the public Discussion Draft issued by the OECD on the above topic on 6 June 2012. We have correspondingly provided our thoughts and comments based on the key principles as discussed in the Discussion Draft. We have not focused on providing suggestions on the exact wording of the text since we understand that this is to be considered as an interim draft and once revised will be circulated once more for final comments.

General remarks

Firstly, we wish to point out that the Discussion Draft adopts a very broad definition of intangibles and does not attempt to define in detail all the potential classes or categories of intangibles. We understand the reasons for this and, subject to the comments below, we support this approach.

The Discussion Draft also enumerates many factors that may affect the value of intangibles (cf. Sections D3 and D4) and the comparability of intangibles (Section D.1(iii)). Whilst these are all clear and accurate, there is a risk that tax authorities come to expect transfer pricing analysis to address each and all of these in every case. The current draft makes some very helpful distinctions (for e.g. in paragraphs 9 and 10 that are echoed elsewhere) to make it clear that some intangibles may have little or no value. Through Sections D2 and D3, it becomes clear that intangibles adding little or no value...
will not require the very detailed level of analysis required if all the different factors are to be addressed.

However, the very broad definition of intangibles means more than ever before, that it is not a case of “all or nothing”. There will be a continuum, with greater detail required the more valuable and complex are the intangibles in question. It would be helpful if the Discussion Draft could reflect this point, particularly in Sections D3 and D4.

Section D3 deals with intangibles in use within a business while Section D4 deals with transfers such as licences and assignments (sales). Again, the very breadth of the Chapter and the wide range of issues with which it now deals such as the valuation principles involved, does suggest that the analysis required in almost any situation will be exhaustive. The distinction between Sections D3 and D4 is very helpful in this regard.

Within Section D4, the Discussion Draft often has to deal separately with licences and assignments (in paragraphs 141 and 142 this is explicit). We would suggest that Section D4 could usefully be split into two: one to deal with licences and one to deal with “transfers of full rights”. This would allow the Discussion Draft to be clearer about the extent to which, for example, the use of valuation techniques (in Section D4(iv)) apply to each type of transaction. For example, we believe that in evaluating a licence, it is clear that what matters most is the specific use to which the licensee will put the intangibles (and not, for example, the “highest and best” possible use). This applies equally to several of the general principles established earlier in the Discussion Draft such as the following:

- In evaluating the perspective of both sides (Paragraphs 81 and 82), there is clear evidence that between independent third parties it is the perspective of the licensee (transferee) that weighs more in the determination of the royalty rate.
- Similarly, valuation techniques will often assume a hypothetical purchaser and a hypothetical seller – when establishing a royalty for a licence this makes little sense and can be misleading, what matters is the use for which the licence is intended.
- When evaluating the factors covered in Section A.4(v) (Goodwill and going concern), these are most likely to be relevant when transferring full rights but less so, if at all, in the case of a licence where the royalty is ongoing (the licensee effectively pays as it earns the future profits implicit in the goodwill or going concern value) and, if expressed as a percentage (for e.g. of revenues) the licensor shares in the upside (and downside) potential of the business.

From a general perspective, we note that many concepts discussed in the Discussion Draft refer to certain principles under Chapter IX “Business restructurings” (cf. discussions on “options realistically available”, “control over risk”, “something of value”). Many transfers of intellectual property, particularly licensing arrangements, are a normal part of business operations, whereas the special levels of analysis often dictated in Chapter IX are more usually appropriate for major changes. This might be the case where a transfer of the full rights in some highly valuable intangibles takes place, but is much less likely to be appropriate in the case of a licence. Again, we would recommend that a greater distinction be drawn between licences and assignments (transfer of full rights). We would also suggest the OECD to consider additional wording in these situations to more
clearly indicate how the discussions in the new Chapter VI and existing Chapter IX should be seen in relation to each other.

We also note that the Discussion Draft is consistent with the principles under Chapter IX “Business restructurings” to positively reaffirm the principle that an analysis of returns related to intangibles should start from the legal arrangements (i.e. registration and contracts), which will subsequently need to be supported by the actual conduct and economic substance of the transaction or arrangement. Further, as discussed above, the Discussion Draft refers to certain Chapter IX concepts such as “options realistically available” when determining the arm’s length price for intangibles. In evaluating one’s “options realistically available”, the parties’ relative bargaining power also plays a part in such quantitative evaluation. In an intercompany context, the evaluation of one’s relative bargaining power or “options realistically available” may prove to be more difficult or subjective as compared to third party situations. In this context, while these concepts are certainly central to evaluating one’s entitlement to economic returns for intangibles, we hope and assume that this should not create an unreasonable burden of proof on taxpayers (for instance, to prove that they have considered all options available).

In particular, with respect to paragraphs 80 and 81, we would urge the OECD to provide additional clarity on the nature and extent to which the exercise of considering the “options realistically available” needs to be conducted. For instance, this guidance could include whether, for a transaction involving intangibles, a cost benefit analysis needs to be conducted for all the available options which could have been exercised before undertaking the transaction e.g. before obtaining rights in intangibles, whether the option of development of intangibles or exploration of other available intangible and their expected benefits needs to be analysed. Analyzing realistically available options would be useful only in the case of business restructurings and may not be of importance for other transactions. In case a detailed exercise is suggested to be undertaken for all the transactions, it would lead to a number of practical challenges and enhance compliance burden. It would be worthwhile for OECD to specify the types of transactions for which such an analysis would be more relevant than others e.g. business restructurings involving transfer of intangibles.

There are a number of places in the Discussion Draft and examples where reference is made to the ability of a tax administration to disregard or recharacterise the transactions as entered into by the taxpayer. We accept that there will be circumstances where this may be appropriate. However we would welcome a strong statement from the OECD to the effect that every effort should be made to follow the guidance in paragraph 1.64 of the OECD Guidelines and that the unique challenges that can sometimes be posed by intangibles should not be regarded as lowering the standard required for disregarding the structure adopted by taxpayer. This is particularly important as there will often be challenges in terms of finding appropriate comparable uncontrolled transactions due to the unique characteristics of intangibles and the acknowledged fact that multinationals may enter into a wider range of transactions than may be commonly encountered between independent parties. Great care should be taken to ensure that these challenges are not addressed by tax administrations recharacterising dealings to fit the available comparable data.

We note that Examples 20 to 22 allude to the example given in the second exceptional circumstance of Paragraph 1.65 (i.e. price adjustment clause due to uncertainty of valuation). These examples are useful in illustrating when and whether a price adjustment clause may be made but provide little
guidance on the standard required for these types of adjustments to be considered appropriate. The examples effectively assume that evidence is available to demonstrate that independent parties would not agree to the particular terms. Clarity around the standard of evidence required to support these adjustments is important as these examples, in particular, may be construed more broadly as being illustrative of the standard of ‘exceptional circumstances’ that Paragraph 1.65 is intended to address. In this regard they may have relevance beyond the Chapter on intangibles.

Section A: Identifying Intangibles

We note that the OECD has proposed a broad definition for intangibles as “something which is not a physical asset or a financial asset” and which does not refer to legal or accounting definitions. Rather, the assessment hinges on a number of characteristics including whether or not it is capable of being owned or controlled for use in commercial activities or transferred by a single enterprise. This approach is considered to be fair and sufficiently flexible to cover the spectrum of assets which can be considered “something of value”. We view that while such an approach does indeed avoid pre-established labels (e.g. “soft” vs. “hard” intangibles), the broad nature of such a definition requires that the OECD provides some guidance on what typically qualifies as an intangible. In this respect, the distinction between intangibles and mere market factors (i.e. comparability factors) as provided in Section A.4 is seen to be a key positive development for providing clarity on the current disputes on the definitional aspects of intangibles.

The Discussion Draft stresses that the corner-stone of transfer pricing analyses should be based on “the conditions that would be agreed upon between independent parties for a comparable transaction”. In this case, we view that the ultimate question to be answered is whether one is entitled to a (stake in) the return. From this perspective, while the definitional aspects may be less relevant, we believe it is still crucial for the OECD to provide some over-riding theme or expectations governing such assessment.

We however, wish to note that while paragraph 13 indicates that the OECD has chosen not to rely on the distinction between “routine” and “non-routine” intangibles, we assume that this does not constitute a rejection of the rationale for the distinction between “routine” and “non-routine” intangibles, since the Discussion Draft encourages the identification of “economically significant intangibles” as well as the manner in which intangibles “contribute to the creation of value” (paragraph 11). Otherwise, it would be difficult to practically assess what constitute “economically significant intangibles” or which intangibles create value. If this is not how the OECD interprets such paragraph, we would like the OECD to consider providing some guidance as to how one could objectively assess if an intangible indeed meets the definition of being “economically significant”?

We view that the OECD has made significant progress in identifying market conditions that are commonly under dispute, including group synergies, market specific characteristics (e.g. high purchasing power, size of market, proximity to markets, location savings). We agree that as these factors cannot be owned, controlled or transferred by a single enterprise, they should not and cannot be seen as intangibles. It is clear that not every single function or activity within an enterprise drives premium returns. It is critical for the identification of intangibles to be based on clear and reasonable principles which are aligned to commercial reality. If every single market or firm specific
characteristic should be considered an intangible for which premium returns should be attributed to, it would be “out-of-line” with how multinational enterprises operate and manage their businesses. In this respect, we strongly believe that having such illustrations of what can typically constitute an intangible or not, will definitely assist in preventing opportunistic readings of the proposed broad definition for intangibles.

Paragraph 22 stresses the fact that “when reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark [...] that reputational value should be taken into account”. If value here means “importance” we agree. If means “worth” in the sense of, for example, discounted present value of future income streams, we believe that this is only true in respect of a sale or assignment (“transfer of full rights”) as the royalty for a licence is paid over the years in which those income streams arise.

Further, we believe there is merit to clarify some of the existing illustrations provided in Section A.4. Specifically, with respect to Section A.4 (viii), paragraph 25 on Assembled workforce, we believe that it is necessary to clarify that the mere presence of an assembled (uniquely qualified or experienced) workforce does not create an intangible. While some of the contractual rights and other obligations may be considered as intangibles, we believe that the basic premise of a workforce is that it cannot be owned (employees are free to leave an enterprise) and cannot be considered as assets or intangibles. In this respect, we respectfully propose for the OECD to include language within Section A.4 paragraph 25 that the “assembled workforce should not be considered as an intangible for the purposes of Section A.1”.

In this context, the first bullet point under paragraph 26 provides that:

"Additionally, it should be recognised that:

- Contractual rights and obligations may be intangibles within the meaning of Section A.1. so that a long term contractual commitment to make available the services of a particular
group of uniquely qualified employees may constitute an intangible in a particular
circumstance....."

We would also like the OECD to clarify the circumstances under which a long term contract for provision of services of uniquely qualified employees would qualify as an intangible. It is presently unclear whether it is suggested that a long term contract to provide services of uniquely qualified people is an intangible, or whether the provision of services of uniquely qualified people represents a transfer of an intangible, as against delivery of a service. The latter appears to be a better view - the remuneration for services provided through uniquely qualified people ought to take into account the intangibles owned or controlled by the service provider as comparability factors. It is suggested that the OECD provides guidance in this area.

We agree with the Discussion Draft’s observations in paragraph 9 on the identification of intangibles and the value attributable to them. Indeed, the identification of intangibles is a fact-based exercise and is dependent on the individual enterprise’s specific circumstances, strategies and business model. We believe there is some merit for the OECD to provide some guidance on how to assess whether an intangible is unique or not. Here, the Discussion Draft refers to “non unique know-how” or situations where “other comparable service providers have comparable know-how”. In practice,
we also encounter many situations where non-proprietary or “open” technologies and in certain
circumstances, “open knowledge” (for e.g. in particular situations, client lists1) may also fall into such
situations where there is little or no economic value attributable to them. Conversely, would unique
intangibles mean that the intangible itself is not publicly available to comparable third parties? Or
does it constitute an asset which derives “economic rent”? We would therefore like to propose for
the OECD to consider expanding the discussion under paragraph 9 to include some of these items.

In accordance with paragraph 10 of the Discussion Draft, we find it important to continue to stress
that not all intangibles “give rise to premium returns in all circumstances” and that the factors listed
in paragraphs 84-102 mean that the value of any premium returns will erode over time. This is also
consistent with the points made in Section D.4(v). Accordingly, the Discussion Draft should continue
to make clear that few valuable intangibles will have indefinite value in perpetuity and it would be
helpful if this point could be made more explicitly.

Section B: Identification of Parties Entitled to Intangible Related Returns

“Intangible related returns”

In Section B and the introductory commentary box to Section B, the OECD has identified two
approaches for analysing the arm’s length return for intangibles. The first approach based on the
“intangible related returns” is currently worded within the text of the Discussion Draft and defined in
paragraph 28 to be:

the “economic return from business operations involving the use of that intangible after
deducting (i) the costs and expenses related to the relevant business operations; and (ii)
returns to business functions, assets other than the particular intangible in question, and
risks, taking into account appropriate comparability adjustments. In a particular
circumstance, intangible related returns with respect to an intangible may be positive,
negative or zero”.

The second (more general) approach is described in the introductory commentary box to Section B
and refers broadly to the arm’s length requirement for:

“the compensation of the various functions, assets and risks of the MNE members to be
consistent with the intangible value they create”.

Firstly, we note that as paragraph 28 is currently drafted, the proposed concept of the “intangible
related return” can certain be seen as a practical approach to the second (more general) approach to
identify whether any economic return to intangibles exists. The notion of “intangible related return”
under paragraph 28 assimilates such economic return to the concept of “residual” profits under the
current application of the arm’s length principle. This suggested approach can be considered to be a

1 It should be noted that we acknowledge that in certain situations, client lists can indeed be valuable, for which appropriate
compensation is paid in third party relationships. However, in our example above, we refer to client lists which are “public
knowledge” and therein, in our opinion, have little or no economic value attached to it.

2 An economic rent is a profit in excess of the market return to the factors of production (e.g. labour and capital). It is typically
considered the economic profit – for which represents the net results of an enterprise net of its operating costs i.e. revenues
minus costs (e.g. raw material costs) – wages (i.e. the market return to labour) – rent (i.e. the market return to equipment and
land) – interest (i.e. the market return to risk capital (including debt and equity)
so-called “indirect approach”. We, however, wish to point out that there exists more than one way of identifying the income attributable to an intangible. In some cases, this may be done in a more “direct” manner. For instance, this can also be achieved through the direct or incremental cash flow method or the identification of royalty income (for e.g. through the use of benchmarking studies to obtain royalty rates and applying these to revenue projects or other appropriate bases). In this case, the OECD could consider using the more general wording as a precursor or preamble to the concept of “intangible related return”. However, the OECD should make clear and explicitly mention that there may be more than one way of identifying such “intangible related returns”, where the choice of approach, like the choice of a transfer pricing method itself, should be based on a holistic consideration of relevant facts and circumstances. This would prevent the current language in paragraph 28 as being taken to represent the one and only way of applying the general concept alluded to in the second (more general) statement in the box.

Further, the mechanism introduced under the proposed notion of “intangible related returns” leaves the overall impression that the OECD would endorse one moving relatively quickly to a profit split mechanism. The concept where “intangible related returns may be positive, negative or zero” is a clear characteristic of the profit split methods (since under the Controllable Uncontrolled Price method – “CUP”, it is not possible for the licensor to have negative returns). We assume that the OECD does not have such an intention. As such, we view that it is important that the definition of what should constitute an economic return for intangibles should be without prejudice on the selection of the transfer pricing methods. In this regard, the expansion on the approaches upon which taxpayers can choose to derive such economic returns to intangibles as discussed above would certainly help to soften this impression.

We also note that this paragraph seems to be written with a highly centralised transfer pricing model in mind where the intangible owner is also the central principal / entrepreneur that is interposed in the invoice flow of the inter-company transactions. However, there are also many situations where the intangible owner is not a principal but simply an intangible owner (i.e. and the local subsidiary as licensee bears market risk). In this case, it is difficult to see how the value of an intangible can be negative as suggested in paragraph 28. In its current form, paragraph 28 gives the impression that the use of an intangible can create “badwill” for which the licensor should pay the licensee. We are of the opinion that this would not reflect third party behaviour as it is the independent judgement of a company whether or not it wants to enter into a licensing arrangement with an intangible owner.

“Control of risks (functions)”

In paragraphs 47 and 54, the Discussion Draft stresses on the concept of “control of risks (functions)” to determine the party entitled to the intangible related returns. In this respect, the conclusions based on paragraph 47, which states that “bearing costs related to the development, enhancement, maintenance and protection of intangible related returns does not, in and of itself, create an entitlement to intangible related returns” is seen to be a positive development. This concept stresses the importance of active control to be a key criterion for assessing entitlement to intangible related returns. The introduction of such a threshold has certainly provided additional clarification on intangible ownership, particularly in light of current disputes based on the current commonly –
known notion of “economic ownership”, which tends to weigh heavily in favour of the parties who have historically (passively) funded the intangible-related costs.

However, it should be noted that such emphasis on the “control of risks (functions)” notion as described in paragraphs 47 and 54 may contradict the basic principles under the Cost Sharing Arrangements or Cost Contribution Arrangements ("CSAs" or "CCAs"), where different parties make unique contributions (for e.g. capital, decision making, pre-existing intangibles etc.) for a share of the intangible related returns. In this respect, it is not uncommon that participants do not actively participate in or exercise “active control” over these activities. As such, the “control of risks (functions)” principles as currently drafted under paragraphs 47 and 54 fundamentally contradict and should correspondingly not be taken to over-ride the principles under the Chapter VIII of the OECD Transfer Pricing Guidelines on CCAs. If this is indeed the case, we respectfully request the OECD to explicitly make this reference within the new Chapter VI. If the OECD intends to indicate that all intangible owners must have active control over the intangible activity, the extreme result would be that the so-called passive participants can no longer participate in a CCA by virtue of the fact that they cannot control the intangible creation or development function, which would render Chapter VIII of the OECD Transfer Pricing Guidelines inoperable.

Further, the new Chapter VI on Intangibles will be closely linked to Chapter VIII on CCAs. There is currently much debate in the context of CCAs related to intangibles creation, particularly in relation to the evaluation or allocation of the CCA participants’ contributions and benefits received. This question is specifically relevant in the context of the transfer of intangibles which are part of an existing CCA. Similarly, we assume that additional guidance on the impact on CCAs will be dealt with in subsequent OECD projects.

Further to the CCA discussion above, we wish to point out that in certain situations (for e.g. in highly risky R&D projects, joint ventures or consortiums), it is also not uncommon for different parties to make contributions to intangible development programs. In these situations, one would reasonably expect that the parties would be appropriately remunerated based on their contributions / functions performed, assets owned and risks assumed. Accordingly, the party providing the financing can be expected to be remunerated adequately and appropriately for providing the funding (for e.g. by way of return on the cost of funding? Or even by way of royalty on sales, in situations where the R&D projects involve high risk of failure.). More critically, one would question how the party providing the “platform” technologies or intangibles would be appropriately remunerated? While such party has not actively controlled or managed the development of the new intangible, the base intangible is certainly instrumental in the development of the new intangible.

Indeed, while we agree that the general principle should be that profit allocation should be guided by the notion “control over risks (functions)”, we think it is critical for the OECD to be mindful of exceptions. This is, for instance, particularly relevant in the financial services sector (for e.g. insurance or private banking) where the operational functions and decision making (i.e. re-insurance activities or investing of funds) is typically outsourced to third parties (i.e. other banks or insurance companies). The same discussion is also reflected in the discussions surrounding the 2001 International Fiscal Association discussion surrounding the “Taxation of income from electronic commerce”. Here, the General Report provides that an enterprise’s “capital intensity [can be]
reflected in its investment in intangible property”3. Indeed, if one should overly emphasize the concept of “control” without recognising the profit attributable to bearing of risks, there is a high risk that the mere application of transfer pricing principles would necessarily result in the changing of the contractual arrangements of the parties. In this respect, we propose for the OECD to expand the current wording under paragraph 47 to provide for the possibility of such situations. A possible wording could be “Where a party bears costs or has made other valuable contributions to the development, enhancement, maintenance or protection of intangibles, but does not control the risks nor perform or control any critical functions related to the intangibles, it would nevertheless, be appropriate to allocate to that party an arm’s length anticipated return for its contribution”.

“Outsourcing”

When discussing the notion of “outsourcing”, the Discussion Draft makes reference to “important functions”. We would like to point out that such intangible related “important functions” may only be controlled by a limited number of personnel in an enterprise. As such, depending on the facts and circumstances, it is not unreasonable that the performance of such functions does not necessarily entail a large workforce. Indeed, it is not reasonable to expect a multinational enterprise to completely decentralize its management function. In this respect, the proposed assessment under paragraphs 47 and 54 appears to be far more onerous for intangibles than those accepted for distribution arrangements or intercompany services (for e.g. in management or headquarter-type services where the service buyer does not exercise control over the service provider). We wish to emphasize that an assessment of whether or not one has the right “substance” should be based on a qualitative and not a quantitative assessment and – provided that the OECD agrees to this view - would recommend that the OECD would include one explicit comment on this.

Paragraph 40 of the Discussion Draft also provides that the party entitled to intangible related returns will “physically perform, through its employees the important functions related to the development, enhancement, maintenance and protection of the intangibles”, which may include, amongst others, “design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible”.

Firstly, we would like to point out that there are situations when third parties (and multinational enterprises) outsource R&D and marketing activities to third party service providers in a comprehensive manner. For instance, we are aware of marketing agencies who provide “turn-key” solutions which could involve the design and planning of these intangible creation activities to the implementation of the ideas generated. As already indicated above, some enterprises outsource or enter into partnerships/consortium on certain risky or “blue-sky” research. Due to the uncertainty of such research, it is often difficult for groups to “control” these activities. In these situations, active control (in particular, operational control) would not be evident. Further, it is a known-fact that in contract R&D arrangements between unrelated parties, the resulting intangible ownership can vary a great extent – depending on factors including how risky the research activities are, the perceived value of the intangibles to be created, the business needs and requirements of the parties (for e.g.

3 International Fiscal Association (2001), General Report, page 43, section 5.1
ownership vs. licensing the resulting intangibles, apportionment of ownership of different intangibles to different owners). In this respect, it is unclear whether it may be appropriate that the intangible related returns should necessarily accrue to the party which is deemed to have “control” over such intangible creation / development activities. We strongly suggest the OECD to consider these complexities in intangible creation / development, in the process, broadening and/or softening the language surrounding the notions of “outsourcing” and “control”. Here, it would be important to stress that the analysis should involve the careful consideration of the various intangible ownership options available and, where appropriate, a profit allocation taking into account the relative contribution of the various parties may be warranted.

“Delegation of authorities”

It is often unclear how one should “prove” or assess the existence of such “control over risks (functions)”, particularly in the context of tax field audits. Here, we would like to request for the OECD to provide some guidance on the documentation that could provide an indication of how tax authorities may approach such an assessment. While groups do maintain documentation such as organisational charts, job descriptions, authority charters and/or key performance matrices as part of internal governance, how should one determine, for instance, at what level would a “delegation of authority” lead to the fact that one has “control over risk (functions)?” To what degree does an individual’s key performance matrix determine how much “control” one has? For instance, in the “global war for talent”, groups may engage a highly qualified professional for a position within what is called in common parlance a “routine function” or, in order to attract or retain talent, offer highly attractive compensation packages. In this respect, groups will likely establish such thresholds differently or may make exceptions to standard policies, often in reaction to specific market or operational drivers. Indeed, the level of education, skills or compensation should not be mixed up with the notion that risk is indeed controlled. Such an assessment would need to be balanced with the existence of, for e.g. a review procedure and the power to demand rectifications of rejects. In this case, we urge the OECD to provide a broad indication of how taxpayers and tax administrations alike could approach the issue of how to assess whether or not one has “control over risks (functions)”.

Another example that may underline the need for further guidance by the OECD is that “control over risks” should primarily be about operational business decisions and not be confused with internal governance systems that today typically exist in any multinational. For example, the delegation of authorities may require the approval of certain decisions with financial impact over a certain limit by a higher up management level (e.g. approval by group or division management vis-a-vis functional (for e.g. within R&D) decision takers). An analysis of who has “control over risks” should be based on the specific facts and circumstances and focus on identifying the person(s) responsible for the “economically significant functions, assets and/or risks”.

The “bright line test” and entitlement to intangible related returns

As provided in paragraph 51, we also note that the Discussion Draft retained the so-called “bright line test” for evaluating whether a party has borne costs and risks or performed functions taking reference from 3rd party situations:
“...In some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities...”

The Discussion Draft also makes reference to examples (2) – (5), which focus on analysing scenarios based on distributors with different functional profiles. These examples (in particular Examples 4 and 5) refer to assessing one’s marketing spend vis-à-vis independent third parties in comparable uncontrolled transactions. We assume that, in accordance with the “control over risks (functions)” principles in the Discussion Draft, that such a mechanical test will merely be one of the factors of assessment and should not be taken in isolation to assess the entitlement to economic return to intangibles. In this respect, it would be extremely helpful if the OECD could consider making such a reference within paragraph 51.

Further, we would like to raise our reservations on a number of points regarding the principles under the “bright line test”.

- The application of such “bright line test” could result in a situation that an entity performing local marketing, using concepts and materials that may be produced for global use, is entitled to a share of residual profit simply by executing a centrally controlled marketing strategy just due to the fact that they incur more marketing spend than what is considered to be “normal”. This clearly contradicts with the “control over risks (functions)” theme of the Discussion Draft and should be clarified. In our view, a local distributor must clearly perform functions and assume risks over and beyond the mere execution of a global marketing strategy in order to have a share in the intangibles related returns. The level of marketing spend should merely be an indicator and not the main consideration in such situations. In this respect, we view that it would be extremely helpful if the Discussion Draft stated very clearly that a distributor that undertakes normal sales and marketing activities in a local market is not necessarily entitled to intangibles related returns.

- It should be noted that the “bright line test” is heavily dependent on availability of comparable third party data. Bearing in mind the standard of comparability required, we question whether it is realistically possible to find data which can meet the standards imposed in the Discussion Draft. For instance, differences in accounting treatment of marketing costs, stage of the lifecycle of the product concerned, market-share, market penetration strategies all account for differences in the marketing spends of the taxpayer and comparables. This thus makes any meaningful application of the bright-line concept extremely difficult in practice.

- Such “bright line test” as exemplified in Example 5 assumes that excess marketing expenditure leads to an additional benefit for the global brand. Not all marketing costs necessarily result in the creation of marketing intangibles. In this respect, we view that it first has to be proven that local intangibles exist (for e.g. through consumer research data or group data) and whether or not the local marketer / distributor has contributed to the creation or development of such intangibles. We would welcome for the OECD to clarify this within the Discussion Draft.
• How would one reasonably assess whether one's marketing spend is “not significantly different” from those of independent third parties? Would the application of certain mechanical tests (e.g. marketing spend / turnover or similar indices) be sufficient? We urge the OECD to provide some practical guidance on this.

Finally, we note that in third party situations (for e.g. licensing or franchising agreements between third parties), it is also common third party behaviour for licensees/ franchisee to bear a certain level of marketing costs. Licensees can spend significantly on local advertising and still be required to pay significant royalties without ever gaining any intangible ownership (economic or otherwise) or an entitlement for such royalty payments to decline over time. In this regard, we view that it is unreasonable if one should claim that licensees, through such local marketing spend, have created increasing interest in the “economic ownership” of local intangibles. As discussed above, we believe that the assessment needs to firstly take into account whether or not local intangibles have been created and if so, whether the local marketer/ distributor / licensee contributed to the creation or development of such intangible. Unless the substance of the transaction deviates from its form, we believe that the legal ownership of the intangibles needs to be respected. In this respect, we think it would be useful if the Discussion Draft could include an example which guides the readers through an assessment of whether or not the legal ownership of intangibles should be respected and to examine the typical relationships that licensors and licensees enter into in respect of such intangibles.

Section C: Transactions involving the use or transfer of intangibles

Firstly, we view that the direct link between Sections C and D (i.e. characterisation of transactions with choice of transfer pricing methodology) are very helpful to differentiate the different considerations associated with each type of transaction. Specifically, in respect of Section C 2(ii) on “Transfers of combinations of intangibles”, the additional guidance provided by the OECD on how to assess combinations of intangibles is very welcomed. The same can be said for Section C 2(iii) on “Transfers of intangibles in combination with other business transactions”.

Under Section C 2(i) on “Transfers of intangibles or rights in intangibles”, the OECD has provided some preliminary remarks on transactions involving the “right to use” intangibles (for e.g. through a license). Further remarks regarding the choice of transfer pricing methodology and comparability are provided further in Section D of the Discussion Draft and we provide our specific comments below. Here, the OECD seems to give the general impression that the CUP that is currently commonly used is not preferred. However, we wish to note that the CUP can nevertheless be used as a valid starting point for analysing or evaluating (setting vs. testing) the arm’s length nature of such licensing transactions. We also note that the current OECD Transfer Pricing Guidelines continue to advocate the use of the CUP - should “the CUP and another transfer pricing method can be applied in an equally reliable manner; the CUP method is to be preferred”⁴. Indeed, practically speaking, where broad CUPs are available, taxpayers usually prefer the CUP method over other methods since it is the most direct method or because the analysis under the other methods (for e.g. the profit split methods) may involve more subjectivity and assumptions than those under the CUP method.

⁴ OECD Transfer Pricing Guidelines, paragraph 2.3.
Naturally, one should be able to provide valid assumptions and arguments to support how one positions within the arm’s length range (for e.g. through analysis of one’s options realistically available or relative bargaining power or through corroborative studies).

We also wish to point out that many multinational enterprises license centrally-owned intangibles relating to technology and/or trademarks, at a single rate across a broad spectrum of products. This is common as the enterprise cannot practically identify and value each individual piece of intellectual property; hence the enterprise takes a high-level approach and licenses all of its intangibles for a fixed royalty to be applied across all of the licensee’s sales. On an aggregate basis the licencsee makes reasonable profits across the broad spectrum of products. We would like to see commentary from the OECD acknowledging that this is often the only practical approach, and tax authorities should recognize such, without expecting individual analysis on a product by product basis.

We also note that the OECD has provided examples in paragraphs 73 and 74, which respectively describes a franchise arrangement and integrated software services. This is particularly relevant in the services industry where there are not necessarily “products” the intangibles concept can be tied to (particularly in the intellectual / professional or creative industries). While it is certainly not our intention to assert that the highly qualified workforce should be seen as an intangible, due to the unique nature of such industries, some of the activities performed should not be seen to be mere “routine services”. In this respect, the clarification in paragraph 75 that “a cost-plus approach will not be appropriate for all service transactions” is very welcome. For instance, in industries such as the logistics and consulting services industry, factors such as a group’s international footprint (that in certain instances is a prerequisite to provide a particular service), best practices and/or organisational structures are often crucial to the group’s ability to realise premium returns. Indeed, on a stand-alone basis, such “factors” may not pass the threshold to be considered as an intangible. However, such factors often interact with or enhance a group’s intangibles (for e.g. brand name) to account for a group’s differentiating factor. In this respect, there may be arguments to consider a franchise arrangement to approach such situations. In the same line of thought, we propose for the OECD to consider extending the discussion beyond such clear examples by including a sentence in this paragraph that franchising arrangements may in principle be appropriate in cases where a multinational enterprise (i.e. franchisor) makes available to the group (i.e. franchisees) a range of intangibles and services that are inextricably linked together (e.g. through a business concept, brand, technology or access to an international network) and /or providing additional guidance on the factors and qualities that should typically exist for a franchise fee concept.

Section D: Determining Arm’s Length Conditions in Cases Involving Intangibles

Comparability considerations

Section D.1 of the Discussion Draft considers the comparability requirements in intangible-related transactions and refers to a non-exhaustive list of factors which could be considered in a comparability assessment. With the introduction of the concept of market conditions and their impact on the comparability assessment, a key question is how to quantify or reflect such “market conditions” into the pricing of intangibles? While this analysis can be seen to be in accordance with the principles under Chapter III “Comparability” of the OECD Transfer Pricing Guidelines, it appears
that the bar for comparability has been raised, while rather little practical guidance has been given as to how to perform intangible specific adjustments.

As indicated before, the Discussion Draft has gone into a good amount of detail on how to distinguish between market conditions and intangibles. It is, however, currently unclear how these market factors will affect the choice of the transfer pricing methodology or pricing model. While the Discussion Draft has repeatedly indicated that these factors are meant to merely increase the level of comparability required as part of the comparability assessment, such comparability assessment will have a direct impact on the choice of the transfer pricing methodology. For instance, we believe that it will be virtually inoperable for multinationals if the presence of such mere market conditions will necessarily result in a discussion on the use of the profit split method. We note that a number of examples were provided as part of the new Chapter III. In this respect, we urge the OECD to consider providing additional guidance or a number of examples of how such comparability adjustments can practically be approached. As will be detailed with specific references below, the consideration of some or all of the above factors would unnecessarily make the exercise of comparability more complex and reduce the acceptability of an external CUP for benchmarking transactions involving intangibles.

Paragraphs 90 and 101 mention the intangibles’ potential for creating future benefits is mentioned as an important comparability criterion. From a practical perspective, direct information on profits or losses resulting from the use of intangibles is rarely available to complement the information on transactional terms of arrangements between unrelated parties involving the use of intangibles. Consequently, broad comparability between intangibles in relation to the "expectation of future benefit" can usually only be taken into account by consideration of other comparability factors that can also be reasonably expected to impact the "expectation of future benefit" (e.g. exclusivity, stage of development, market characteristics, competition, industry, etc.). Reliability of the results that are achieved under the method can also be increased through other means referenced in the OECD Guidelines (e.g. use of statistical means to limit the number of observations used to calculate an arm’s length range). It would be helpful if the OECD could add language that clarifies that a failure to directly establish comparability between intangibles in relation to "expectation of future benefit" should not preclude the use of the method as long as other comparability factors listed in paragraphs 92 through 100 - which have a "bearing on the expectation of future benefits", are adequately considered and accounted for in the analysis. Otherwise such an exercise may become highly subjective and difficult to apply in practice.

With regards to comparability adjustments in an application of the CUP method, paragraph 103 states that "...in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, there may be reason to believe that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not comparable to support a valid transfer pricing analysis." It is our view that the reliability of comparability adjustments should not be assessed based on the magnitude of an adjustment without consideration of the underlying rationale for that adjustment especially when other significant comparability factors are adequately considered and accounted for. Furthermore, the guidance contained in this paragraph has the potential to be applied by tax authorities to apply a formulaic criterion in rejecting an otherwise reliable application of the CUP method. This would be inconsistent with the established principles for the selection of a transfer pricing method which
should be based on a rigorous consideration of relevant facts and circumstances and availability of market-based data.

The Discussion Draft addresses the issue of useful life for intangibles under D.1(iii)(d) paragraphs 95 – 96 and D.4(v)(d) paragraphs 164 – 167 to conclude that such lives for most intangibles are ultimate finite. We suggest adding a sentence at the end of paragraph 96 as follows: "Even in such circumstances where an intangible is used as a base of ongoing research and development, however, the useful life of that intangible is not presumed to be indefinite.” Including such a comment would align this discussion with the statement contained in the last sentence of paragraph 166 which states, "It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that nonroutine returns are attributable to such intangibles in perpetuity.”

Paragraph 124 provides that ".........In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors......". Although it is very important to undertake comparability adjustments for differences between comparables, guidance would be required from OECD as to how to undertake adjustments for differences in the stated factors. A few illustrations/examples in this regard would be extremely helpful. Practically, the kind of data required to conceptualise and actually adjust for these factors is rarely available. Further, "locational advantage” may not be a relevant factor for making comparability adjustments in cases where the comparable cases are also from the same country/ economically similar geographies. It may be more relevant in case of regional searches undertaken wherein the comparables may be from economically different geographies. Even in such cases, it may be practically very difficult to quantify such differences.

**Choice of transfer pricing methodology**

We also note that paragraph 116 discourages the use of “rules of thumb”. We agree with the point that rules of thumb are no substitute for proper analysis. However, we also consider that application of a rule of thumb can be a useful part of a more rigorous analysis – for example when testing the reasonableness (or otherwise) of a transfer pricing method. These can be helpful both to taxpayers and, in our experience, to tax authorities in cases where an intangible is valuable but not enormously so – i.e. in cases where it would not be appropriate to pursue each and every point in the current Discussion Draft and to make an onerous exercise out of a problem that does not require it. We would recommend that the conclusion of this paragraph be amended to state that it is the sole use of a rule of thumb that is to be discouraged.

A consistent theme throughout the Discussion Draft is the apparent viewpoint that the owner of intangible(s) is not necessarily entitled to all of the residual profit in the controlled group. For example, paragraph 108 cautions against "adopting a transfer pricing methodology that too readily assumes that all the residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns.” We believe that this viewpoint warrants further development. In particular, is it the OECD’s view that all members of the group participate in the residual income generated by the group’s exploitation of intangibles or is it simply a cautionary statement not to assign value resulting from synergies or other types of non-
intangible factors to the intangible(s)? Several examples comparing such situations would be very useful to refine the OECD’s viewpoint on this matter.

We also believe that the current language in the Discussion Draft regarding this theme or viewpoint probably unnecessarily undermines the credibility of the Transactional Net Margin Method ("TNMM") when used to establish routine returns and, in turn, isolate the value attributable to intangibles. While we understand that the OECD does not necessarily have such an intention, the Discussion Draft appears to have a somewhat general negative tone with regards to the use of traditional transactional methods and the TNMM. If this is indeed the intention, we propose for the OECD to strengthen the language on the validity of the use of traditional transactional methods and the TNMM to avoid giving the general impression that complex methods such as the profit split method and valuation techniques will in future become the “default method” for intangibles.

Specifically, paragraph 134 provides that any of the five OECD transfer pricing methods might constitute the most appropriate transfer pricing method to the circumstances of the case, whereas valuation techniques can be useful tools in some circumstances. The profit split method may have advantages where one or both parties to the transaction make unique and valuable contributions to the transaction (see paragraph 108, 128, 141). However, this method can hardly be used where a unique intangible is transferred between two taxpayers. This is also made clear by the OECD in the context of the application of profit split methods in connection with transfers of full rights in intangibles (paragraph 142) when making reference to projected revenues and expenses (i.e. to valuation techniques). In the case of a transfer, valuation tools have merits (are superior). Against this background, the wording “can be useful tools in some circumstances” appear to be too weak. When it comes to pricing intangibles in practice, the profit split method and valuation techniques are both valid alternatives to the CUP method as appropriate. The OECD should therefore consider amending paragraph 134 correspondingly.

On this note, under a contribution analysis, the division of combined profits is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions. Where the division of profits under a transactional profit split method is generally achieved using one or more allocation keys, the differences between the profit split method and formulary apportionment become somewhat obscured. Hence, doubt may arise whether the simple distribution of profits among the parties involved based on their contribution to the coalition given by the multinational enterprise, is in line with the arm’s length principle, because according to this principle, companies are expected to look first and foremost at maximizing their own profit rather than maximizing that of the group as a whole. Here the question changes into how to allocate the profits resulting from the sale of a product or service between the parties to the transaction, taking account of both their unique and valuable contributions and all their alternatives for action.

Nevertheless, should the contribution profit split be assessed to be the most appropriate method, we would like to point out that if such method has been withheld to be the most appropriate method, it should be acknowledged that while the process is seen to be subjective, the best assessor to the group’s value chain and relative contributions is the taxpayer itself. We would strongly suggest for the OECD to include such an acknowledgement, which will no doubt help to set the tone for discussions with tax authorities.
In the application of the residual profit split method, one of the key controversial issues is how to split the residual. While the use of the cost base may not be the most ideal matrix to measure contributions, costs are frequently used to assess the relative contribution of intangibles from a practical perspective or as a corroboration. In this respect, it would be helpful if the Discussion Draft addressed some of the issues when applying relative cost, such as – should costs incurred in different jurisdictions, different time periods, and on different functions such as R&D or marketing, be valued equally? This could provide a good compromise to balance the practical considerations for using the cost base as an allocation key while providing the opportunity for taxpayers to perform adjustments to improve the use of such a methodology.

In a typical arm’s length licensing situation, assuming that no unexceptional circumstances take place, the general expectation is that the licensee is normally required to pay the license fee regardless of whether or not it is able to earn sufficient profit to cover that fee. We are also of the opinion that the OECD should clarify that the mere fact that a licensee does not achieve at least routine profits even when employing a particular licensed intangible, does not imply that any payments for the use of such intangible to the licensor should automatically be rejected. In this case, an implicit push towards a profit split method in a licensing transaction could have a significant impact on the (contractual) risk allocation between the parties. We have encountered situations where the licensor may end up having to make “market support” payments when the licensee realizes a loss, which may or may not be consistent with arm’s length behaviour. In this respect, the use of the traditional methods (for e.g. the CUP) may better reflect arm’s length behaviour.

**Valuation considerations**

We view that it may not be realistic for the OECD to provide a comprehensive discussion on the individual valuation techniques that can or should be used in analysing returns to intangibles. The current Discussion Draft, in our view, gives a good balance between providing sufficient starting point regarding the application of valuation techniques while maintaining flexibility on the choice of valuation approaches. Indeed, due to the unique nature of intangibles, one can only anticipate that the analysis and pricing of individual intangibles will be so case-specific that it will be virtually impossible to anticipate methods that can fit every single case.

Paragraph 110 concludes categorically that "valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes (emphasis added)." We believe this statement contradicts the acceptance of financial valuation techniques described in the prior paragraph 109 which are often used for accounting purposes as well. In addition, it appears to be overly broad in that it disqualifies the specific values derived for all intangibles included in such valuation analyses. We believe the conclusion in paragraph 110 could be interpreted to imply that there cannot be an overlap in the value of an intangible derived for accounting purposes and the value derived for transfer pricing purposes.

Similarly, in many instances, due to certain operational constraints, many taxpayers start with valuation analyses that have already been performed (e.g. due to mergers & acquisition activities) or critical assumptions used for other business purposes as the starting point for pricing their intangibles. We wish to point out that imposing a requirement to necessarily provide separate valuation analyses for tax or transfer pricing purposes may impose unrealistic or additional burden
on taxpayers. We suggest that there is enough cautionary language included in paragraph 110 that the last sentence can be eliminated without diluting the meaning of the guidance provided in that paragraph.

It is our view that the language in the Discussion Draft seems to be overly dismissive of transfer pricing methods based on intangible development cost (see paragraphs 112 and 113). We doubt whether the viewpoint set out in the Discussion Draft necessarily reflects proper valuation techniques. For example, the replacement cost approach can be used in situations involving significant first mover advantages by coupling the replacement cost approach with values derived from a lag model to capture the value of the first mover advantage. Our point is that the language used in the Discussion Draft can be easily misconstrued to mean that the cost approach can never be used. Similarly, it is not uncommon in certain industries that have long research cycles, for example in the pharmaceutical industry, to use cost-based approaches to approximate the value of very early stage projects that are simply too uncertain to develop reliable cash flow projections but for which, for various reasons, it is believed that the transferor should be rewarded for having undertaken the initial investments. We encourage the OECD to relax the language in the Discussion Draft on the use of cost-based valuation approaches.

We believe that the arguments set out in paragraph 143 and 144 are potentially in conflict with other statements regarding the use of cash flow projections such as that described in paragraph 148. It is quite common to use cash flow valuation techniques as the basis to value early stage or "partially developed intangibles." Specifically, the analyst uses projections that reflect the current stage of development, incorporates estimates of future investment necessary to develop the intangible and considers the potential benefit to be derived from exploitation of the intangible. These projections are discounted back to present value using an appropriate discount rate which reflects the opportunity cost to the party undertaking the future investment. In this manner, the valuation is essentially a form of a profit split between the transferor and transferee by putting a "price" on the opportunity cost that the transferee will require in order to be induced to make future investments. Done properly, the technique described in paragraphs 143 and 144 will yield solutions very similar to solutions developed in the technique described in 148. Moreover, both techniques will necessitate reliance on similar assumptions and the same types of forecasts. As such, we fear that the language currently within paragraphs 143-144 of the Discussion could potentially undermine the credibility of commonly used valuation techniques.

Further, paragraph 148 makes it clear that “[t]he discount rates used in calculating the present values of the stream of projected cash flows reflects both the time value of money and the risk that future cash flows may not materialize”. However, it should be noted that the discount rates moreover represent the alternative investment forming the basis of the valuation/comparison (third task of the discount rate, see also comment to paragraph 169 below).

Paragraph 149 also stresses that small changes in the discount rate or in the growth rate can have a profound effect of the value. We would appreciate an additional note, that this is rather true for a valuation based on perpetuity.

It is our view that the suggestion in paragraph 151 that taxpayers include "sensitivity" analyses with respect to assumptions and valuation parameters in their documentation packages as "good practice"
risks to be overly burdensome. We believe that such a requirement may trigger disputes between taxpayers and tax authorities with respect to the robustness of the valuation relied upon by the taxpayer. It is our opinion that the documentation package developed by a taxpayer should be sufficiently robust to support the assumptions and valuation parameters relied upon by the taxpayer.

The Discussion Paper provides a brief discussion on assumptions involving tax rates in paragraphs 168, 169 and 170. The discussion draft provides that prices for transfer pricing purposes under a discounted cash flow analysis must typically be determined on a pre-tax basis. However, in third party scenarios, tax cost in a transaction can play a pivotal role for decision making. Especially in cases involving transfer of intangible assets wherein the valuation is undertaken under a discounted cash flow basis, the buyer would surely be interested in the net cash/profit (after paying off taxes) that would be available to it from the use of the intangibles. Therefore, the statement does provide a guidance which may not be applicable in third party scenario and therefore, may not be in compliance with the arm’s length principle. It is also pertinent to note that in the Example No. 19 involving the use of an application of the discounted cash flow approach, the analysis is done on post tax basis from the perspectives of both the transferor and transferee. Accordingly, it is advisable that OECD may clarify its position and align Para 169 and Example 19.

This mismatch is also exemplified through the issue on tax adjustments. Firstly, as provided in paragraph 169, it is certainly true that in discounted cash flow valuations, the financial projections and the discount rate are based on a post-tax basis. However, the reference that post-tax financials results in post-tax prices which need to be amended to prices on a pre-tax basis cannot be seen to be correct. A discounted cash flow valuation is based on a comparison, i.e. the comparison of the cash flows of the valuation object and the cash flows of an alternative investment (typically a financial asset) represented by the discount rate. If so, this comparison must be made on a post-tax basis in order to adjust for possible differences in the taxation of the valuation object and the alternative investment. However, after this comparison the resulting number is neutral, i.e. not an after tax number (this can easily be seen where the same tax rate applies to both the nominator, i.e. the cash flows of the valuation object, and the denominator, i.e. the discount rate; here, the tax rate is cancelled out when calculating the present value) and therefore does not need to be adjusted to a pre-tax basis. In addition, once the value has been established on an after tax basis, related parties transfer the asset in a taxable transaction and/or in a transaction that generates tax deductions for the transferee. This impact of taxation needs to be inserted into the valuation or layered on top of the value derived. The after tax cash flows to the transferee could be higher than those of the transferor under their realistic alternative of retaining the asset. One solution is to value the asset two ways and then decide on how the tax arbitrage should be shared.

We also wish to highlight that paragraph 170 assumes the use of the relevant tax rate of the respective country for the valuation. In multinational enterprises, it is common practice to use an average group tax rate for investment decisions. We like to suggest including this as an appropriate alternative approach.

In relation to paragraph 180 which discusses alternative forms of payments, we agree that a payment form contingent on future sales will involve greater risk (in terms of volatility) to the transferor than a payment calling for a either a lump-sum payment or a series of fixed instalment payments. However, the same holds true from the perspective of the transferee - i.e. a payment form contingent
on future sales will involve greater risk (in terms of volatility of payments) than alternative non-contingent payments since actual sales could be higher or lower than anticipated. We suggest that the last sentence in this paragraph be revised in a manner such that it reads "...the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased uncertainty that the total payment would be different from the lump-sum value because future sales may be higher or lower than anticipated in the valuation analysis, as well as..." so as to provide more general and economically accurate guidance. We would also therefore like to suggest that a license rate calculated in converting a total value of the intangible should be calculated in a way that both – the cash flow of the intangible and the respective license – lead to the same net present value.

**Arm's length pricing...when valuation is highly uncertain**

Paragraphs 171-178 deal with particularly difficult valuation questions and ask what independent third parties would do in such circumstances. While this is true in extreme cases, we believe that it is important to note two things.

First, the use of the various valuation principles set out in paragraphs 145-170 will often mitigate the uncertainty inherent in forecasting cash-flows. For example, the use of an appropriate discount rate that distinguishes between the different uncertainties in relation to revenues and costs will take account of the difficulty of estimating financial figures into the future. The fact that uncertainty exists (and grows significantly the further forward the forecast looks) is a normal feature of business reality and should not be a reason for rejecting a more straightforward approach and insisting on a more extreme remedy such as a price adjustment clause (cf. paragraph 177).

Secondly, in transactions between independent parties, the transfer of intangibles is often expressly about transferring (or sharing) the risks arising from an uncertain future. As an example, Company A may not wish to bear that risk and may sell the intangible that gives rise to it to Company B which assumes the risk going forward. If Company A and Company B are part of the same group, it does not follow that suddenly, Company A (or its tax authority) should have a claim on the profits of Company B forever.

This is related to the principle that intangibles do not have indefinite lives and that valuations should not assume that they do. This is recognized explicitly in the Discussion Draft in paragraphs 95-96 and it would be useful in preventing confusion if it were reflected here too.

**Examples**

We note that the OECD has provided over 20 examples to illustrate some of the principles discussed in the Discussion Draft, which have been very helpful to lay the foundations for the interpretation and application of the arm’s length principle in the context of intangibles. The fact pattern for each example is clearly differentiated and the key messages resulting from each example is well defined. However, it is unlikely that many practical real life cases will fall into such clearly delineated boundaries. As such, we expect that in addition to the examples, the principles for which to assess entitlement to intangible related returns need to be sufficiently clear within the text of the new
Chapter VI to avoid any long-drawn disputes between taxpayers and tax authorities. Below, we provide our comments on the specific examples provided in the Discussion Draft.

**Example 2**

This example provides a fairly clear mismatch between the characterization of the entities and how they bear the recall costs. It would be useful that when the Discussion Draft outlines the most appropriate adjustment that it states that the costs should be borne consistently with how arm’s length parties would bear them, which in this case may be by way of an allocation from Company S to Primero, or some sharing of those costs. Also, we would recommend not presenting the alternative view (where the characterization and pricing is restated for the early years) as it essentially represents a retroactive adjustment that relies on the use of hindsight, and would be impractical to implement.

**Example 3**

This example shows that a distributor that bears no risk in its marketing and advertising (i.e. it’s all reimbursed) and does nothing entrepreneurial, is entitled to a basic distribution return and a return on its sales and marketing functions (i.e. costs plus). This is not a very common scenario, yet this is the only example given where the distributor should not be looking to share in the intangible return. We would not want to give readers the impression that in order to be satisfied with a routine return, all advertising and marketing costs must be fully reimbursed.

**Example 4**

This example reflects the responsibilities often allocated to many MNE’s international subsidiaries. Hence it is critical that this example be very clear. Unfortunately it may not be all it appears to be, that S should get what arm’s length parties doing the same thing get, which is not defined. In this example, the distribution subsidiaries exercise some autonomy in the local market and do not expect reimbursements for their marketing activities. It would be helpful to suggest in this example that a sample of comparable companies established using the TNMM, which have comparable levels of SG&A, can be used to benchmark this company’s results without it expecting a share of intangible profits.

Also, it is not unusual for a start-up company to expect slim margins compared with the comparable companies established in a TNMM analysis, as those comparable companies are mature public companies in most cases. Hence, Company S’s slim margins in the early years should not entitle it to intangible returns.

It is not clear why paragraph 196 should suggest that a portion of the intangible related returns should pass to Company S unless what is meant is that the baseline routine return of comparable companies includes a portion of the intangible return. The conclusion is that no separate or additional compensation is required to Company S but it is unclear how much they have already received and what companies were used as comparables. It would be helpful for the OECD to indicate that the baseline routine return established by comparable companies through a TNMM analysis can be considered sufficient with no sharing of the intangible return for this level of activity.
Example 5

Paragraph 198 makes the assumption that several uncontrolled companies engaged in similar marketing and distribution functions under similar long-term marketing and distribution agreements can be identified. This is highly unlikely and it would be better if the examples did not make such assumptions.

Further the language used in paragraphs 199 and paragraphs 200 could be misconstrued to suggest that a transfer pricing adjustment will be appropriate merely because Company S has borne marketing expenses beyond what independent enterprises incur. In particular, paragraph 200 states it is “evident” from this excess expenditure that Company S has acted to “increase the value of the intangibles”. We note that it is equally possible that the expenditure has been unsuccessful and as a result has not increased the value of the intangible. Such a possibility should be recognised as it will have a significant bearing on whether an adjustment is appropriate and the methodology adopted.

Paragraph 200 provides three examples of how adjustments might be made in a situation where the marketer distributor has incurred substantially more expenditure than comparable marketer distributors. However, there are huge differences in the three alternatives presented. The first, whereby the prices are adjusted to provide profits similar to those of comparable marketers and distributors is the most realistic approach. The third alternative, which calls for a reimbursement of the excess marketing expenditure, is also a realistic alternative basically equivalent to the first, where the resale margin is increased to cover such costs. It should be noted that this third alternative could result in the (re)characterisation of the distributor from a full risk marketing distributor to virtually a service provider. This is in contradiction to the basic fact pattern of the distributor performing key functions surrounding the marketing strategy. However, the second alternative, whereby the residual profit split is applied, seems more problematic since no guidance is given on how to treat marketing spending relative to pre-existing intangibles owned by Primair and raises the question of whether it is fair that simply spending on marketing entitles one to a share of intangible profits.

Again, we note that paragraph 199 states that Company S has the “opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. The first and third alternative likely have a significantly different impact than the second (residual profit split) alternative in circumstances where the expenditure has been unsuccessful in increasing the value of the intangible.

A further inconsistency within this example stems from comparability considerations. The premise of the example stems from having a distributor which has incurred marketing expenses “beyond what independent enterprises in comparable transactions with similar rights incur”. This poses a dilemma in the benchmarking analysis – how should one proceed to identify comparables? Based on the comparability standards advocated in the Discussion Draft, should one scrutinise comparables to obtain those which have closer comparability with respect to marketing expenditure (for e.g. by examining the intensity of marketing expenditure)? In which case, the example would be rendered unnecessary. Or is it acceptable to merely identify broad comparables, thus arriving at the crux of the large differentials in marketing expenditure? Naturally, we appreciate that such considerations have to be assessed on a case-by-case basis and would like to request for the OECD to be mindful of these nuances.
It would be appreciated if the OECD could be clearer on the circumstances in which investment in marketing should give rise to reimbursement of cost or entitlement to share in residual intangible profits.

**Example 6**

We think it is helpful that Paragraph 205 equates reimbursement of marketing expenditures with a price reduction thus increasing the resale margin. Not all tax authorities recognize these as equivalent.

**Example 8**

As noted above, this royalty/outsourced manufacturing scenario is a very common situation and an excellent opportunity to identify the differences, if any, between the profit margin that a marketer/distributor should expect when it buys from the intangible owner versus when it buys from an outsourced manufacturer and pays a royalty. Should company S get intangible returns if it has not invested more than the comparables? Please also see our remarks on the “bright line test” within this submission.

Paragraph 212 indicates that Company S is entitled to intangible returns by virtue of its activities far beyond what comparable independent licensees would incur. The question remains whether licensees are entitled to intangible returns simply by virtue of the fact that they are licensees, and are not buying direct from the intangible owner.

**Example 9**

Paragraph 215 suggests that in determining a service fee, the relative skill and efficiency of the Company S R&D personnel should be considered as a comparability factor. We feel that the Discussion Draft risks to over-simplify the difficulties in making such comparability adjustments. Would a TNMM sample of companies engaged in research and development allow such a comparison? Would that return be sufficient?

**Example 11**

In this example, Company T has acquired intangibles at fair market value and engaged the other group companies to perform R&D on a cost plus basis, yet has no technical personnel managing such. Paragraph 224 suggests that Company T should not be entitled to intangible returns in respect of R&D conducted after the date of transfer. It may be helpful to address the payments Company T is making i.e., that they should be refunded since these costs will not be creating any new intangible value for T. Also there is certainly a return due to T for the intangibles it acquired, based on their fair market value and some reference should be made to address this.

It would be particularly helpful to clarify the basis for the adjustments. For example, does this example rely on a reconstruction of the transaction based on the exceptional circumstances envisaged in paragraph 1.65 of the current OECD Guidelines. If so, what are the alternative transactions or characterisation that is being substituted to allow the intangible related returns to accrue to Shuyona?
It is not uncommon that a group company may acquire intangibles at fair market value, from a 3rd party and licence it within the group. Such a company should be allowed to earn a return on this IP despite having no R&D team to continue development of the technology. Legal ownership should entitle the licensor to a return even without control over ongoing R&D. The presumed result of this situation is a profit split based on pre-existing, and newly developed intangibles by the group company managing the R&D. We would welcome guidance on how this might work. We view that the value paid vs. the costs incurred may be the only practical option. However, the overall sentiment of the Discussion Draft appears to discourage the use of “cost-based” matrices to determine intangible ownership.

This example also raises a common dilemma which is the concept of the R&D platform on which the R&D after acquisition will be based. This later R&D will not benefit Company T, yet Company T owns the platform that is being used to further develop intangibles. Complexities arise in how the benefits should be split in such a situation. As discussed in the main text on this issue earlier, we wish for the OECD to further contemplate these points.

**Example 13**

Paragraph 230 is rather vague in its comment that “the goodwill and ongoing concern value of the going business transferred to Company S, should be taken into account”. Does that mean a lump sum purchase of all of the assets, tangible and intangible, is required? Or, is it referring to the TP method to follow after the transfer? For example, it could be interpreted that Company S deserves a higher return because it will be buying goodwill. Alternatively, this could also suggest that Company S deserves a low return if it does not buy the goodwill. If a royalty is paid to Ilcha for its intangibles licensed, the return to Company S could be controlled either way depending on the purchase of intangibles. Some greater clarity is highly welcomed.

**Example 14**

This example seems to make it clear that simply funding advertising, but performing no functions to create, enhance, or maintain the intangibles will not create an entitlement to an intangible return. It is not clear whether this implies that it is irrelevant who pays for advertising or whether it is who controls development of the message, etc. that should be the key factors of assessment? This should be contrasted with Paragraph 200 where a company incurring marketing spending greater than normal may be entitled to some intangible return? It would be helpful if the OECD provided clear guidance as to what type of spending on marketing would entitle a marketer/ distributor to a share of the intangible returns.

**Example 17**

Paragraph 244 implies that the employees with experience and available software tools can perform their services more effectively and efficiently and this should be reflected in the service fee. It would be helpful if the Discussion Draft provided ideas or suggestions as to how to reflect that in the service fee. Would the average TNMM set of comparable service providers be presumed to have similar efficiencies?
Example 18

Firstly, it would be helpful in paragraph 249 to carry on with the numerical example and say that T needs to pay 75 (i.e. (160-10) / 2).

Further, we are significantly concerned by this example. Here, the acquirer (Osnovi) pays a premium for the target (S) in part to reflect attributes of Osnovi’s own business (as reflected in paragraph 246). In the example, Osnovi subsidiary T acquires an interest in the S intangibles and pays not merely their underlying value but also for the “product complementarities” (within its own markets). We note that while S was trading at 100 in this example, the values of competing bidders would pay 120-130 while Osnovi pays 160. The difference between these two values is a feature of Osnovi’s business which it brings to the deal. We agree that the value T pays S for its share of the intangibles should reflect the basic premium (the higher competing bids of 120-130) but not the additional value (160) that arises from attributes of Osnovi’s business. If T is also required to pay the relevant proportion of this (say 15-20) to S then there is a potentially large, gratuitous transfer from the tax authorities and taxpayers of T’s country (where those attributes reside) to those of S’s country (where they do not).

Example 19

We note the following additional concerns:

- We struggle with the reconciliation of how the author arrived at the value for intangibles in Table 1. In Table 1, the residual value of the intangible is based on the assumption of a remuneration of 2% on Cost of Goods Sold (“COGS”) of 500 for production. However, in year one, company S does not exist and the COGS for the parent company was 600 (according to paragraph 252). In this respect, the value of the intangible in table one should likely be lower.

- Most valuators establish intangible value as the enterprise value, i.e total Discounted Cash Flow (“DCF”), less the underlying tangible net assets. It appears some charge has been made against the DCF for asset use, but it is not clear to us how this has been done.

- The use of the same discount rate for all scenarios may not reflect the varying risks in the different entities and countries.

- In this case, the value should be based on all likely market participants and thus would not be affected by differing tax rates. The concept of “value to owner” seems to be being used which may not be appropriate. Most valuators would do this on a pre-tax basis.

- The use of a five year life makes the example somewhat less likely to occur in real life since the arrangements would likely carry on in perpetuity.

- The example in Table 2 computes intangible value as 941 but this includes a return for manufacturing. The true intangible value, in our view, can be no more than the 735 amount in Table 3. If all likely buyers would have low tax rates it could be higher.
There would be costs and risks associated with making the changes which would reduce the DCF values.

**Example 21**

At Paragraph 265, it is implied that there is evidence that independent enterprises would have provided for a price adjustment clause with an annual review. Based on our experience, it is not necessary that all arm's length parties would necessarily require price adjustment clauses. Also, the current OECD Guidelines provide that transactions should be priced as they are structured, where the legal framework and contractual terms should continue to be respected, notwithstanding exceptional circumstances. We would recommend the Discussion Draft to provide a more explicit link to the principles under Chapters I and IX on situations for which recharacterisation should be considered.

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On behalf of the global network of PwC Member Firms, we respectfully submit our response to the Revision of the special considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines. For any clarification of this response, please contact the undersigned or any of the contacts below. The insights and efforts of each of them and their teams have been pivotal to come to this submission.

Yours faithfully,

Isabel Verlinden
*PwC Transfer Pricing Leader - Europe, India, Middle-East & Africa*
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September 14, 2012

By E-Mail: joe.andrus@oecd.org

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Re: Public Comments on the Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Mr. Andrus,

Thank you for the opportunity to provide comments on the revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines (the “Guidelines”) and related provisions. Please find herewith our comments and suggestions of issues to address.

A. Identifying Intangibles

1. Paragraphs 5 to 9 set out general concepts for intangible assets in the context of transfer pricing analyses that may be distinguished from concepts for accounting, legal or other purposes. It appears that distinct from any commercial definition of “intangibles”, the OECD has defined intangibles in a transfer pricing context as an asset that is “not a physical or financial asset, and which is capable of being owned or controlled for use in commercial activities.”

2. This basic definition is then supplemented with a discussion of certain types of intangibles in paragraphs 14 to 26. However, it appears that the above definition does not adequately define intangibles for the purposes of a transfer pricing analyses. For instance, in discussing group synergies, the Discussion Draft concludes “[a]s they are not owned or controlled by a single enterprise, they are not intangibles within the meaning of section A.1.” This conclusion seems inconsistent with the definition since the definition simply characterizes an intangible asset as an asset that is capable of being owned or controlled for use in commercial activities and the definition does not speak to the relevance of being owned by one or more enterprises. It appears that an attempt is made to exclude group synergies from intangibles in the transfer pricing context through the definition rather than a

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1 OECD, Discussion Draft – Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (“Discussion Draft”), Section A, para. 5.
2 Ibid, para. 23.
analysis of why this intangible asset may not be relevant for transfer pricing analyses (see below paragraph 10 for a further discussion).

3. Moreover, the Discussion Draft is not quite clear on whether an assembled workforce is recognized as an intangible asset and the proposed definition, that the asset must be "owned" or "controlled" by the enterprise, would not apply to an assembled workforce, yet the Discussion Draft indicates that they should be considered in a comparability analysis.

4. Perhaps a broader definition of intangibles may be more useful for purposes of discussing intangible assets and their relevance to transfer pricing analyses. In this regard, we propose a definition that is consistent with a definition in the usual commercial context and that is the value that is attributable to an enterprise taken as a whole that is over and above the fair market value of its tangible assets. This definition lays the foundation of the factors that characterize intangible assets;

i. Non-tangible asset;
ii. Excess value not attributable to tangible assets;
iii. Specific to the enterprise.

5. This definition precludes items, such as market conditions, because it is not specific to the enterprise. This result is consistent with paragraph 24 of the Discussion Draft and it is consistent with the way business valuators regard intangible assets for commercial purposes.

6. From this broad definition, intangible assets may be further broken down into the following four categories as submitted by G. Smith and R. Parr:

i. Intellectual property (e.g., patents, trade-marks, trade secrets or know-how);
ii. Rights (e.g., contracts and franchise rights);
iii. Relationships (e.g., assembled workforce and customer relationships); and
iv. Undefined intangibles (e.g., goodwill and going concern).

7. The first two types of intangible assets are discussed in paragraphs 15 to 20 of the Discussion Draft and are adequately addressed.

8. Relationships include such things as assembled workforce and customer relationships, distinct from customer contracts, which would be included as rights. We submit that these intangibles, similar to goodwill and going concern value, cannot be segregated or transferred separately from the business as a whole. In that regard,

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3 The suggestion may be that an employer "controls" the work performed by a workforce, which is true, but this control exists for any workforce and does not necessarily give rise to an intangible value that would significantly affect a comparability analysis.
these intangibles would only be relevant in a transfer pricing context where an entire business is transferred within an MNE group, for instance, as illustrated in example 13 where a business carried on through a branch operation is transferred into a separate legal entity.

9. These intangibles cannot be relevant in comparability analyses because every enterprise will have goodwill, going concern value, assembled workforce and relationships, and it would be impossible to isolate the value of these intangible assets with the data available when conducting a search for comparables. Without isolating the value of these intangibles, both with the comparables as well as the tested party, these elements cannot be informative in carrying out comparability analyses.

10. Also included in the category of undefined intangibles are those that the Discussion Draft identifies as “group synergies”. Although these are intangible assets, we believe these should be ignored for transfer pricing purposes because by definition, the arm’s length principle asks us to price transactions as if parties are dealing at arm’s length and therefore, the effect on pricing from factors such as group synergies in a controlled transaction should be ignored. Under this premise, the natural result is one where returns associated with group synergy intangible assets, if any, accrue to the non-tested party in a controlled transaction.

B. **Identification of Parties Entitled to Intangible Related Returns**

11. As a preface to Section B, the Discussion Draft states that Working Party No. 6 is of the view that “neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.”

12. We understand from this statement that the OECD’s view is that a complete functional analysis, including functions performed as well as risks undertaken and assets owned, must be considered in determining entitlement to intangible related returns. While we understand the thrust of this statement, and we agree for the most part, we believe some clarification would be helpful. Depending on how we define “intangible related returns”, whether it is considered as excess profits or all profits generated from an intangible asset, we would then be able to determine which parties are entitled to intangible related returns as well as the nature of the return received.

13. For instance, consider the following alternatives:

   i. If intangible related returns are considered to be the residual profit attributable to intangible assets after taking into account any amount that is paid for services rendered with respect to the development, enhancement, maintenance or protection of the intangible asset, then legal ownership and assumption of risk will be the main factors in identifying the parties entitled to intangible related returns. By definition, “residual” profit suggests that the parties entitled to intangible related returns assume risk of no profit, but also potential for unlimited gain.

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5 Discussion Draft.
Alternatively, if we define intangible related returns as all profits generated from an intangible asset, then all factors, including functions, risks and ownership must be considered in identifying parties entitled to intangible related returns. However, the quantum and nature of that return (as a service fee, royalty or residual profit) will be commensurate with the contribution to the intangible, whether it is a contribution of functions, assumption of risk or ownership.

Making such a clarification allows us to put context to the statement in paragraph 11 above. If the second interpretation of intangible related returns is used, then we agree with the Working Party’s statement. In the case of the first definition, we would challenge the OECD to reconsider or clarify why risk assumption and ownership alone cannot determine entitlement to intangible related returns. In the absence of performing functions, the amount of intangible related return would decrease, but it should not be a determining factor in evaluating which party is entitled to residual profits or intangible related returns.

In our experience, we have seen arm’s length transactions where parties invest in the development of an intangible through financial means without contributing any functions, know-how or other expertise, either because they do not possess such expertise or because they mandate the execution of functions and decision making to another party, who in turn is compensated for these contributions, but does not share in the intangible related return (that is defined as residual profit). Therefore, we question why these same conditions cannot apply in a related party context where one member of the MNE group owns an intangible asset and bears the costs and risks associated with ownership, and is therefore entitled to a return on the investment in that asset.

In that regard we question the validity of the conclusion in Example 11. In this example, the Parent Company sells patents and other technology related intangibles to a related company, Company T, for an amount that reflects “the arm’s length value” of the transferred intangibles. Company T immediately thereafter contracts with Parent Company, the vendor, to continue providing research and development (“R&D”) services in respect of these intangibles. The conclusion is that Company T “should not be entitled to intangible related returns related to the ongoing R&D because it does not control risks or perform and control the key R&D functions.”

Notwithstanding that Company T paid an amount that represents an arm’s length value for the intangibles and continues to finance the R&D activity, the Discussion Draft asserts that Company T is not entitled to intangible related returns.

This seems to be an illogical result when one considers that the purchase price of the intangible assets essentially reflects the future discounted earnings from these assets. Parent Company, by selling these assets, is monetizing the future earnings today and essentially transferring the risk and rewards of actual future earnings to Company T. These are common transactions among arm’s length parties and one would not suggest in an arm’s length situation that the purchaser of an asset does not have the right to future returns just because it subcontracts the R&D activity back to the vendor.

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6 Annex to the Discussion Draft, para. 224.
September 14, 2012

18. Working Party No. 6 also asks us to comment on whether the Discussion Draft “communicates the economic principles at issue”7 in determining parties’ entitlement to intangible related returns. Our understanding of this framework can be summarized in the following steps:

i. The legal ownership, contractual terms and relationships will be considered as a starting point in the analysis.

ii. The actual conduct of the parties will then be reviewed to ensure that parties’ conduct is aligned with legal form.

iii. Where there is misalignment between parties’ conduct and legal form, taxing authorities may re-determine either the transfer price of the goods/service and/or entitlement to intangible related returns.

19. We agree with this overall approach, with one clarification to the last step. To the extent possible, we believe that any transfer pricing adjustment made by a taxing authority should be one that is most consistent with the overall legal relationships and contractual terms. For instance, Example 2 proposes two alternative reassessing positions by the tax authority. It can either:

i. reallocating the costs relating to product recall and liability, recognizing that a “limited risk distributor” does not bear these costs; or,

ii. adjust the product pricing over the last number of years to change the characterization of Company S from a limited risk distributor to a “full risk” distributor.

20. The first adjustment should be the recommended approach because it is in line with the overall legal arrangement and terms and conditions of the relationship between Primero and Company S. This type of adjustment corrects the issue at hand without recharacterizing the entire contractual arrangement between the parties.

C. Transactions Involving the Use or Transfer of Intangibles

21. We have no comments to make with regard to this section.

D. Determining Arm’s Length Conditions in Cases Involving Intangibles

22. The objective of valuing intangible assets for commercial and accounting purposes is to establish a “fair value” to assist in determining a selling or purchase price for the asset(s) and to report these fair values to stakeholders of financial information. For transfer pricing purposes, the goal is to establish an appropriate arm's length

7 Supra note 5.
entitlement to intangible related returns. All of these purposes have the same fundamental objective, which is to
determine a fair market value of the intangibles. Given the common objective, we question why there would need
to be a different set of rules or principles in valuing intangibles for transfer pricing purposes versus for accounting
and commercial purposes. It would be helpful for Working Party No. 6 to clarify these differing objectives that
would affect the valuation of the assets.

23. Our view is that a common value used for transfer pricing, tax, accounting and commercial purposes will lead to
greater assurance that values are not established with a transfer pricing or tax bias and will ensure a greater
probability of representing a fair market value.

24. For instance, paragraph 110 states that “valuations of intangibles contained in purchase price allocations
performed for accounting purposes are not relevant for transfer pricing purposes”\(^8\). Normally, the starting point of
a valuation exercise in the context of a purchase price allocation is an arm’s-length price paid for a business.
The purchase price allocation attempts to separate the value of the intangible assets into the various categories
based on generally accepted valuation principles. How we treat these intangible assets for transfer pricing
purposes may differ (as described above in our submissions), but we do not understand why these values could
not be used for transfer pricing purposes. Additional clarification would be helpful to understand what factors
should affect the values of intangible assets to be different for the various purposes.

Other Considerations – Options Realistically Available

25. The revised Chapter VI indicates that a transfer pricing analysis of a transaction involving the use or transfer of
intangibles must consider the options realistically available to each of the parties to the transaction\(^9\).

26. As we have previously indicated in our comments on the transfer pricing aspects of business restructurings\(^10\), it
is our view that the “realistically available options” concept is very ambiguous and unpractical. Similarly to
situations involving business restructuring, we submit that for a transaction involving the use or transfer of
intangibles, the starting point must be the evaluation of the contractual arrangement of the parties, both in its
legal form as well as its legal substance (i.e., whether the parties have acted consistently with the legal terms of
the arrangement). Only if the legal substance of the transaction does not conform to its legal form, a tax
administration should be evaluating other options realistically available and making necessary adjustments. To
illustrate this point consider the following example.

27. Assume Company A in country X has recently acquired one of its competitors, Company B in country Y. Both
companies manufacture similar type of products using unique patented technologies. In order to centralize its
intellectual property (“IP”), Company A decides to transfer the technology of Company B to Company A.
Company B received fair market value for its technology and paid the applicable taxes on the gain. Following the

\(^8\) Ibid, Section D, paragraph 110.
\(^9\) Ibid, Section D, paragraph 80.
\(^10\) See RSM Richter Chamberland LLP’s comments on the discussion draft on the transfer pricing aspects of business
transfer of technology, Company B continues to perform some R&D and is compensated by Company A on a cost plus a mark-up basis for its R&D services. When one has to consider options realistically available to each of the parties on the transfer of technology, one option would be not to transfer the technology at all. Although this option could be more beneficial for Company B, as it would be entitled to intangible-related returns if no transfer occurs, there could be many reasons why the transfer of technology would be beneficial for the company, as a whole (e.g., centralizing the IP in one company would not only simplify the overall business model, but also minimize cost of managing the IP). Therefore, it would be misleading to consider options realistically available for each of the parties by disregarding the overall benefit to a MNE. For this reason, we suggest making necessary modifications to paragraphs 80 to 83 to allow the use of the “options realistically available” test only in situations where the substance of the transaction does not conform to its legal form.

**Conclusion**

Thank you again for the opportunity to share our concerns, ideas and issues with the OECD on transfer pricing matters. As always, we welcome guidance from the OECD to facilitate the application of transfer pricing concepts for both tax administrations and taxpayers.

Yours very truly,

**Richter Consulting, Inc.**

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September 13, 2012

By email: joe.andrus@oecd.org

Mr. Joseph L. Andrus
Head of the Transfer Pricing Unit, CTPA
OECD
2, rue André Pascal
75775 Paris
France

Re: Comments on The Revision of The Special Considerations for Intangibles in Chapter VI of The OECD Transfer Pricing Guidelines and Related Provisions – Discussion Draft

Dear Mr. Andrus:

RoyaltyStat is grateful for the opportunity to comment on the OECD’s Discussion Draft containing special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions.

As you may be aware, RoyaltyStat is recognized as the world’s premier online database of publicly disclosed license and service agreements. Our comments are summarized below.

**Assembled Workforce**

It is unlikely that workforce can be isolated from the business and sold separately. Therefore, it cannot have a separate and distinct price from the business. Workforce should be considered as part of goodwill and going concern.

Following classical economics, exchange value, and thus price, can be measured or attributed to dated quantities of labor time spent, but labor itself stopped having exchange value since the end of slavery. In capitalism, people ceased being alienable property subject to buying
and selling. The product of labor or workforce time spent has value, but not the workforce-in-place itself.

**Licenses or Similar Arrangements**

Paragraph 35 of the Discussion Draft provides that in the case of licenses, the licensee “will be the entity entitled to intangible related returns attributable to its licensed rights, subject to its obligation to provide arm’s length compensation for the grant of the license.” This provision seems to indicate that more compensation should be attributed to licensees, and less to licensors. Why make such a presumption? The updated Discussion Draft should clarify that this may not be the case when the licensee is undertaking neither significant risk nor significant functional activity, which remain with the licensor.

**Safe Harbors**

In the field of intangibles valuation, the provision of safe harbors would be useful to speed-up disputes proceedings, decrease risk exposure and documentation burden, and provide more certainty to taxpayers and tax administrations. The use of well-designed safe-harbor ranges reflecting industry-specific criteria would improve transfer pricing compliance, especially in developing countries, where availability of comparables is more restricted.

**Secret Comparables**

Paragraph 104 of the Discussion Draft addresses the use of “commercial databases or proprietary compilations of publicly available license or similar agreements” to search for comparable intangibles and related royalty rates. It is our belief that the Discussion Draft should reject the practice of claiming comparables based on non-publicly available data (i.e., it should prevent the use of secret comparables), which weakens the spirit of cooperation between taxpayers and tax authorities and undermines a consensus via mutual agreement procedures. The exclusive use of public available data should be mandatory because it provides parity between taxpayers and tax administrations, allowing one party to verify the comparables data alleged by the other party.

**Similar Profit Potential**

The OECD Transfer Pricing Guidelines should adopt a concept analogous to the “similar profit potential” of the U.S. Treasury Regulations Section 1.482-4(c)(2)(iii)(B)(1)(ii), which provides that the CUT method (known as “CUP” in the OECD Guidelines) applies only if the
taxpayer can demonstrate “similar profit potential” by using net present value (NPV), or other reliable calculations, passing a *post factum* forecasting error test to satisfy the “commensurate with the income” standard (e.g., at 20% of the “prospective profits or cost savings,” as provided by the U.S. Treas. Reg. § 1.482-4(f)(2)(ii)(B)(6)). Also, the risk of double taxation may be increased by the discrepancy between the intangible valuation standards (including the similar profit potential and commensurate with income standards) adopted by the United States, as a recognized pioneer in transfer pricing rules, and by the OECD, which guides the transfer pricing rules of over 100 countries around the world.

**Closing Remarks**

RoyaltyStat hopes that these suggestions are of assistance in the discussion of special considerations for intangibles in the OECD Guidelines.

RoyaltyStat would welcome the opportunity to contribute further through participation in the consultation meeting in November. In the meantime, please feel free to contact us if you have any questions.

Yours sincerely,

Cristiane Drumond, LL.M.,

For RoyaltyStat LLC
OECD Centre for Tax Policy and Administration  
Attn. Mr. Joseph L. Andrus  
2 rue André Pascal  
75116 Paris  
FRANCE

September 11, 2012

Subject: RSM International comments on the Discussion Draft on the Revision of the Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines

Dear Mr. Andrus,

On behalf of the RSM International network (please see www.rsmi.com), we respectfully submit for your consideration, our comments on the Discussion Draft on the Revision of the Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines.

Identifying Intangibles

Recognition of goodwill

Paragraphs 21 and 22 of the discussion draft and example 13 of the annex do not conclude on a clear definition of goodwill. This may result in increased controversy because tax authorities could assert that any profits that are not related to (other) tangible or intangible assets of a company must represent goodwill, without any further substantiation of this viewpoint. The absence of clear guidelines in this respect may trigger double taxation or non-taxation. For example, one tax authority may assert that goodwill exists, whereas another tax authority may reject that assertion.

To decrease the risk of double taxation or non-taxation in this respect, we recommend to include a conclusive definition of the concept of “goodwill.”

We believe that the suggestions above are more workable from a practical perspective and would bring a balance between the technical precision of the guidelines and their practical application.

Assembled workforce

From theoretical and practical perspectives, we suggest changes be made to the current wording in paragraph 25 of the discussion draft.

Employees can normally switch between employers quite easily and are therefore not "owned." An assembled workforce may entail or create intangibles (such as know-how, etc.), but cannot be qualified as an intangible asset of
the company. Therefore, an assembled workforce itself may constitute an (intangible) asset in situations where the employees have significantly less options (or more restrictions) to switch to another employer (e.g., non-compete or non-disclosure agreements, etc.).

In practice, it may be impossible to obtain information regarding the presence of uniquely qualified or experienced employees when carrying out a qualitative analysis of a set of potential comparables.

As a result, we suggest amending paragraph 25 to stipulate that an assembled workforce may constitute an intangible asset in situations where the employees have significantly less choices to switch to another employer.

Group synergies

Group synergies are not recognized as an intangible, which we can certainly agree with. However, since synergies need to be taken into account as a comparability factor, it would be helpful if the update of the transfer pricing guidelines could contain an example of how to apply this criterion as a comparability factor. We recommend that this example takes into consideration the following practical difficulties:

- In many countries, it is required to select “independent” comparable companies (i.e., that are not affiliated within a group), in order to reduce the risk of non-arm’s length transactions. As such comparables are usually unable to realize synergies, this comparability aspect may be difficult to apply in practice;
- Even if it would not be necessary to use independent comparables, it would still be difficult to obtain information on whether or not a multinational has actually organized its business in such a way that it obtains group synergies. Hence, it will (in many cases) not be possible to determine whether a comparable has business synergies, let alone to determine the value allocable to such business synergies.

Accounting treatment

In paragraph 6 it is determined that identification of intangibles for accounting purposes is informative, but will not be determined by such characterisation only. We believe that this is a sensible approach. Nevertheless, there is a risk of double taxation or non-taxation since many tax authorities rely upon the characterization for accounting purposes. As a result, tax authorities may not accept transfer pricing adjustments made to the accounting profits. We would recommend more guidance with respect to the taxable income adjustment mechanism.

Identification of Parties Entitled to Intangible Related Returns

Functions

In paragraph 41 reference is made to paragraphs 9.23 up to 9.28 of the OECD Transfer Pricing Guidelines. To avoid confusion in practice, we suggest avoiding the reference to this part as far as it concerns paragraph 9.25 (discussing the situation of a fund manager and an investor). For the purpose of this discussion draft it appears to us that the most important paragraph in this respect should be 9.26 (discussion a contract research situation).

Level of control

We believe the concept of “control,” as used in (for example) par. 40 of the discussion draft, requires further explanation. Although we realize that the level of control required in each case depends on the facts and circumstances and upon the standards of the industry, as a result of which it is difficult (if not impossible) to provide a clear definition of “control,” we feel that further attempts must be made to create more clarity as to the concept of
“control.” The examples contained in the discussion draft are certainly helpful, but do not provide the level of certainty that multinational companies need.

An alternative (or addition) to the use of examples could be to provide a (strict) safe harbour rule, that could for example consist of several lists of tasks (tailored to common situations such as contract research, marketing, etc.) that must be performed by a principal in order to have sufficient “control.” Taxpayers could choose to deviate from the safe harbour rule, but then they can be required to establish why their allocation of tasks meets the market standards in their specific situation. Although it is noted that par. 9.26 of the OECD Transfer Pricing Guidelines already contains such a list, the tasks mentioned in that paragraph are only examples.

Reference to par. 9.23 up to 9.28 of the OECD Transfer Pricing Guidelines

In reference to paragraphs 9.23 up to 9.28 of the OECD Transfer Pricing Guidelines, as well as related remarks in the current discussion draft, we request that you consider the practical situation when a larger company acquires a smaller startup company without exercising a significant amount of control over the newly acquired company, as imposing their “control” framework could restrict the creative development process within the acquired company. The above entails that there may be situations where the level of control required by the paragraphs 9.23 up to 9.28 are not applied in practice for non-fiscal reasons.

**Financial strength**

Another important criterion to determine the entitlement to intangible related returns (in addition to the management & control of the functions that have been outsourced) is the presence of sufficient financial strength with the party that is contractually entitled to these returns. Even if a principal has staff who are sufficiently qualified to control the risks involved with the intangibles and who also control such risks in practice, a lack of sufficient financial strength at the level of the principal could be a reason to not allocate any intangible related returns to the principal.

**Valuation based on cost**

In paragraph 112 it is stipulated that in general there is little correlation between cost of developed intangibles and their value. Nevertheless, in limited circumstances there are exceptions; for instance, for non-unique intangibles. In these situations we would support a more detailed definition of costs that may or should be included in the cost base.

**Split ownership of intangibles**

We recommend that the revised transfer pricing guidelines contain more elements on the entitlement to intangible related returns in cases of split ownership of intangibles. Perhaps these elements may be included in the forthcoming Cost Contribution Arrangement additions to the chapter by WP6.

**Application of Profit Split Method**

The (residual) profit split method may provide a proportionate alternative to the CUP method or financial valuation techniques, especially where it concerns small or mid-sized companies. The use of a relatively straightforward profit split method (as opposed to a CUP method with comparability adjustments) may provide a proper split between technical perfection and a practical application resulting in a reasonable transfer pricing compliance burden.
We therefore request that you consider including specific remarks relating to small or mid-sized companies and how the profit split method (or potentially other methods) could be applied in order to reduce the transfer pricing compliance burden of such companies to an acceptable level. In this respect it could also be considered to refer to the contents of the discussion draft on the proposed revision of the section on safe harbour rules in Chapter IV of the OECD transfer pricing guidelines (e.g., in order to determine in which situations the use of the profit split method could be further stimulated).

We thank you for the opportunity to provide our input. Should you have any questions on our comments, please contact Mr. Guido van Asperen at +31 23 5300 426 or gvasperen@rsmnlk.nl.

Yours sincerely,

On behalf of the RSM International Transfer Pricing Group

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Transfer Pricing within RSM International

The RSM International network has member firms in 94 countries around the world with over 32,000 people serving the needs of their clients.
MEMORANDUM

To: Joseph L. Andrus, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration

From: Anne Quenedey, Partner, Salans

Date: September 13th, 2012

Subject: Comments on the Discussion Draft dated June 6th, 2012 containing a proposed revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines

On September 2010, I have provided comments on the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles, the shortfalls identified in the existing OECD guidance and the areas in which OECD could usefully do further work (http://www.oecd.org/ctp/transferpricing/46018101.pdf).

During the Meeting with Business Representatives on the Valuation of Intangibles for Transfer Pricing Purposes held on 21-23 March 2011, I was invited by delegates from Working Party n°6 of the OECD Committee on Fiscal Affairs to make a presentation on the legal protection of intangibles with my partner Isabelle Leroux (http://www.oecd.org/ctp/transferpricing/47421262.pdf).

Today, I am pleased to respond to the OECD request to send comments on the Discussion Draft on the revision of Chapter VI of the Transfer Pricing Guidelines dated June 6th, 2012 (hereafter referred to as the “Draft”).

First of all, I am thankful to the OECD for the responsible and serious approach taken. In fact, although transfer pricing aspects of intangibles are a very complex and sensitive subject, substantial work have been done by the Working Party n°6 of the OECD Committee on Fiscal Affairs to propose detailed and clearer guidance. This effort must be encouraged and strengthened.

From a general perspective, I believe that maximum security must be ensured for the business community with regards to transfer pricing aspects of intangibles, especially as regards the issue of identifying an intangible. Eliminating risks resulting from uncertainties of tax costs related to transfer pricing of intangibles must remain the main goal.

Therefore, we would like to make the following comments on (i) elements included in the Draft that we agree with, (ii) elements included in the Draft that we disagree with and (iii) matters which are missing or need to be clarified.
1. **Elements included in the Draft that we support**

As mentioned above, the Draft already includes lot of elements which constitute a true evolution on establishing transfer pricing guidelines on intangibles.

Among the elements we agree with, our attention was particularly driven by the following:

- acknowledging that characterization for accounting purposes does not determine a intangible for transfer pricing purposes (paragraph 6);

- the end of the use of categorizations (old distinctions between trade intangibles and marketing intangibles, between “soft” intangibles and “hard” intangibles, between routine and non-routine intangibles did not provide much) (paragraph 13);

- comments on illustrations of identifying intangibles are generally accurate (paragraph 14 to 26);

- tentatives to limit the scope of intangibles like for example:
  - paragraph 8: “It is important to distinguish intangibles from market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise.”;
  - paragraphs 23 and 24: group synergies and market specific characteristics, as they are not owned or controlled by a single enterprise, are not intangibles;
  - paragraph 26: “While the transfer of isolated employees does not, in and of itself, constitute the transfer of an intangible, such a transfer may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm’s length dealings”;

- “Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns” (paragraph 30);

- examination of functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles are key criteria to identify parties entitled to intangible related returns (paragraph 37);

- “In a transfer pricing analysis, the use of valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return is generally discouraged. There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, financial valuation techniques based on the cost of intangible development should usually be avoided” (paragraph 112);

- the positive introduction of valuation techniques (paragraph 145) together with the recognition that in determining discounted rates, intangibles are of a particular
nature and may be among the most risky components of a taxpayer’s business (paragraph 162);

- we observe that certain examples given in the Annex of the Draft, illustrating the application of the provisions of the Draft, are very helpful (such as examples 1, 9, 10 and 11).

2. **Ideas included in the Draft that we disagree with**

Among the elements we disagree with, our attention was particularly driven by the following:

- Comments which open doors to exceptions/derogations to the criteria that the Working Party n°6 is trying to determine should be carefully reviewed with an aim to understand why they still exist at that stage of the Draft, and redrafted.
  Example: “while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterized as an intangible for transfer pricing purposes.” (paragraph 7).
  These open doors are dangerous as they create too many uncertainties;

- “The illustrations given in this section should be adapted to the specific legal and regulatory environment that prevails in each country” (paragraph 14). It is dangerous to introduce any particularism for each country. MNE seek harmonized guidelines for the application of transfer pricing principles in order to mitigate double interpretation by the tax authorities of two different countries;

- “In extraordinary circumstances described in paragraphs 1.64-1.69, contractual allocations of entitlement to intangible related returns may be disregarded by tax authorities notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles” (paragraph 53). When the form and substance are stated to be aligned, there is no reason that the tax authorities can still disregard the contractual arrangements. Only discrepancies between form and substance can lead to such a conclusion.

3. **Matters which are missing or need to be clarified**

Regarding the issue of identifying intangibles (Part A of the Draft), we suggest that efforts should be made in order to describe also what should not be considered as intangibles. Currently, the negative comments/definitions are spread all over the Draft and it is very difficult to get a clear synthesis on that. For security of the transactions, we believe that a new Part or Section of the Draft should be added after the Part A entitled “Identifying Intangibles”. This section would be helpful as it would contribute to better encapsulate the meaning of “intangibles” for transfer pricing purposes.

In addition to the exhaustive list of examples provided in the Draft, it would also be useful to add a description of a clear methodology that both taxpayers and tax
authorities could follow in order to identify an intangible. For example, we understand that accounting or legal criteria may assess whether or not an intangible asset exists but it is indicated that they are not in itself necessary conditions for an item to be characterized as an intangible for transfer pricing purposes. Articulation between criteria should be enlightened.

Regarding the issue of determining arm’s length conditions in cases involving intangibles (Part D of the Draft), the wording of certain paragraphs could give the impression that valuation techniques are promoted as a primary method for valuing intangibles in situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified. We observe however that valuation techniques require often the support of external advisors and can be in some way burdensome for the taxpayers. We thus recommend that the use of external advisors be not compulsory even when valuation techniques are retained and that the use of valuation techniques be stated as limited to complex cases.

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We are at the disposal of the Working Party n°6 in order to contribute further, in particular on the combination of the various criteria or the clarifications on the limits.

Very truly yours,

Anne Quenedey,
Partner
Dear Mr. Andrus,

let me first thank you for the work done so far by Working Party No. 6 on “Intangibles”, one of the most pressing problems in International Taxation. Schlütter Bornheim Seitz (SBS), a medium sized German law firm, has a long standing history in International Taxation. One of our founding partners, the late Prof. Dr. Debatin, contributed significantly to the OECD Model Convention. When joining SBS in 2010, after overlooking the tax affairs of the Bertelsmann Media Group for more than 20 years, I learned, that especially small and medium sized companies are significantly challenged with transfer pricing issues, when expanding their businesses across the German borders. As many of these companies are world leaders in their specific fields, they have developed significant intangible values over many years. Typically such German companies are either family businesses for more than one generation, or closely held companies. Expanding within Europe or towards the U.S. and Asia confronts them with different tax issues and risks, especially related to transactions involving the use or the transfer of intangibles.

Therefore, I am grateful for the given opportunity to comment and hopefully also contribute to the Discussion Draft for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines. Considering all the comments you received so far from interested parties I would like to restrict myself to

- Identifying Intangibles and
- Identifying the Parties Entitled to Intangible Related Returns.

A. Identifying Intangibles

According to German tax legislation (§ 5 Abs. 2 EStG), intangible assets can only be capitalized when purchased. Intangibles which are self-developed, for the use and conduct within the business, must be immediately expensed and cannot be capitalized. In the past a similar treatment of intangible assets was also mandated by the German rules on accounting so that up to 2009, tax and accounting rules on the capitalization of intangible assets were identical. Only under the accounting rules newly introduced in 2009 by the German Accounting Law Modernisation Act (“BilMoG”), self-developed intangibles may now be capitalized. As a consequence, all self-developed intangibles before 2009, cannot be identified in the financial statements of German small and medium sized companies. As many of these intangibles, developed many years or generations before, are not registered or patented, it is a difficult task to identify them as an asset. In addition, family businesses and closely held businesses tend
not to take use of the new accounting opportunity to capitalize expenses for self-developed intangibles. Although not shown in a balance sheet, most of these intangibles carry a significant economic value. Therefore, there is a need to consider them for transfer pricing purposes.

As the draft no longer restricts an intangible to an intangible asset, a much broader look can be taken when identifying intangibles. The absence of specific categories of intangibles also seems helpful in this respect. At the same time, the given illustrations provide sufficient guidance for identifying intangibles. Thus the new OECD approach with a wide view on intangibles seems helpful for identifying intangible values, especially in small and medium sized family businesses.

The Draft also states, that the guidance on intangibles is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes, especially regarding Art. 12 of the OECD Model Tax Convention. Considering the tight time frame and your goal to replace the current version of Chapter VI by 2013/2014 this restriction is required under technical aspects. The pressing need for a revised Chapter VI makes it an acceptable priority. Nonetheless it seems necessary to align the new meaning of intangibles in Chapter VI with other provisions of the OECD Model Tax Treaty, especially with Art. 12 on royalties.

It may, therefore, be recommendable to set up a new working force on this issue when the finalizing the draft or as soon as convenient.

B. Identifying the Parties Entitled to Intangible Related Returns

Accepting the given circumstances in family owned businesses, which have conducted business successfully for more than a generation, it is important to note that such businesses have often had a more hands on approach in the past. Thus, often there is a lack of original written documentation regarding intangible assets and the rights related to them. In absence of written terms the contractual relationships that entitle parties to intangible related returns must be deducted from their conduct and the economic principles that generally govern the relationship between independent parties. This relates especially to the use of intangibles which are not protected under any applicable law. It seems that the draft gives sufficient guidance under this aspect.

Functions, risks and costs related to intangibles may well be taken from the parties conduct as the best evidence concerning the true allocation of entitlement to intangible related returns. We appreciate the view that the sole bearing of costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns.
With family owned businesses entering new markets it may often be the case that their name and brands are not known in these new markets. In penetrating new markets names and brands get more and more attraction. The examples 3 to 9 in the Annex provide a broad range of situations which reflect different approaches to enter new markets and how to deal with them under transfer pricing aspects. It is important to understand, for the taxpayer as well as for the taxing authorities, that not every intangible used in a transaction requires a consideration. This is especially the case when trade names and brands are not known in a market.

I do hope that the comments above will enhance and support the efforts of Working Party No. 6 and I will be pleased to provide further input if required.

Yours sincerely,

(Prof. Dr. Jörg Hernler)
September 14, 2012

Joseph L. Andrus
Head of the Transfer Pricing Unit
OECD Centre for Tax Policy and Administration

Comments on OECD Discussion Draft on Revised Guidelines on Transfer Pricing of Intangibles

Sudit K. Parekh & Co. (“SKP”) is pleased to provide comments in response to OECD’s Discussion Draft on Revised Guidelines on Transfer Pricing of Intangibles released on 6 June 2012. Intangibles is a complex topic, paralleled with lack of guidance. We welcome OECD’s deliberations on the subject matter, and strongly feel that OECD’s involvement will lead to a higher degree of certainty on the subject. We look forward to the results of this work.

SKP Comments

We respectfully submit the following comments on the Discussion Draft. For the sake of brevity we have restricted our comments to the key facets that might benefit from further analysis. Further, we have not taken every opportunity to indicate where we agree with the observations expressed in the Discussion Draft, to do so would have made our response even longer. We have our comments corresponding to the topical analyses undertaken in the Discussion Draft.

A. Identifying Intangibles

The Discussion Draft provides illustrations of items that would be considered as intangibles such as patents, know-how and trade secrets, trademarks and trade names, and licenses and similar limited rights in intangibles. Goodwill and going concern value are also treated as intangibles (paragraph 22). However, paragraph 22 also mentions that for transfer pricing purposes it is not necessary to establish a precise definition of goodwill. We feel that Discussion Draft’s broad definition of goodwill could result in increased controversy since tax authorities would be inclined to assert any unexplained cash flow as goodwill. Thus a narrow definition would be beneficial in this regard. Regarding assembled workforce as an intangible, the Discussion Draft is
unclear, we look forward to more clarity on this front.

B. Identification of Parties Entitled to Intangible Related Returns

Paragraph 37 states that in order to determine the parties entitled to intangible related returns it is important to examine the conduct of the parties vis-à-vis the legal terms and conditions. In the case the conduct of the parties is not aligned with the terms of the registrations and contracts, reallocation of returns may be appropriate. The reallocation of returns should be based on the functions, risks and costs that relate to the development, enhancement, maintenance and protection of the intangibles. The parties’ conduct should generally be taken as the best evidence in this regard. We agree with the above comments and emphasize ‘substance over form’ to identify the parties and the allocation of the intangible related returns. However, we would also like to add that to arrive at an arm’s length result it is important to take into account the conduct of the unrelated parties under similar circumstances. The economic analysis performed would complement the analysis based on third party conduct, but can’t replace it.

Paragraph 41 notes that the parties claiming entitlement to intangible related returns need to exercise ‘control’ over the relevant functions and risks. In applying the concept of ‘control’ the Discussion Draft makes reference to paragraphs 9.23 through 9.28. We agree with the concept and wish to convey that it is increasingly being relied upon. Paragraph 47 makes an important observation; just bearing costs related to the development, enhancement, maintenance and protection of intangibles does not by itself create entitlement to intangible related returns. This is important in the Indian context where the tax authorities tend to rely on costs as the benchmark for contribution to intangible creation. We agree with paragraph 47, and as mentioned above, believe that it is imperative to also look at factors such as functions performed, risks undertaken and third party conduct, to name a few.

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1 In the Indian context, Finance Act 2012 has provided clarifications regarding the term ‘intangible property’. Intangible property has been explained to include human capital related intangible assets such as trained and organised work force, employment agreements and union contracts. Excerpts from the Indian Income Tax Act regarding intangibles are provided in Annexure I.

2 Chapter IX: Transfer Pricing Aspects of Business Restructurings
Paragraphs 49 to 51 provide commentary on the performance of marketing activities by enterprises that do not own the trademarks or trade names they promote, and whether such marketing activities be treated as provision of marketing services or could the activities also be considered as contributing to the creation of marketing intangibles owned by the trademark owner. This is an important issue in the Indian context with taxpayers and the tax authorities regularly at odds regarding the meaning and scope of marketing intangibles. The tax authorities use the notion to attribute non-routine returns to local affiliates that perform local selling and marketing activities, even though all the legally protected intangibles are owned by foreign related entities. In this regard the Maruti Suzuki Case in India garnered considerable attention.

We believe that the guidance in paragraphs 49 to 51 is close to the existing in Chapter VI. We feel that this is a critical topic the OECD should look at more closely and provide detailed guidance. It would be helpful if more light is thrown on aspects such as analysis of the nature and extent of the marketing activities/expenses and the proposed handling, in particular of the non-routine expenses; recognition and treatment of key decision making functions such as the development of marketing strategy and cost controls; investigation into the arrangement between the entities in terms of bearing the risks/expenses for the marketing activities to be undertaken; business and economic significance of the marketing activities in the relevant industry/geography etc.

C. Transactions involving the use or transfer of intangibles

The Discussion Draft describes two categories of transactions that involve intangibles. In the first category there is no transfer of intangibles or of the rights, rather intangibles are used by one or both parties to a controlled transaction in connection with sales of goods or services. The second type of transaction encompasses transfer of rights in intangibles in controlled transactions. Such a transfer could be that of all the rights (e.g. sale of the intangible) or of limited rights (e.g. license, with underlying restrictions). We agree with the above, however, our concerns lie in the case of transfer of intangibles in combination with other business transactions. Looking at business franchise arrangement as an example, paragraph 73 provides the following comments:
“If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.”

Firstly, we believe that in practice segregation is difficult, if not impossible. To draw a line to differentiate the provision of services from intangible generating functions is a tricky proposition. Further, hypothetical valuations of individual components could throw the computation away from an arm’s length result.

D. Determining arm’s length conditions

Paragraphs 80-81 communicate the role of the options realistically available (“ORA”) concept in the comparability analysis for the transactions involving the use or transfer of intangibles. For the ORA concept reference is made to paragraphs 9.59 through 9.64. In performing the ORA analysis, the perspectives of each of the parties to the transaction must be considered rather than just conducting a one-sided analysis. We agree with the ORA concept and consider it important in bringing the analysis (including pricing) on the same platform as between unrelated parties.

The Discussion Draft provides certain features of intangibles that may prove important in a comparability analysis. Such features include among others, exclusivity of the rights in the intangibles, the extent and duration of the legal protection, geographic scope, useful life of the intangibles and the expectation of future benefit. Further, the Discussion Draft states that if there are differences in the comparability factors, those differences can have significant economic consequences that may be difficult to adjust for in a reliable manner. We agree, and believe that analyzing the comparability factors taking into account the uniqueness quotient of the intangibles could be tricky and might lack exhaustiveness. Moreover, judgment on the role played by each factor, by itself and in conjunction with others, could be subjective and case specific.

3 Chapter IX: Transfer Pricing Aspects of Business Restructurings
The Discussion Draft for the first time recognizes the use of financial valuation techniques for transfer pricing purposes. Paragraph 109 carries the following remark:

“The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions.”

Furthermore, paragraph 148 briefly demonstrates the steps involved in approaches based on discounted cash flows. However, paragraph 149 observes the following regarding such approaches:

“When applying valuation techniques, it is important to recognize that the estimates of value based on such techniques can be highly volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to extreme swings in the intangible value the model produces.”

The Discussion Draft also discusses the major elements of a discounted cash flow analysis; some of the observations made are as follows. The accuracy of the financial projections is important and depends on the source and purpose of the projections, length of time and the track record of the financial performance. Another key element is the projected growth rate, and care should be taken that revenue and expense growth patterns of the industry and the company are analyzed. Discount rate is another critical factor. The quantum of risk and the volatility of the expected cash flows should be evaluated in determining the appropriate discount rate. The useful life of the intangibles depends on the nature and duration of legal protections and the rate of technological change in the industry.

We welcome the recognition of financial valuation techniques in the transfer pricing sphere. Valuation approaches based on discounted cash flows would be helpful in reducing the uncertainty surrounding the pricing of intangibles. The Indian tax authorities too are heavily relying on such approaches. We also appreciate the word of caution provided by the OECD regarding the volatility of these approaches and the criticality of the underlying assumptions.
We realize that the factors that go into a discounted cash flow analysis are complex and an in-depth analysis of each would be too ambitious, however, we do think that more guidance is required to address the specific issues and challenges regarding the use of such valuation techniques in the context of transfer pricing. We also recommend investigating approaches such as the option pricing models that hold a lot of promise.

**Conclusion**

We hope the OECD finds these comments helpful. We support the OECD debate in the sphere of intangibles, and look forward to the next step in the process.

In case of any questions regarding the submission please contact:

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Annexure I

Following are the excerpts from the Indian Income Tax Act regarding intangible property.

“The expression ‘intangible property’ shall include—

(a) marketing related intangible assets, such as, trademarks, trade names, brand names, logos;

(b) technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical know-how;

(c) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;

(d) data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;

(e) engineering related intangible assets, such as, industrial design, product patents, trade secrets, engineering drawing and schematics, blueprints, proprietary documentation;

(f) customer related intangible assets, such as, customer lists, customer contracts, customer relationship, open purchase orders;

(g) contract related intangible assets, such as, favourable supplier, contracts, licence agreements, franchise agreements, non-compete agreements;

(h) human capital related intangible assets, such as, trained and organised work force, employment agreements, union contracts;

(i) location related intangible assets, such as, leasehold interest, mineral exploitation rights, easements, air rights, water rights;

(j) goodwill related intangible assets, such as, institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill, general business going concern value;

(k) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;

(l) any other similar item that derives its value from its intellectual content rather than its physical attributes.”
Observations on interim draft on intangibles, safe harbors and timing issues of transfer pricing guidelines (June 2012)

1. General concepts,
I start with basic question included in the draft:

Business is requested to comment as to whether the formulation contained in section B, successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks (OECD interim draft on intangibles - June 2012- para 26).

I think that partly the formulation of the draft hits the above mentioned target. I am going to explain why I refer to the adverb “partly”. Indeed in my opinions problems are not on theoretical definitions but on other parts of the drafts. In any case I start with comments on general concepts.

On the theoretical point of view I think that reading the draft on intangibles in connection with already existing parts of OECD Transfer Pricing Guidelines (hereinafter Guidelines), the concept of the attribution of returns in compliance with activity, risks and assets should be clear. But interpretation and application of Guidelines and of arm’s length principle (hereinafter ALP) is, in my opinion and as a matter of fact, currently so unsatisfactory. One circumstantial evidence of that is i.e., on side of Administrations, the sentence that

“Some countries recover very little tax from their transfer pricing audits or enquiries whereas others recover very large amounts from almost all their audits” included in the OECD Report “(Dealing Effectively with the Challenges of Transfer Pricing, OECD 2012 page 17)1.

*** I am grateful to prof. Giampaolo Arachi, Econpubblica Bocconi Milan, as well as Dr. Fabio Comelli of the IMF, who read a paper to be edited for International Transfer pricing journal by IBFD with similar concepts than in this paper, and to Prof. Angelo Baglioni, Economic of uncertainty Catholic University Milan, all, for helpful comments on economic studies of actual transfer pricing by firms, and on microeconomic theory. I am also grateful to Dr. Deloris Wright for helpful comments on the whole paper. Any opinion and/or error is solely attributable to me.

1 Please note I used the term circumstantial evidence and not full evidence because it’s also possible that all firms whose income was adjusted up (in Countries where all audits end in an adjustment by Administration) breached the arm’s length standard; that seems to me not probable while it seems more probable that in those Countries the arm’s length principle (ALP) is applied in a non consistent way with the way it’s applied in other Countries.

On the other side one of the prevailing conclusion of a lot of economic studies is that transfer pricing constitutes an important channel of tax planning, perceived as an illegal way to breach anti-avoidance legislations and the arm’s length principle despite tax Administrations audits based on the same principle.

The mentioned conclusion is groundless because those studies give only circumstantial evidence of what they conclude; only when are available information about how the firms’ integrated business risks have been split between associated units (located in various Countries) one can conclude whether intrafirms’ prices and contracts are (or aren’t) in compliance with arm’s length pricing (ALP).
In any case the concept of intangible is not strictly necessary to project transfer pricing rules. What is important (essential) is that a clear model of allocation (to associated entities) of returns and of group’s incomes is included in the regulation.

If I refer to current microeconomic studies about integrated businesses and to contract theory one of most important concepts used for depicting behaviors of independent parties is the concept of asset ownership as “the right to control the use of asset (in particular, the owner can exclude anyone else from using it)” . Few words are able to explain this point of view and related bargaining mechanism:

“Asset ownership is relevant because it determines the threat point of the date-2-bargaining game. If the buyer owns the asset, the default payoffs of both parties are zero. According to the Nash bargaining solution, the seller then gets half of the gains from trade at date 2, hence there will be underinvestment.

If the seller owns the asset, she could sell her good on the spot market, while the buyer’s default payoff is zero”.

The (second) optimal solution (after ability to make a complete contract) to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best interest and possible equilibrium state is to give, in the contract, the right to use the business assets to the seller; what is important is just the (intangible?) property assigned by the contract: the right to use business assets, material or immaterial.

I try to resume.

The distributor position i.e. is the theoretical position of who is going to make a specific investment that has a value under a locked relationship (with producer); the group form of enterprise is just the solution to prevent the hold up of his investment in advertising while Group solution can’t be a solution for Governments that need an equitable division of tax revenues.

The first best solution to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best interest and possible equilibrium state, is the ability to make a complete contract where distributor is fairly remunerated for his investment in each possible event: this is what is depicted as a normal marketer (example 4).

The second best optimal solution (when the first best solution is not possible) is to give in the contract, the right (or a share of that right) to use the business assets (the name) sourcing from investment to the seller: this is depicted as abnormal marketer (example 5).

Here what is important is just the (intangible?) property assigned through the contract: the right to use business assets, material or immaterial.

Economic studies which are based on database data to come to conclusion about generality (or categories) of firms (i.e. the Bundesbank MIDI database, and so on) are not based on appropriate information because database do not show how each group has individually split his own business risks.

For more details see an upcoming paper, A. Musselli, Saving arm’s length pricing: from economists studies myth to reality (provisional title), which will be edited in International transfer pricing journal, IBFD, November-December 2012 issue.

Obviously some firms, in some cases (and this has been individually proved) have breached, breach and will breach ALP.


3 See Schmitz, supra note at page 13.

4 This way of thinking would be also coherent with all patterns describing capitalism, classical (Ricardo etc), neoclassical (Walras, Marshall), Marxian economics till modern microeconomic and firm theories. In all these patterns the concept of asset is fundamental in characterising capitalism.
This the right way theoretically pursued in the draft (para 49.50-51 of the draft) already included in chapter VI of Guidelines) that is not explicitly expressed.

In any case also the concepts included in the intangibles’ draft (returns of a group entity must relate to functions performed, assets employed and risks assumed in the business) may reach similar effects as asset ownership concept that I above mentioned. This “non definition” of intangible included in the draft could be too abstract to be easily understood and could be enriched in the context I above mentioned giving reason of the bargaining game of parties in these contexts.

2. Guidelines as a Janus Bifrons: suggestion on economic valuations but target of ruling taxation. Necessity to separate the ex ante firms’ view from the Administration audit ex post view; timing issues draft

Indeed I frankly perceive that the most important problems of Guidelines’ interpretation and application source in force of the misunderstanding currently and actually present between the double nature of Guidelines (as Janus Bifrons): they are written as to explain what economic theory suggests about valuation process to set transfer prices with ALP but they are targeted to serve as fiscal law.

This is not the place to discuss about the juridical nature of Guidelines, that usually are not internal laws of OECD Countries, also if in some cases the internal legislation of some Countries is just interpreted in force of what suggested by Guidelines text and without any national specific detailed rule.

Here what I am going to underline is that in many circumstances Guidelines leave open some options to comply with ALP, (brief examples):

- Arm’s length range
  A range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm’s length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods (Guidelines glossary).

- transfer pricing is not an exact science (the requirement is found four times in the Guidelines at paras. 1.13, 3.55, 4.8 and 8.3, to always allow more than one result as the arm’s length price)

I think that these words have (or should have) a practical juridical effect: firms have at the moment they are setting transfer prices more than one option to set them at arm’s length; this is particularly true when data on comparable transactions are extracted by databases where are included information about millions of firms and the user must extract the more comparable firms (in terms of function assets and risks – and other comparability factors recommended by Guidelines) to the intercompany ones.

Perfect comparability is often not possible just in these cases and more than one option is possible.

Here firms i.e. may choice (giving arguments to do so) a method (most of times a profit comparison with external comparables), and then a “target” PLI and, then, more, they must extract comparable firms’ and results.

All these processes and methods leave open more than one proceeding to set transfer prices; results produced by these different ways may end in having more than one, but all acceptable, arm’s length transfer prices.

This is clearly affirmed in Guidelines with the range concept of the arm’s length price.

But I know that actually where more than one option is allowed and Guidelines do not prescribe a mandatory aspect of the proceeding (and so it’s allowed a sort of flexibility) often when firms have calculated a certain price, several years later the Administrations (rejecting or non rejecting method or some aspects of it chosen by taxpayers) use different methods and different options.

5 In fact if Guidelines would be well interpreted already now a lot of litigations should not exist

6 Some scholars call Guidelines “soft law”
comparables from those used by firms just to adjust firm’s transfer prices: they adjust upwardly the audited firm’s income neglecting the process used by firms years before. Therefore Legislator must do more than what is already done at this moment through the range concept (and other concepts already present in Guidelines text). Legionator might give a strong safeguard to firms, that are obliged to set in advance prices which will be audited later, that if they choose one of allowed options, then, years later, Administrations cannot neglect that –allowed – choice; obviously Administrations must challenge a non allowed choice; but if same Guidelines leave open a space to estimator to make some assessments those assessments can be amended (with information available at operation time and not after) only when they are irrational and not because other assessments could be equally rational!

In my opinion timing issues of Guidelines must be projected in coherence with the mentioned safeguard.

It’s not important if the comparable data to apply ALP must be available at the moment to do intragroup transactions or at the moment to fill the fiscal return or even later (so that data are of the same period of intragroup transaction and affected by same economic conjuncture); the real important thing is that Legislator specifies if one timing or both timings are allowed so that a clear rule can be applied by firms and then audited by Administrations; if both timings are allowed it is not acceptable that firms choose one of the allowed processes and then the Administrations (one Administration of a particular Country) neglect that choice on base of choosing the other one because “it’s more coherent with (economic?) ALP”!

About timing issues my opinion is that for practical reasons more than one option can be allowed at the sole condition that these rules are applied with coherence during firms’ life (i.e. more than one method is allowed but when firms have chosen one of them same firms must continue to apply that method and Administrations, given that both methods are allowed, cannot neglect firm’s choice).

If legislators want to restrict the options must clearly do that! And this is really what is important on timing issue!

3. The value, per se, of certainty about fiscal rules application

Economists underline that uncertainty surrounding the proper fiscal rule to apply is detrimental for business, because the immunity of property from arbitrary expropriation by governmental authorities is one of most important conditions for growth of economies. Uncertainty as to tax consequences (but also regarding administrative, labour law and other aspects of corporate existence) of cross-border transactions serves to discourage worldwide trade and investment, and worsens current difficulties related to growth. This is a significant negative consequence in terms of the lack of economic growth (not immediately and fully observable, but present nevertheless).

In this period of recession, these negative consequences must be carefully evaluated by judicious legislators. The first signal of what is going on in reality is also observable in some countries where multinational enterprises protest their lack of certainty as regards rules of law and threaten to under-invest in those countries.

I find some reference to these concepts in OECD draft on safe harbours (see i.e para 11), but I would like to underline that certainty about the rule to apply in real and specific cases is a value for taxpayers but for Administrations too; I think that certainty about the right rule to apply is a general value, is a value per se, because in providing certainty to eligible taxpayers the law aids

7 Some aspects of the (i.e. timing issues in comparability) existing Guidelines are indeed not fully coherent with this target...
8 W.J. Baumol ,The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism (Princeton University Press, 2002). See chapter 1. The limitation of state authority is historically significant: “The century after Magna Charta inaugurated the process of conceding the sanctity of property, including immunity from taxation without representation, a process carried to its conclusion in England in the struggle between Charles I and his parliaments” (at 69, emphasis added).
economic growth (and so more investments and more tax revenues for Countries) and also
Administrations to more easily focus on the breach or the non breach of the clear (on what is right
and what is wrong) enforced rules (avoiding they are same Administrations to depict the right rule
to apply, ex post transactions, at the expense of legislator).

4. **What is necessary to clarify in the text of Guidelines and why is necessary to underline
that pricing into an arm’s length range is a juridical concept (and not an economic
suggestion).**

In my opinion Legislator (and OECD in this role) must take a clear decision:

- **a)** or Guidelines enter more in details of rules to be applied suggesting (rectius: enforcing)
  only one procedure and one way of proceeding to set correct transfer prices when more
  options are in front of firms, all purportedly admitted by fiscal law
- **b)** or they leave more than one option allowed but strongly underline that a range of transfer
  prices is possible and that this is not an economic suggestion but a juridical statement!

This last point of view might seem already included in Guidelines text but I think that often this is
not complied with actually and in reality and so, given the fact what is mostly important is what
really occur and not what might occur, OECD must find more incisive way to affirm the enforced
rule also in changing some paragraphs of existing Guidelines.

I think that the most important work to be done on Guidelines text should be aimed just in
parting when is necessary to act under the above mentioned line a) (working to better specify
Guidelines text to focus clearer and binding concepts and behaviors asked to firms) and when is
necessary to act under the above mentioned line b) (specifying that more than one method allowed
to set transfer prices is a juridical mandatory statement).

5. **More details on intangible asset ownership assessment, leaving some flexibility in the
calculation of non intangible owners’ remuneration and of both intangible owners
remuneration (when both firms transact owning intangibles)**

I think that more details should be provided (previous point a)) in order to specify which is the
group entity entitled to intangible returns of the business.

While about the remuneration of non (intangible) asset owners, and of each of intangible owners
when transactions are made between associated entities owning both intangible properties, Guidelines should clearly specify which are essential rules for calculating those remunerations but underlining that when more than one option is allowed, several (i.e a range) are the legal solutions. Obviously one time the proceeding is so planned it’s not acceptable that firms are blamed and that their incomes are adjusted up to have chosen one of allowed ways; if Legislator think to have left too much freedom to firms in setting transfer prices they have duty to enter in more details of regulations, narrowing allowed options (but I think this is not the best way, I repeat, in case of non intangible asset owner remuneration and when the double intangible problem is present).

Examples may become a useful tool in reaching certainty about rules to apply in compliance with
what above projected and with required flexibility to reach mentioned goals.

The Example may become a way where Legislator is able to give some detailed instructions in order to consider as current some principles enforced in the general part of guidelines (also at expense of precision of analysis and so by making some simplifying assumptions); in this way readers of Guidelines are able to understand that if a severe analysis is possible, also given available data, conclusions follow the analysis but if available data do not allow conclusion in compliance with enforced principles (principles enforced in the general part of Guidelines) some simplified assumptions (as much as possible coherent to the general rule) allow to give a rule to specific case to be ruled; this way of “producing” rules allow to enforce predictable behaviors that when complied with by firms cannot be challenged, years later, by Administrations (similarly to safe harbours but with some peculiarities).

I repeat that the step to give more details than details already given in Guidelines could be
appropriate but it could be also appropriate to consider sufficient the details already present in
Guidelines text if a strong safeguard (of no Challenges by Administrations) to firms that have
chosen one of allowed prices would be enforced in same Guidelines text.
6. An “independent” study to monitor ALP application could allow to better understand which are concrete problems in applying Guidelines. A proposal about the study and on questions to be answered through it

To verify whether transfer prices truly comply with the arm's length principle, due to the nature of the principle and to how this economic principle has become a legal standard data are required regarding how a group of companies has “individually” organized its proper business in terms of risks assumed and assets employed by its units in various countries. No other ways are capable to reach grounded conclusions and I criticized some economic studies which have based their conclusions on data extracted by databases but that are not able to know individual groups’ division of risks among units: conclusions reached in this way are groundless in proving (or in non proving) the non compliance with the ALP by firms!

An “independent” study could be projected by Governments or OECD as part of the monitoring of the application of the OECD Guidelines, on a no-name basis (to respect the confidentiality of data of the tax Authorities and taxpayers) and with the target of improving future rules about the arm’s length principle, rather than at constituting a further appeal for resolving current litigations between firms and Administrations. This would allow a fine-tuning of the application of the arm’s length principle and a proposal of solutions to those problems. The OECD, with its highly skilled professionals, and in light of the organization’s authoritativeness, would really be the best body to carry out this proposed study. Are litigations based on intangible owner identification? Are they based on calculations about non intangible owners’ remuneration or on splitting of both intangible owners’ combined profit? Are they based on remuneration of hidden permanent establishment? Answers would give important inputs in projecting Guidelines text changes.


10 Indeed it would be important to project a study on ALP compliance through data of audited taxpayers by tax authorities and, perhaps, at the OECD level, on a no-name basis (with regard to both tax authorities and taxpayers) to be used to improve existing rules and not to constitute a further appeal on current litigations.

Here are some (humble) suggestions on hypothesis to be studied:

On comparables extracted by database, it would be interesting to know:

- How much current litigation between taxpayers and tax authorities involves comparables extracted from public databases (set 1)?
- Among this pool of litigation (set 1), which cases involve the basic assessment of setting the arm’s length price in such a way that the tax authorities have asserted that the associated tested party was not comparable to the taxpayer’s database set because it was the owner of intangibles, or bearer of entrepreneurial risks for the group business (set 1a)?
- Under the pool of litigation remaining from set 1 after the litigation from set 1a is removed (and so where the challenge is not the categorization of the associated enterprise as an enterprise not involved in entrepreneurial risks that may be compared to independent enterprises in a database), which are litigations where the two involved Administrations do not agree on same transfer price (set 1b)?

On litigations based on the concept of hidden permanent establishment:

- How much current litigation involves a hidden permanent establishment that is challenged by tax authorities such that at the outset the tax authorities of one country have imposed a massive income increase related not to activities performed locally but to sales in a host country (set 2)?
- How much litigation included in set 2 has concluded with the assessment of limited income in the hands of the hidden permanent establishment related to the actual activity performed where the tax authorities have waived an assessment of income from sales in exchange for a waiver by the taxpayer of its right to appeal against recurrence of circumstances that trigger the deemed existence of the permanent establishment (set 2a)?
7. **Specific observations on draft documents on safe harbours and intangibles**

In any case apart from the proposed study (which indeed could help a lot to focus real problems in applying Guidelines) I make some specific observations on draft documents of OECD about safe harbours and intangibles.

8. **The draft on safe harbours**

I appreciate a lot the moving of the safe harbour draft on bilateral safe harbours just because:

- I above affirmed that certainty about rule to apply is essential: on non intangible owners’ remuneration some flexibility may be kept but in any case a safe harbour on remuneration when it has been assessed that the entity is a non intangible owner is a right way to solve the problem; here precision is exchanged against simplicity and certainty and this is a good job given the nature of non intangible owner entity (low risk firm) at audit.

- I do not subscribe to words on tax planning on the draft (see i.e. para 28 11). Obviously firms may misuse provided safe harbours but when this occurs Administrations has power to stop that misuse (and this would just be their duty). Tax planning must not be perceived generally and in every case as a “bad” job; tax planning is a bad job i.e. when transfer prices do not reflect activity (risks assumed, key function staff control and so on) of the involved firms; but tax planning has also a “good” meaning when one understands the need that firms, as per any other production factor, must know in advance which is the cost deriving from their activity localization (tax rate and taxable amount may be perceived as the cost for localizing firm in a specific territory).

- What I find so appropriate is the possibility to have distribution, research and manufacturing activities included in the possible (bilateral) safe harbours on low risk firms.

- What I find also more appropriate is the protection of enterprises eligible for safe harbour against the challenge of being a permanent (hidden) permanent establishment of the foreign principal associated firm; this is a path that i.e. USA and Mexico have historically run about maquiladoras (with some specific aspects). This way of ruling is able to contrast the paradox that when enterprises are going to lower functions performed and risks assumed may become the (hidden) permanent establishment of the foreign entity; often the permanent establishment income is adjusted (here I do not call back reasons why this happens) to a value that is huge and not related to performed functions and assumed risks and this is just a paradox because the lower the risks and function are going to be performed and assumed the lower (average) remuneration (and volatility) must be; OECD Report (authorized approach) in 2008 on permanent establishment contrasts misuses of hidden permanent establishments adjustments but often this is not sufficient; paradoxically this happens to the simplest economic firm as the low risk permanent establishment. The draft in this case is particularly appreciable on certainty provided to taxpayers about the fact that when the price is correctly included in the safe harbour rule the entity may be not challenged as a permanent establishment of the foreign associated Principal.

- The drawback of this way of doing is that the bilateral safe harbour program is a voluntary program given to Countries; the bilateral safe harbours will be current only between those Countries that will do that negotiation and so the real and actual influence on the transfer pricing arena will be disclosed only when one will be able to count which Countries will adhere to the program.

9. **The interim draft on intangibles**

10. **The definitional aspect**

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11See para 28 “Enterprises may have an incentive to modify their transfer prices in order to shift taxable income to other jurisdictions. This may also possibly induce tax avoidance, to the extent that artificial arrangements are entered into for the purpose of exploiting the safe harbour provisions. For instance, as safe harbours are generally applicable to “simple” or “small” transactions, taxpayers may be tempted to break transactions up into parts to make them seem simple or small”
The draft (para 5 above all -and following) is focused on what is not an intangible (is not a physical or a financial asset); then the draft continues in specifying that one must not focus on legal or accounting definitions because the target is to match the behaviour of independent parties. Here I think that in any case the non definition is a better way than the wrong definition, maybe reached in attempting just to define.

However what I can suggest is to follow the line of the independent parties behaviour already chosen in paragraph 5, but to try to go further on. I think that the best way to give a broad definition of intangibles in this context is just to exclude what it’s not intangible (as till now this is done) but also specifying which is the model implied in Guidelines to match independent parties’ behaviour.

The notion of bottleneck input as sunk costs creating a competitive advantage for existing firms or a barrier to free entry of new firms is one of best way to give an idea of what is an “intangible” also in the transfer pricing context.

Therefore also right to use an asset as the ownership of that asset, physical or immaterial, may constitute an intangible contractually disposed; a physical asset (including goodwill of the business) too may become an intangible when is able to create a barrier to free entry of new firms and/or a competitive advantage on other existing firms and is contractually disposed; ownership, we say again, may have contractual origin (and this is recognized in the interim draft) because in certain cases when investment create externalities the property ownership factor agreed in a contract may solve the underinvestment problem and may prevent moral hazard conducts of the buyer.

This is the typical case of the distributor-marketer who without an appropriate remuneration or a reward set as a portion of the ownership of the commercial name that is trying to improve would not make marketing investment at the sole benefit of the producer. Here a spot transaction is not able to allow business (marketing of distributor) while only contractually is possible to give rules in a way to prevent moral hazard of producer at expense of distributor.

I think United Kingdom Administration (HMRC) makes reference to similar concepts, observing that it is necessary to investigate which is the implied model in the OECD Guidelines. You can see HMRC Manual on transfer pricing 12 where is affirmed that “Although the term ‘bargaining power’ is not used in the OECD Transfer Pricing Guidelines the concept is implicit in references to relative bargaining and competitive positions, for example at 1.30 and 3.19” (emphasis added).

The model implying the assumption of specific risk pertaining to the single enterprise (multinational)13 that in a case of positive development of the investments become an intangible, in term of a bottleneck input granting a competitive advantage will be dealt with also further on.

11.Identifying intangibles
From para 13 to 26 analysis is dealt with in saying what may constitute intangibles and what may not; I agree with the great part of analysis; but I think conclusions of this part depend many times to facts and circumstances while solutions of what may constitute or may not constitute an intangible could be better dealt with by reference to the economic model implied in guidelines that I above mentioned.

12. The economic model implied in para 26 and 37?
I refer to Hines economic model14 when the arm’s length principle is complied with by assigning:

12. Available at [www.hmrc.gov.uk/manuals/intmanual/INTM467085.htm](http://www.hmrc.gov.uk/manuals/intmanual/INTM467085.htm)

13. Specific risk pertaining to the multinational at focus are depicted in contrast to generic functions assuming risk available on the (functional) market.

14. J. Hines, *The Transfer Pricing Problem: Where the Profits Are*, NBER Working Paper w3538 (December 1990), at 26, available at [http://ssrn.com/abstract=226838](http://ssrn.com/abstract=226838). When intangibles are developed not simultaneously but rather in sequence, the rule is not appropriate because connecting costs, when they have been invested at different times, would not allow an appropriate consideration of the different degrees of their risks.
- anything more than a “normal” economic return \(^{15}\) to those affiliates that do not participate in risks (hereinafter also named entrepreneurial risks) that generate potential extra profits or losses.

- extra profits or losses (that remains from global results of the whole group after having assigned normal returns as above) have to be parted on location base costs (and on related affiliates) share assuming entrepreneurial risks.

I think that para 26 and para 37 correctly refer to functions, asset and risks and are affected (consciously or not) by the above mentioned economic model in identifying intangible owners (extra profit or loss collectors of the whole business); nor are the arrangements or the formal registrations of patents or trademarks, that may change this perspective related to real activity performed!

This is an appropriate point of view that (as specified in the draft) must be coordinated with chapter IX of Guidelines instruction where key relevant staff is requested to assess that certain risks are assumed by an entity.

### 13. Contract marketer

Para 50 let’s one understands that marketing is not a special function \(\textit{per se}\), and so when risks of marketing investments are assumed by another enterprise on respect of that performing marketing activity also marketer is a contract marketer (like contract manufacturer) performing a service for a Principal.

This is nothing new but I well know how marketing distributors have been object of challenges by Administrations and so I will make specific consideration especially about following marketing examples (in special mode example 3).

### 14. Difference between use and transfer of intangibles

I subscribe to para from 59 to 75 illustrating what is using and what is transferring intangibles.

- **Comparability analysis: group interest vs single associated firms’ interest?**

Para 81 and following, and example 19, deal with some issues raised in the business restructuring part of Guidelines (chapter IX). Here the general problem is about the options realistically available to firms. It would be too long for the comment by my side to re consider some observation made to that part of Guidelines some years ago\(^{16}\). What Legislator might not do, in my opinion, is presenting the group interest as an interest contrasting with interests of single associated firms; single business units do integrated business in view of reaching advantages that in a sole interest

Entrepreneurial risk is the risk that when all inputs are combined together by the global firm the final result of the same firm is a profit or a loss.

For a summary of the Hines model in diagram form, see A. Musselli and A.C. Musselli, \textit{The Arm’s Length Standard in Multinationals’ Taxation}, Tax Plan. Int'l Transfer Pricing, BNA International (October 2007), at 5. Chapter IX of the \textit{OECD Guidelines} seeks a further requirement that tax administrations accept a risk allocation as it is decided by group entities ("in the absence of comparables evidencing the consistency with the arm's length principle of the risk allocation in a controlled transaction, the examination of which party has greater control over the risk can be a relevant factor to assist in the determination of whether a similar risk allocation would have been agreed between independent parties in comparable circumstances. In such situations, if risks are allocated to the party to the controlled transaction that has relatively less control over them, the tax administration may decide to challenge the arm’s length nature of such risk allocation").


\(^{16}\) If one is patient could look at, Musselli A, Musselli A.C., Observations on OECD Discussion Draft on Business Restructuring: Is the Notion of Control over Risk at Arm’s Length?, \textit{INTERNATIONAL TRANSFER PRICING JOURNAL}, IBFD, JULY/AUGUST 2009, at 239, and to Musselli A, the comments at the OECD draft posted at http://www.oecd.org/tax/transferpricing/42266748.pdf
point of view of the business they could not reach; the consequence is also that they could suffer losses too for similar arguments (when investments reveal unsuccessfully). Delicate problems rises when one gives the power to Governments to interpret which is the “commercially rational manner” to manage a private business, granting a power to same Governments to not recognize some business operations considered not commercially rational. This is not the place to reconsider those issues while I would like to make specific observations further on example 19 (see following point).

16. Arm's length conditions in cases involving intangibles

I agree with what affirmed in para from 87 to 89: here is a suggestion to Administrations and firms to not rejecting comparables when it’s not clear that they use different intangibles; the draft makes example that also independent distributors (included in a sample of comparables) may have commercial contacts with clients as could have the associated tested party. Here is at focus the problem of information which are available i.e. by using commercial database which are not able to provide so detailed data. The reasonable argumentation is that one can imagine (suppose) that also comparables have the same level of “expertise” about customers like tested party distributor has and so that only when there is a clear evidence they have not such an expertise, he is allowed to reject that comparison. This is a prescription (suggestion?) included in a discursive part of the draft that if well interpreted could give really more certainty to taxpayers (and Administrations too) giving a sort of shift of burden of proof about comparables rejection. I fear that if this suggestion is not enlarged in a general issue about the flexibility of more options allowed (as I mentioned more times above) will not have power to stop or limit litigations.

17. Comparability of intangibles

These parts of the draft relate to economic concepts and are of good sense: nothing new. Novelty is the discourage about royalty rates (external CUP) extracted from databases and about possibility to know all information previously listed in the draft to effectively conduct a comparability analysis. Discouraging may not be intended as a juridical ban to use external comparables on royalty rates but better as sort of shift of burden of proof for that when it’s taxpayer that uses these tools he must evidence that the comparison is appropriate.

In any case also this passage of the draft is a further step about certainty of rules to be applied.

18. Use of valuation techniques

Here is a novelty but I ask particular attention to this issue. I personally well know how is complicated, and on certain point of view subjective, to valuate business and assets with Discounted cash flow techniques (DCF- and other similar). I have used this type of valuations during my professional life having been concrete valuation studies on real firms and so having been included on Milan Judicial Authority register of expert also on field of “valuation of firms”.

I well know that there are a lot of issues in applying a valuation technique which may be due to a subjective choice of the estimator expert. It’s also obvious that this last has the duty to give and to explicitly explain reasons of his choices. These concerns are included in the draft:

149. When applying valuation techniques, it is important to recognise that the estimates of value based on such techniques can be highly volatile. Small changes in one or another of the assumptions underlyng the valuation model or in one or more of the valuation parameters can lead to extreme swings in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

The draft give some suggestions on how reducing drawbacks:
151. Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm’s length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

In my opinion the point of view chosen in the draft is the one underlined in the best and most authoritative economic perspective but that will be not sufficient to avoid litigations between firms and Administrations and between Administrations of various Countries. The draft must be aimed in reducing litigations and this opening to valuation techniques, if strong legal safeguards for users are not built, may turn to enhance litigations and not to reduce them.

I call back considerations I made at the opening of this paper:

In my opinion Legislator (and OECD in this role) must take a clear decision:

a) or Guidelines enter more in details of rules to be applied suggesting (rectius: enforcing) only one correct procedure and one way of proceeding to set correct transfer prices when more options are in front of firms (and Administrations)

b) or they leave more than one option allowed but strongly underline that a range of transfer prices is possible and that this is not an economic suggestion but a juridical statement.

DCF is a process where a final number (the result of valuation) comes out then a lot of assumptions and arguments by the estimator are made. Firms set transfer prices and then Administrations audit them: only when it is allowed a sort of flexibility of results (a range as Guidelines affirm) all to be considered as in compliance with ALP it’s suitable to quote DCF in the Guidelines, while if this is not actually granted the novelty may be counterproductive on respect to the target to have more certainty about the right rule to apply.

In any case when assumptions are made by estimator it must not be allowed to disregard them using information not available at estimation time (hindsight17), because if this is allowed litigations are sure consequence.

On respect of specific aspects of DCF use in transfer pricing valuation I find appropriate to explain cases when this “technique” may be used.

For example a cost valuation about intangible is generally discouraged (para 112 value has no link to costs).

But the cost evaluation has a sense when the intangible is easily to be replaced (para 113). In my opinion it could be appropriate to link more strictly also such a type of valuation to the model of assessing arm’s length condition implied in Guidelines and to link also such a valuation to level of information about business profitability available to operators at valuation moment.

I allude to argument I developed in 2005 at OECD Paris Business restructuring roundtable where I wrote about the possibility to compensate the going to be stripped of functions firms:

- When strategy [ ndr here the meaning of strategy is about the knowledge – or the non knowledge- of future results deriving from investments carried out previously by the “going to lose “function operator and is not used in the sense of the term used i.e. in Guidelines ] is still uncertain a fully fledged operator and its foreign commitment are indifferent to turn the old contract into a

17 Ban of hindsight is already included in Guidelines text but it is not sufficient to avoid, actually and effectively, drawbacks as those I mentioned......

18 The previous part of the sentence means that “when a fully fledged operator (who is going to lose function- that is, is going to sell activities) is still not aware about actual results of its investments and is managing business in a competitive market .......
relationship between a foreign Principal and a low risk operator, like if this relationship would be agreed from the beginning. So the “turned”, now low risk, operator is entitled (eventually by a foreign producer payment) to cover costs of its past investments plus a mark-up similar to that gained, in the free market, by comparable low risk operators. Independent parties would have insisted, ex ante, for a so designed termination clause, before of carrying on transactions and investments

19. Valuation when using and when transferring intangibles
I agree with the choice to further divide both parts of the draft in a) when comparables are available and b) when comparables are not available. This is just coherent with the sense of existing guidelines.
I think further detail might be developed in examples about how comparables are extracted and managed.
I well know that this task is already explained in the “general parts” of Guidelines, but I think that more details might be provided in examples parting when comparables are based on complete contracts with independent parties (i.e. internal cup with all clauses, on marketing, product guarantee and so on) and when comparables are based on PLIs (profit level indicators) of independent companies extracted by databases (and as everybody know currently the majority of cases—or a great part- are solved in such a way). My point of view will be clearer when discussing about examples where I will develop the argument. I will discuss just there about normal versus abnormal marketer in relation to the fact of having or non having comparable arrangements and prices and so eventually having necessity to make profit comparisons.

20. Profit split is eligible when comparables are not available and valuation techniques (financial valuation) may support a profit split.
Here we are in a very “subjective” world where many prices (and processes to arrive to prices) may be considered at arm’s length; also the economic model (I named Hines model) I referred above may not give so definite solutions.

“Where one intangible is already developed and another is going to be developed, it is not permissible to use shared costs of developing both intangibles to split integrated results, as it is necessary to assign a value to the former related to the latter, based on market values and not based on development costs. In any case, no uncertainty is acceptable with regard to the arm’s length principle from a legislative perspective; more clear rules need to be promulgated by legislators regarding behaviour requested of taxpayers. Otherwise, the discretionary authority of taxpayers cannot be blamed and considered a breach of the arm’s length principle, as determined in the legal standard

But here it is strongly necessary that OECD legislator gives its proper sense to the nature of fiscal regulations that guidelines must have: Guidelines are not an economic handbook but a fiscal regulation and so I see in their front the usual (and more times called back in this paper) alternative in front of legislators to grant certainty about the rule of law. OECD Guidelines could decide to enter in more details enforcing binding and (detailed) processes to calculate arm’s length pricing; or, as in the case I am commenting, Guidelines may leave more flexibility for taxpayers to choose the mentioned measurements, clearly allowing for more results to be regarded as legally acceptable arm’s length pricing.

19 See A. Musselli, Comments about “stripping of functions” issues, edited in 2005 at OECD website as a comment to roundtable on business restructuring and transfer pricing aspects. Time of investment, information available at that time (and the ban of Guidelines to use hindsight) are fundamental to assess the degree of risk of that investment.

20 This is what I write (before of knowing the text of the OECD draft on intangibles) in a forthcoming article to be published on International Transfer pricing Journal edited by IBFD.

21 So also the para 147 of the draft
Also in this case, a clear decision on the text of the regulations is to be taken as a matter of legislative policy so that eventual residual litigation, concerning only facts and circumstances, will be left to judicial authorities.

It is no longer acceptable for companies and tax authorities to quote the OECD Guidelines regarding the assertion that “transfer pricing is not an exact science” in order to justify “everything and its opposite” as regards arm’s length pricing. Indeed, this state of affairs could even exist in the field of economic theory surrounding the arm’s length principle, but must not exist in the field of tax regulations because it has a worse economic effect in the latter case (because of the uncertainty it creates for investors). Uncertainty surrounding the legal application of the arm’s length principle cannot be the aim of prudent legislators (and the OECD is certainly one of them) because a law must regulate a matter so as to encourage logical behaviour in economic parties that seek to comply with that law, and in a way that such behaviour can be audited by tax authorities (and judicial authorities).

If the arm's length principle is applied so as to create uncertainty for businesses (and for tax authorities in auditing the activities of businesses) the supremacy under unitary rules of splitting a multinational business result is certainly lost.

21. Valuation of intangibles when income from use is uncertain;

This issue is the so called and well note problem of periodic adjustment (under the US experience). I agree with projected rules but I fear they are not able to solve with effectiveness real cases. Considering examples 20 -21 and 22 the solutions are clearly already included in presented facts and I subscribe those solutions.

In fact the pharmaceutical cases there depicted with the royalty rate prefixed for long time when is already known high profitability of the intangible and difficulties in understanding real income flows deriving from use (but with high profitability sure) and with a comparison with industry standard of “eccentricity” of a so prefixed royalty rate for long time, ask for an Administration adjustment.

The absolute unpredictable event of example 21, indeed, doesn’t allow an Administration adjustment.

It could be targeted to grant more certainty to taxpayers in explaining what Legislator require in other cases.

I propose one of them.

Another point to bear in mind concerns the possibility of incurring marketing expenses in fragmented amounts so as to limit the amount at risk connected to these last expenses, allowing the resolution of uncertainties related to demand before making relevant amounts of marketing investments. Examples proposed in the draft seem to me to under evaluate the importance of intangibles already current on production side when the distributor is going to start his duties..

22 This is what I write in a forthcoming paper, see one of previous footnote. The difficulties involved in OECD work are well known, as before the OECD can have its own position there must be consent of Member countries (and this is often not a simple affair).

23 This behavior is confirmed by empirical studies on the economics of real multinational enterprises. See thesis of I. Horstmann and J. Markusen, Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise, 37 Int'l Econ. Rev.1 (1996) (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market).
For example\textsuperscript{24}, one may consider that when a pharmaceutical active ingredient has become a patented drug, the degree of risk for the business is drastically changed from the time when there was no conception of that active ingredient and some research expenses were incurred just to discover that ingredient.\textsuperscript{25} In this case, the value of patented drug is not related to the discovery costs, but to the profit arising from future business. Also when there is uncertainty surrounding the integrated business results (including distribution and marketing activities), that uncertainty may be resolved in the future with marketing costs at risk in fragmented amounts so as to be recovered over time and ultimately permitting an understanding (without assuming new relevant risks) of the actual value of the drug.\textsuperscript{26}

In these cases business may be managed reducing amount of marketing investment at risk and so agreement with distributors, enforced for long periods of time and setting prefixed conditions, are to be considered unusual......

22. Examples

Now I come to comment the most interesting part of the draft on examples, where I focused my attention.

23. Example 1

I agree with example facts and conclusion.

24. Example 2

I agree with conclusions but I think that facts and arguments to come to conclusions should be improved to have an example proper for more complicated and general cases.

It’s not explained how it has been calculated the arm’s length return for S; if a comparison with independent prices (internal cup?) has been done for calculating the intercompany prices it’s the analysis of that prices with other conditions of contracts that doesn’t match with intercompany conditions; Auditors (and firm before) should have possibility to check that in independent contract the costs of recall of the product are costs to be assumed by Primero (producer of the drug) and not by S (distributor at limited risk); the contract would have shown that a cover for costs of recall of product would have been addressed to Primero. But what is if the independent contract where it was extracted the price to be considered as arm’s length price was agreed with liability of recall assumed by S (and so the price was adjusted for that guarantee)?

Indeed the example is built on these assumptions: given S a limited risk distributor – given arm’s length return for limited risks – given substantial costs for recall – (ergo) therefore the Administration adjustment is on price to be lowered in reason of liability to be assumed by S or on costs of recall of the product to be charged by S to Primero.

The problems of the example are more extensive when we suppose that the arm’s length return for S is calculated (as the most part of cases at now days) with a net profit return; here the costs for liability are already included in the net profit and so the return of S is not affected by recall costs because the greater are the operating expenses, given the fact operating profit is prefixed, the lower the intercompany purchase costs become.

I well understand that an example should involve the maximum of possible cases (and so without giving information about how is calculated the arm’s length return for S may involve a lot of cases

\textsuperscript{24} This is what I write (before of knowing the text of the OECD draft on intangibles) in a forthcoming (november – december 2012 issue) article to be published on International Transfer pricing Journal edited by IBFD

\textsuperscript{25} J. Hejazi, \textit{Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?}, 13 Int’l Transfer Pricing J. 1 (2006), at 8 (observing that in recent years with the explosion of generic drugs, one sees the “erosion of patent protection [that] increases the level of risk bearing on the R&D function”).

\textsuperscript{26} This type of analysis was applied to the US Glaxo case in, A. Musselli and D. Marchetti Hunter, Glaxo \textit{Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues}, 14 Int’l Transfer Pricing J. 3 (2007), at 165, Journals IBFD supra n 32.
where this return has been calculated with different methods) but this way of producing examples has the great risk that misunderstand can source.
I think that more detailed information on facts and on how it has been calculated the arm’s length return for S should be provided.

Here are now the examples on marketing.

25. **Example 3, starting marketing examples: the agent distributor**

In example 3 the price for the watch is complying with ALP (by independent comparables) and gives compensation for selling and distribution activities of S.
The marketing expenses of S (distributor) take the form of a service of S (distributor) to Primair (producer) and so there is a fee which covers cost and allow an appropriate profit (extracted from comparable independent marketing agents).
The conclusion is for no challenge allowed to intercompany transactions.
I agree with conclusion but I would like more explications also on other frequent cases because the conclusion is implied by making assumptions that are not so frequent that one is able to meet in real cases: the example assumptions are two: the fact that is possible to conclude that the purchase price is at arm’s length by comparables and the fact that the purchase price may be analyzed separately from the advertising service performed by S.
This type of analysis is certainly possible when an uncontrolled comparable price for R watches is available (internal cup) but may present difficulties when that is not available.
In reason of assumptions the example comes to correct conclusions.
But now I come to deal with other frequent cases to be ruled.
I allude to necessity to rule also cases to be solved through profit comparisons when it’s not so easy to distinguish in comparable distributor sample (i.e. when extracted by commercial databases) the type of marketing are performing the distributors included in that sample.
In fact it’s not easy to understand in extracted companies from databases the operating expenses volume and it’s near impossible to have access to contracts eventually regulating marketing activity.
What is about a net margin extracted from a such a type of comparable sample but that (for its nature) is going to cover all operating expenses of the associated entity (S) - distributor?
The real problem in this case is that the profit margin would be a single profit margin (applied to the full amount of operating expenses = distribution costs and other operating expenses + marketing expenses, while in the example all operating expenses are covered and it’s allowed a margin for distributor but the margin of marketing expenses may be different from that of distribution activities).
Here is another dilemma in fiscal regulation: the analysis may be not perfect due to constraints in having perfect information on independent comparables but in giving anyway a “right” rule in the example (by regulating in such a way I do the audited transaction) the OECD would give certainty of taxation to firms and Administrations when easy “perfect” solutions are not at sight; in this way OECD would avoid that the real rule to apply to this case will be developed ex post transaction at eventual litigation moment by Judges (and one well knows what a variety of situations include this term in mentioned contexts - Countries’ judicial Authorities, Competent Authorities under international Treaties and so on).
I think that with regard to ex post transactions, during a tax audit carried out years after the commencement of distribution activities, the tax authorities might have a clear way to assess if the ALP has been breached or not in similar cases.
When a normal net profit return (maybe tested to what is gained by independent distributors) has been left in the hands of the distributor for each audited period, the Administrations have an incontrovertible evidence that marketing expenses (if any have been assumed) have been borne not at the risk of the distributor. This assessment becomes an (historical) question of fact.
In this case, the actual conduct of the parties prevails over any (even written) agreement.
Transfer prices are in ALP compliance because the normal return on activity under a distribution contract was appropriate in any case, i.e. – in case a marketing activity was unnecessary or non at risk (because the name was already well known) or in case a risky marketing activity was appropriate but by a choice of group it was not performed at distributor risk.

If and well applied I think that this assessment could stop a lot of litigations.

It’s totally irrelevant in the example the circumstance that at the end of marketing period the name R of marketed watches by S becomes well known; the fact that the name becomes well known may induce misunderstanding because the remuneration of S might not change also if after marketing the name R remains “unknown” (given the fact S is a limited risk distributor); Legislator should specify that if returns from intangibles are attributable to P in case of successfully marketing those returns (in a lower measure maybe to reach a business loss) are specularly attributable to P in case of unsuccessfully marketing.

26. Example 4: the distributor normal marketer and its remuneration

Here S is marketer at his own risk: the example is built with an assumption on slim margins of S and high operating expenses (marketing costs) on first activity period.

This is one of central examples to explain the rule about distributors.

The final conclusion is that S is entitled to a portion (with another portion for Primair – the producer) of the returns granted by trade name R, which was unknown at the beginning of distribution activity while has become well known due to marketing expenses assumed by S.

It’s not clear till the end of the example how transfer price of watches has been set.

It’s specified that the price is lower than in example 3 (but in this case that price is going to recover part of marketing expenses......) and that different criteria are used for identifying comparables here than in example 3.

The bulk of analysis could seem that S gains slim margins and assumes high operating expenses (before of good exploitation of the name).

But at the end of the example it’s affirmed that “information on comparable uncontrolled arrangements suggests that the return earned by company S provides it with the arm’s length return for its functions, risks, costs and its resulting entitlement to intangible returns”. This seems to be the best tool to give a solution to facts of the example: the firm is able to make comparisons with arrangements between independent parties.

Now I am able to understand that firms and auditors had comparable uncontrolled arrangements to give support at analysis; are they making internal comparisons?

In any case when I have these arrangements and I think that transactions are really comparable (with adjustments or not) to those at audit (this is the bulk of the assessment) I have prices and other clauses about rights and duties of parties included marketing activity (i.e. I have clause on liabilities for guarantee on products and so on). The independent arrangements rule out also about the consequences of such a marketing activity performed by S and so about the proper entitlement to a portion of returns attributable to development of R name (or on an appropriate return for development). Obligations and rights of the contract are all and clearly disclosed in independent arrangements: a distributor is not going to invest in marketing (at the benefit of name owner) if he has not agreed his remuneration under all circumstances (present and future); i.e. distributor would agree with producer what type of investment would do, which type of purchase price would be set at present and in the future for reselling goods in a way would have a chance to recover investment done (but also having possibility to lose investment put at risk......), terms of life of the contract and possible termination clauses.....

Existing independent arrangements could be the base, with eventual adjustments for differences, in planning the intragroup transaction.

In any case the slim margins and high operating expenses are not the bulk of analysis of the example and the driver for conclusion because they seem a consequence of applying rules of the

27 note the verb to seem because this is not what it is in reality about the existence of comparable uncontrolled arrangements
independent arrangements to the activity of S in first years of business when the R name was not known in target market.

I think that the example could try to further rule the issue with projecting how it’s possible to give instruction when comparable independent arrangements are not available. This could really be a step forward in giving certainty to Taxpayers and Administrations because a lot of current litigations are about the role of the distributor and the “correct” amount of marketing expenses and comparable independent arrangements are not available.

Therefore I have to start with a new hypothesis: independent arrangements are not available.

It’s time of depicting the marketer at his own interest with profit comparison, maybe with data extracted by public databases.

The problems are several in this case but here are welcome some simplifications, to be paid as lower “perfection” of solutions, that may give further guidance and certainty to Taxpayers and Administrations.

The bulk of analysis must be how to characterize and detail a marketer distributor which is going to invest at risk some of his proper capital and so is entitled to a portion of return generated by successfully development of the name while has possibility to recover a loss when and if the development reveals unsuccessfully.

The role of the marketer at his own risk by S necessarily implies a recognition of marketing expenses that must be classified as risky expenses for that slim distributor margins are reached for first years of activity in comparison of a non marketer distributor; obviously a slim margin of the associated distributor is due to three different aspects:

a) a comparison with normal margins of independent reselling distributors
b) a setting of intragroup transfer price for goods to be resold
c) a given level of marketing expenses included in operating expenses of associated distributor.

I analyze the three aspects of this first period of life of an hypothetical arm’s length agreement.

a) The normal margin of a distributor (for reselling distribution activities).

When I search comparable distributors from databases usually data show actual figures included in the balance sheet and in profit and loss but do not show contracts between parties where are agreed clauses related to events that are supposed to set, if any, volatility of possible results.

First I can try to select firms with a low level of marketing expenses and activities.

Here I could have a range and a mean (or average) of distributor net profit margin to be considered appropriate for selling activities.

The slim margin of the associated entity is just by comparison with the profit of the independent mere reselling distributors.

b) The purchase price of goods to be resold is a transfer price and causes how the distributor margin is slim in comparison with normal above mentioned

c) The level of marketing is the factor that I focus in operating expenses that causes (among others) a slim margin of the associated entity as above mentioned

The contract with such a starting period is in compliance with ALP if it is built in a way that is sufficiently long to have a second time of life where it’s possible to test if marketing revealed successfully or unsuccessfully and to provide consequences.

In the case the marketing revealed successfully I must check that distributor margins are higher than margin of selling distributors (as those above mentioned extracted by databases).

This may happen in various ways; or by a change in purchase price of goods to be resold, or by a lowering of advertising costs per unit, or by a rise of returns by reselling activities and to be considered attributable to distributor (or in other ways like the attribution of a portion of name ownership ...); the effect of all or one of this factor is clearly a rise on net margin of associated distributor.

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28 It is evident that I focus only some aspects of economics of the distributor because the slim margin could be due also just to inefficiency of his proper managing the business.
The marketing may reveal unsuccessfully and so the lower distributor margin (or the loss) for past years cannot be recovered.

Here comes the problem that when there is not chance to recover loss with future activity that activity must even cease.

The agreement between independent parties would rule all these aspects in a sole moment, before of starting distribution and marketing by distributor.

But here we have not an independent agreement as a benchmark.

Therefore I must try a way to assess when the marketing is successfully developed and when is unsuccessfully developed; this aspect is not ruled in the example while it’s important to have guidance also on that; I think a line between successfully and unsuccessfully development may be drawn only having data on the full line of integrated business and so knowing combined results (profits or losses) coming from producing and selling goods in the distributor market.

In this way I could test if marketing costs (as all other costs) have been covered and in what extent by combined activity of producer and distributor (successfully marketing) or if losses (unsuccessfully marketing investment) were generated.

Also a temporal line must be drawn in connection with the time when marketing expenses may reveal a success or a failure (i.e. in the example the time is 3 years).

Now I can build a complete contract with the last assumption (i.e. 50% 30) about the degree of probability of success or of failure of mentioned marketing.

The contract enforces that if marketing revealed successfully the distributor, in the second period of the contract, could gain an extra profit mirroring difference, in positive (plus a premium on risk) between slim margins (or losses) and margins from mere reselling activity; if marketing revealed unsuccessfully, in the second period, the distributor margin must be aligned to reselling distribution activity (or with combined activity not profitable the activity may be ceased for a producer decision), without possibility for distributor the covering of past investment with extra profits.

I think that without further guidance taxpayers and Administrations would litigate a lot in depicting the normal versus abnormal marketer when a comparable contract was not available and so when transfer prices would be set only with data extracted by public databases and with profit comparison methods (the most of cases actually dealt with by Taxpayers and Administrations...).

I drafted some concepts but others could be projected: what is important is that in a so delicate context regulations goes further more in detailing what is asked to firms to do and in a way it’s clear what Administrations have to audit then Taxpayers have set prices, in the spirit that when what is right and what is wrong is clearly depicted to avoid litigations (and to solve them by Judges) will be easier.

27. Example 5: the abnormal marketer; how to test abnormality when comparable arrangements are not available?

The facts are those of example four but the level of marketing performed by S is excessive (here is the role of abnormal marketer).

Also here the first issue is to disclose how data have been obtained and which data allow to conclude that “the comparability analysis (that) identifies several uncontrolled companies engaged

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29 There is only the affirmation that the name becomes well known
30 Obviously if 30% was assumed the results is going to change; this is why, as I called back many times in the paper, Guidelines must specify that reasonable assumptions cannot be neglected by Administrations; see specifically what I observed on introduction of valuation techniques and DCF calculation in the Guidelines
31 The greater the difference between slim margin and normal margin is the greater the premium must be.
32 i.e. where I am able to select comparable distributors performing marketing activity at their own risk I could consider results in the low boundaries of a range as marketer in the first stage and results in the high boundaries of the range as successfully marketing distributors.
in similar marketing and distribution functions under similar long term marketing and distribution arrangements”.

I understand that is possible to identifies companies but also distribution arrangements. More, I am able to compare the marketing of S with marketing of comparables having possibility to conclude that marketing expenses of S far exceed those incurred by comparables (abnormal marketer).

It’s not called that at a certain moment the R name becomes well known but calling facts as in example 4 also this fact should be implied. As a consequence marketing expenses beyond what independent enterprises would assume with similar rights at their own benefit determine significantly lower profits for S than such independent enterprises.

Abnormal marketer is depicted in reason of lower profits due to set transfer prices in connection to higher, than comparables, operating expenses and without appropriate future projected or possible returns in comparison with set conditions in independent similar arrangements.

Then Administration in auditing S (the one who has interest to do so) is allowed to make some upward adjustments to income of S through different ways (reducing transfer prices or splitting residual profit from brand S or directly compensating S for marketing).

I think that example is similar to example 4 but without “happy ending” for S. Therefore I think that considerations I made for example 4 are recallable.

In particular OECD could go further on in analysis, by separating cases where comparable independent contracts are available from cases where more assumptions might be done (profit comparison and databases data), in order to build an arm’s length distributorship agreement.

In any case I have a concern related to the great importance OECD is giving to distributor role that is going to lower importance of producer in the integrated business.

I think OECD might run also another (further) step (perhaps with a new example) where it is not appropriate to refer only to the distributor’s activity when determining an appropriate transfer price.

OECD must give a pattern about how to value marketing intangibles (when some authors even consider they do not exist!) in the context of an integrated business for that without a valuable product, marketing can do nothing (or, that is the same thing “marketing is a routinary activity, aimed only to inform customers about product features”).

The starting point must be an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated business): one estimator is faced with an eventual marketing intangible to be developed by distributor that must be connected to the intangibles developed on the production side. This must be a clear pattern, able to divide cases when it is sufficient to look at the sole distributor side to project a remuneration rule and when this is not correct. Concepts to build such a rule are identifiable in assessing that when marketing costs are put at risk, many times, valuable bottleneck inputs have been created on production side just because, usually, marketing is performed at the end of whole investment process and when the market value of the output is going to be disclosed.

Profits, in an integrated business, is generated by the fact that resources are to be committed before of having information about output value and so when time for having disclosed the output value is short (marketing at the end of investment process) most of risks are over.

Here more than one economic pattern may consent to assess arm’s length conditions and time of investments, I repeat, time (time of investment on the production side versus time of making a marketing investment) is an important factor when evaluating the different degrees of investment risk. At the end of the investment process the market value of the output is disclosed (or near to be

33 See Hines quoted supra at note 14

34 Please consider that I use the term risk in the sense given by economics and so the fact that a risk is over means (simplifying) that a single result is possible (now near to be actual), that may be positive result (a profit) but also a negative result (a loss).
disclosed) and so when marketing costs are put at risk, many times, valuable bottleneck inputs have been created on production side.....

I think one of examples might be targeted to reaffirm these principles maybe at expense of losing a sort of perfection of the analysis. In any case the most part of level of analysis is developed now days, in real transfer pricing cases, with imperfect data like those extracted by databases.

Now I come back to conclusion of example 5: the example concludes (between allowed options) about a profit split and this is a correct solution; example gives the power to Administration of Country Y to adjust the income of $ under profit split method, but without other details as I wished.

28. When distributor cannot develop marketing intangibles cause marketing has no risk in reason of choices of group management in exploring a new market; the challenges of Administrations charged to tax producers: absence of examples

Another problem to be dealt with to give certainty for distributorship is to complete regulations in a way to rule totality of cases. In my opinion till now it’s not dealt with the case where no marketing intangibles can be developed and I refer to a necessary link between what is considered periodic adjustment in other part of Guidelines and the starting point of distribution examples. Is fiscal regulation over evaluating the role of marketing intangibles in an integrated business?

I am going to express my opinion.

I consider the distributor saga:

• Example 3 is about distributor marketer agent; here the name of producer is not well known but the distributor will not become intangible (name) owner cause marketing is not at his risk
• Example 4 is like example 3, and distributor is partly intangible owner
• Example 5 is like example 4 and distributor, given excessive marketing and “poor” related returns, has not been adequately remunerated.

But what is about the case where the producer is going to market (also when the name is not known before) a product that has a so important value that marketing expenses are not risky expenses (and so there is any marketing intangible that can be developed)?

I allude also to cases where valuable patents are in the hands of producers........

Consider what some empirical studies underline about multinationals and the development of new markets: companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market

If I deal with this case in fiscal regulation I am going to think to a sort of periodic adjustment, and so to the necessity that producer and distributor must agree short term contract in order that Licensor (producer) is allowed to capture all extra profits which were not projectable at the first moment in entering the new market, but that are going to be projectable when licensee – distributor “explores” a new market without assuming marketing risks.

In this case the sole arm’s length contract is the one where distributor is going to assume the role of normal distributor (rectius: marketer agent distributor where risk are not current for the whole integrated business).

In this case, usually, the Administration interested to deal with the problem would be the one charged to tax the foreign producer while all examples are targeted to focus adjustments that will be done by Administration charged to tax the distributor.

I made some considerations above at point 21.

The starting point of such an analysis must be the detection of the situation when real risks are in front of integrated business and when they are not in front (also in reason of the behaviors of

group managers in exploring the new market) so to understand if marketing really presents risks.

Also here if one example (and I think that OECD should project that) is made it must be done in a way to give certainty to Firms and Administrations.

29. The distributor role and paragraph 2.73 of Guidelines: a further example on unique factor causing profit or loss; using net profit level indicator frustrates the relevance of functional risks assumed by tested group entities

I think it could be interesting to project a further example about distributor and for specifying a frequent situation that could recur into para 2.73 of existing guidelines (it could be addressed also in other parts of guidelines). It’s newly the case of profit comparison (TNMM) and what could be interesting would be to rule the case when I am going to reward a distributor with profit comparison and I use a PLI with net profit (margin).

I can extract a sample of independent distributors similar to the associated one having opportunity to build a range and a mean (average) of arm’s length net profit. Is S, the associate distributor, allowed to gain a “positive” profit in any circumstance?

Consider that, S, has an important client going to bankruptcy.

Net profit of the sample is already affected by losses on accounts receivable.

But S is able to show:

a) That account receivable/sales ratio of the sample as an average, was not so different from the one of S (obviously I must have available data to allow such a comparison – here I must argue similarly as for abnormal marketer)

b) The losses on account receivable (credit losses/receivables ratio) of the sample was as an average so much lower than the one experienced by S including the loss due to mentioned bankruptcy

c) S was responsible with appropriate staff of credit policy to clients of managing the credit risk.

In this case the difference between real credit losses experienced by S and losses that S would have suffered if it had reached a ratio –credit losses/receivable– as the one of independent firms produces a cost that may affect the net profit (of S) over what is the comparable net profit of the sample. Obviously the reverse case would be if a unique factor of profitability would have affected S business.

I think that a so projected example could enrich the distributor examples of guidelines enriching the distributor’s saga and giving more certainty to Taxpayers and Administrations.

A further work of OECD (this is a too long task for these notes) should be targeted in asking that in intragroup contracts the risks are assumed as independent operators really would do while currently net profit level processes tend to give to group operators a normal profit in any circumstance; with reference to net profit the group operators are not affected by risks really assumed by independent parties in their proper business. Considering the example that I proposed, with a net profit indicator the abnormal loss on credit is automatically attributed to producer and not to distributor: this may be correct only if a contract provides so (before of knowing if a real abnormal loss will become an actual fact) and key people of the producer have managed credit risks of distributor customers. In other words: the fact that some risks at arm’s length are assumed by the tested group entity (also when risks are pertinent to performed function but in any case are proper of the single group business) is practically frustrated when net profit level indicators (especially when they are means or averages) are used. Indeed also group operators which are functionally comparable to limited risk independent firms may assume some proper risks by a choice (and an agreement) that must be evident before the fact setting the risk happens.

36 Please see what I think is the appropriate role of examples in the Guidelines context at point 5

37 Here some assumptions must due to the fact that the net profit mean (or range) of comparables already includes a mean (or a range) of risks assumed by those operators….. but that the fact resulting in a risk for the group operator when happens may cause further effects on his profit and loss.
Para 2.73 of OECD Guidelines does not give the proper relevance to this case which (seems totally due to judgment of firms while) is so important about ALP. This would really close more net profit level indicators legal processes with the economic principle and obviously also here it would be necessary to create rules with would allow certainty about requested behaviors to be applied.

Now I resume a lot my observations

30. Example 6
I agree with facts and conclusions.

31. Example 7
I agree with fact and conclusions. I only observe that conclusion are generally drawn on royalties not appropriate in case of obtaining only the right to use the name but what might result from the example is that it’s the reward of S that is not appropriate considering both transfer price and royalty (together). So it could be even appropriate the mentioned reward, maybe, when a royalty was current but was current also a lower transfer price.

Distributor is going to invest in marketing when has possibility in a prefixed contract (agreed before of investment) for that he may suffer a loss or may gain a profit (adequate to assumed risk considering purchase price and any other transaction like royalty, maybe) or when same distributor has a right to use (ownership- partial ownership) the property (the commercial name) sourcing from that investment (economics of contract).

32. Example 8
I agree with fact and conclusion but I observe that the bulk of the example is the analysis that the marketing of S far exceeded that of independent distributors under similar long term agreements. I newly call that this concept should be further explained just in reason of how comparables are searched and are available.

On the contrary (and I am currently well aware of that) a lot of litigations between firms and Administrations and between Administrations of different Countries too will source on the notion of abnormal marketer (see observations to examples 4 and 5).

33. Examples 9-10-11-12-13-14
I agree with facts and examples’ conclusions.

34. Example 19
This example is based on different evaluation of a business (with DCF - discounted cash flow) and related intangibles when is going to be managed by a company Pervichnyi (P), using a contract manufacturer (with lower production costs and a lower tax rate) from when is going to be sold to the same contract manufacturer (that has the same production costs but has also a lower tax rate on income sourcing from the business and so the business has more value for him than for the seller).

The target of the example just seem to underline that the buyer of a business and of related intangibles, when he has a lower tax rate, may have possibility to evaluate more that business due to the fact that discounted cash flows (net of taxes) are higher than for the seller (which has a greater tax rate).

Conclusion is that one must look at both perspective, the seller and the buyer one, to set an acceptable transfer price for both entities.

I feel some inconsistency of what is here affirmed with what is affirmed in chapter IX of Guidelines (and US Regulations) about “location savings”.

Under location saving principle any saving of costs (typical is of labour costs) that is due to the fact that a certain firm is located in a Country where the factors of production cost less than in other Countries do not pertain to the firm located in that Country when an associated firm is going to agree a contract manufacturing with the mentioned firm.

38 the reality is that sometimes available data give difficulties in doing that and so the focus in Guidelines text must be shifted from firm discretionary power to availability of data.
The economic mechanism is simple: all other firms of the Country with lower labour costs are allowed to gain labour advantages and so a private auction on de localizing business would end to make that cost advantages would be transferred to the de localizing firm. In my opinion in example 19 the logical correct passage should be: is the group decision to sell the business from P to S? If the answer is yes, I have to estimate an arm’s length transfer price (in view of both firms maximum interest). This transfer price must be 941, that is the transfer price that another (independent) company, located in same Country of S would pay for that business, having granted the same (lower) tax rate than S.

The fact that S has granted a lower tax rate in his Country must be considered at the same level as for other production factors allowed in the same Country (the tax rate is nothing other than a production factor to be paid for localizing in that Country the business and due to the payment of public services performed in the Country).

I feel other problems in the example, on side of eventual differences between projected revenues and actual ones and other assumptions for using DCF techniques: here I call back what I observed when dealing with the introduction of DCF in the text of Guidelines and cautions to avoid litigations.

Nothing is said in the example on the problem of periodic adjustment when I well know that just here the problem of periodic adjustment could source if the sold intangible is considered as an intangible sold for a lump sum (as it’s without a doubt) but whose income was uncertain at the moment of sale. When an example on DCF is built, the problem of the comparison between actual results sourcing from the intangible and projected ones with a clear judgement about unpredictable events and information available at sale moment might be done.

The link between the use of valuation techniques and the problem of periodic adjustment could be deepened just in this example.

35. Example 20-21-22

See what I observed above commenting paragraphs on periodic adjustment.

36. Limited Conclusion – reminder to specific conclusions drawn on previous issues

I do not want to call back all observations specifically drawn on single points of the drafts that I made above; these are some limited conclusions and this is a reminder to consider them.

a) The concept of intangible is not strictly necessary to project transfer pricing rules. What is important (essential) is that a clear model of allocation (to associated entities) of returns of group’s incomes is included in the regulation. The best method rule (and para from 26 to 37 of the draft) depicts a mode that, when and if fairly interpreted, could give a profit allocation which would be in compliance with the economic model I drafted at point 12 and which would come to predictable rules. This is what should be in theory but some problems are underlined following.

First I give my opinion on what is in theory, problems will follow.

The distributor position i.e. is the theoretical position of who is going to make a specific investment that has a value under a locked relationship (with producer); the group form of enterprise is just the solution to prevent the hold up of his investment in advertising while Group solution can’t be a solution for Governments that need an equitable division of tax revenues.

The first best solution to prevent underinvestment of firms, when specific investments are planned, to explain behaviours of firms acting at their best (conflicting) interests to come to a possible equilibrium state, is the ability to make a complete contract where distributor is fairly remunerated for his investment in each possible future event: this is what is depicted as a normal marketer (example 4) and in general part of the draft.

The second best optimal solution (when the first best solution is not possible because for well note reasons to build a complete contract is very difficult in forecasting all possible future events) is to

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39 when certain well known conditions are met.

40 And this is why the vertical integration (the form of group of an enterprise) is an economic solution (where it is not a solution on tax problem)
give in the contract, the right (or a share of that right) to use the business assets (the name) sourcing from investments to the seller: this is what depicted as abnormal marketer (in example 5 and in general part of the draft)\(^1\).

Here what is important is just the (intangible?) property assigned through the contract: the right to use business assets, material or immaterial (see back point 1 about contract theory and related references).

This the right way pursued in the drafts (para 49.50-51 of the draft, already included in chapter VI of Guidelines) also if these concepts are included into the Guidelines and into the drafts without explicit reference to the model.

As a conclusion, in my opinion, the concepts included in the intangibles’ draft (returns of a group entity must relate to functions performed, assets employed and risks assumed in the business) may reach similar effects as asset ownership concepts that I above mentioned also without explicit reference to the model. But this “non definition” of intangible included in the draft could be too abstract to be easily understood and could be enriched with concepts I above mentioned giving reason of the bargaining game of parties; this could be useful just to “find” a concrete rule when some doubts arise as in the contexts I underline following.

b) Second I want to underline a problem about the way to “produce” legislation that is independent from economic concepts I above referred but that has a huge effect on economic system and society. I think Legislator (OECD) must give more certainty to Firms and Administrations in applying ALP and when this target is not reached underinvestment of firms (or investment only in Countries assuring that principle) arises, with a (not simple to be measured but certainly current) recessionary effect.

If the certainty about the correct rule to apply is the real target to be reached an important change in projecting fiscal rules must be done, because one can easily ascertain that under the present text of Guidelines a lot of litigations just about which is the correct rule to apply, are widely current\(^2\).

I think that Legislator must give more details on asked behaviors to firms when he wants that a specific process is used to set transfer prices in a wished way; providing further details should allow firms and Administrations to follow issued guidelines with less uncertainties than now; but when more options are allowed by Guidelines text it must be clear that this is not an economic suggestion but a juridical statement!

Therefore Legislator (I repeat, if certainty about the right rule to apply is the wished outcome) must give a strong safeguard to firms, obliged to set in advance prices which will be audited later, that if they (firms) choose one of allowed options, then, years later, Administrations cannot neglect that allowed – choice; obviously Administrations must challenge a non allowed choice; but if same Guidelines leave open a space to one estimator (first, a firm) to make some assessments those assessments can be amended only when they are irrational (or non in compliance with Guidelines text) and not because other assessments could be equally rational\(^1\)

In my opinion the sole “range “concept of the arm’s length price is not sufficient in actually and effectively stopping misunderstandings on this fundamental issue; this is an allegation which is historically proved by presence of wide litigations and new tools are to be provided in addition

\(^{42}\) At less in some Countries as it’s mentioned also in OECD 2012 Report “Dealing effectively with transfer pricing challenges “ at page 17

\(^{43}\) It would be too long for the paper to propose these tools; a lot of concepts already included in Guidelines should lead to the mentioned target but I fear that just the strain of Guidelines is too much discursive (cause Guidelines have to be implemented by internal legislation?) : this doesn’t help; it would be necessary to insist on what it’s possible to do with a reasonable burden in order to comply with a certain (and well identified by
c) About intangibles ownership I think more details could be given as to the way to identify which is the associated entity that becomes intangible owner (or the entity entitled to intangibles return). This, above all, will be clearer further when I will deal with marketing intangibles in case no comparable arrangements are available about distributor role. Indeed, fundamental guidelines must be given (and already they have been substantially given in current Guidelines’ text) on non intangible owners reward calculations and on way to split combined profits when both transaction parties are intangible owners; in these last cases I think than more than one method and several options must be allowed on those calculations. This could be the right choice of OECD combined with the safeguard mentioned above.

d) The introduction of DCF valuation (and/or of other financial techniques) in Guidelines text may have two different alternative effects, the one positive or the other very negative. If DCF is considered (as a bona fide interpretation would consent) a way to round the value of an intangible, this may be another good tool provided to firms and to Administrations to make compliance with ALP; but as any estimator well knows, if Legislator lets that firms proceed with a calculation and that then during an audit, maybe years later and using information current at time of the audit, Administrations are allowed to easily remove i.e. the discounting -adjusted for risk-rate used by firms also by a little amendment (one % point less or one % point more?), neglecting argument provided by firms for choosing just that rate, the same ALP concept is no more a rule for that it is possible to predict ex ante the requested correct values (or at least a range of correct values).  

e) About Examples of Guidelines I think that just examples may be one of most appropriate legislative tools to reach the certainty about the right rule to apply:  
- In case of intangible owner identification the examples may give more details just to make less complex the analysis also at expense of a sort of precision and “perfection” of economic analysis when available data do not consent such a perfect analysis. 
- In case of calculations the examples may give a way to be followed (similarly to what constitutes a safe harbor) so that other ways of proceeding are equally allowed when available data consent more rigorous analysis, but providing safeguard that following example behaviors no challenges are possible.

Guidelines) concept of (legal) ALP. As mentioned in the text it could help a strong legal statement about arm’s length compliance as a proceeding, different for the two fundamental actors of the game (firms and Administrations). Firms must set prices in advance and using information available at transaction time; Administrations’ audit should be targeted to prove the evident irrationality and non compliance with issued Guidelines of the firm assessment and not targeted on the possibility to calculate other (from those calculated by firms) reasonable (in compliance with ALP) prices.

APAs become the sole way to have an ex ante rule to apply ALP; this couldn’t involve (for clear quantitative limits) the millions of Taxpayers affected by transfer pricing

Let me call back my vision about examples role in Guidelines. Examples may become a useful tool in reaching certainty about rules to apply in compliance with what above mentioned project and with required flexibility to reach above mentioned goals. The Example may become a way where Legislator is able to give some detailed instructions in order to consider as current some principles enforced in the general part of guidelines (also at expense of precision of analysis and so by making some simplifying assumptions); in this way readers of Guidelines are able to understand that if a severe analysis is possible, also given available data, conclusions follow the analysis but if available data do not allow conclusion in compliance with enforced principles (enforced in the general part of Guidelines) some simplified assumptions (as much as possible coherent to the general rule) allow to give a rule to specific case that may be followed with predictable behaviors; those behaviors when complied with by firms can’t be challenged, years later, by Administrations (similarly to safe harbors but that operates in a different way....). I repeat that Legislator might also choose to leave more flexibility to firms by not giving a secure behavior in the examples but when this is the chosen rule, firms cannot be blamed for choosing one of allowed options.
f) In marketing examples I think Legislator must divide the analysis in when independent comparable arrangements of distributors are available (and so the rule is already done because all intragroup conditions must correspond with eventual no relevant adjustments to the independent ones) and in when such arrangements are not available. This would match also what is dealt with in the general part of the draft where this division is done. I think examples now current in the draft are not clear about this partition (my observations are expressed back at points 25 and following of this paper).

When independent arrangements are not available I think legislator must give in any case a rule, also at expense of a perfect analysis that in this context may be impossible, to solve in the best way, at arm’s length (and coherently with economic model I referred at point 12, that I think is implied in Guidelines text), the case with current information constraints.

g) The first target is to give a clear rule for the marketing agent distributor (also when are not available comparable arrangements).

Here it’s possible a simple rule whose compliance with is tested also ex post transactions during an Administration audit managed years later those transactions.

When a “normal” net profit return (maybe tested to what is gained by independent “normal” distributors or also by a provider of “similar services” extracted by databases) has been left in the hands of the distributor for each audited period, the Administrations have an incontrovertible evidence that marketing expenses (if any have been assumed) have been borne not at the risk of the distributor. This assessment becomes an (historical) question of fact (irrespective of contracts) and is able to solve a lot of real cases, where eventual returns (profits or losses) from name (intangible) development, if any, are attributable to foreign producer and not to distributor. This will avoid litigations in a case where the plain application of ALP can come only to mentioned conclusion. Example 3 must give a solution not only when comparable arrangements of distribution are available but also when they are not.

The fact that in example 3 the Legislator specifies that marketing expenses have enhanced the group commercial name may create misunderstandings: the rule about the marketing agent correctly might conclude that distributor remuneration is irrespective of what happens about the promoted name and so the same rule would have been applied also if the name exploitation would have resulted in a failure.

h) When comparable independent arrangements on distributor are not available and the distributor is not a mere marketing agent of the producer the role of normal marketer versus the abnormal marketer 46 must be depicted with more details in reference of what is present now in the draft which seems to base that partition on presence of comparable independent distributorship agreements.

I think that if these details are not provided firms and Administrations and also Administrations of different Countries will litigate a lot about the notion of “excessive marketing” of the distributor (just when comparable independent arrangements are not available and about the identification of normality or abnormality of marketing).

I made some proposals on details to be provided (point 26) 47 in a profit comparison context where the difference between normal distributor return and the slim margin (due to marketing investments) of associated distributor may be used to build an arm’s length arrangement; i.e. if the name is successfully developed the extra profit is specularly measured just with the mentioned

46 A lot of litigations between firms and Administrations and between Administrations of different countries currently are just due to different interpretation of the excessive versus normal level of marketing expenses of the distributor; clear words also when comparable independent arrangements are not available are necessary......

47 See back point 26 about details to be provided and proposed solutions (How to test the successfully versus unsuccessfully development of a commercial name? – which are consequences of the non successfully development of the name?)
(positive) difference (plus a premium at risk\textsuperscript{48}) to be attributed to same distributor\textsuperscript{49}. In any case the rule might be projected also for cases when the name development is unsuccessfully (see back point 26 and following).

\textbf{i)} I think (see back point 28) that in the draft regulation is also absent an example of when distributor cannot develop marketing intangibles just cause marketing may be managed without risk (further cases of periodic adjustments)! This is an analysis ending to (periodic adjustment concept) necessity to agree only short terms contracts between producer and distributor.

I allude to cases where the value is on site of the patent producer and when challenges to eventual sharing of value between producer and distributor should be moved (when income is not appropriately assigned to him) just by Administrations charged to tax that foreign producer. The starting point of such an analysis must be the detection of the situation when real risks are in front of integrated business and when they are not, so to understand if marketing presents those purported risks which are considered current only with the sentence, included in examples, that the “commercial name is not known in the distributor market”\textsuperscript{50} (and then the positive effect of marketing is current with the sentence that “the name has become well established”) .......... also when the name is not known is possible to manage marketing under an integrated business, in a way to reduce risks\textsuperscript{51}.

\textbf{j)} I think also that OECD might run in detail (see back point 27) a new fundamental example with another case where it is not appropriate, similarly to previous point of view, to refer only to the distributor’s activity when determining an appropriate transfer price\textsuperscript{52} and where intangibles on producing side are valuable and to be taken in account! Here I must give a pattern about how to value marketing intangibles (when some authors even consider they do not exist!) in the context of an integrated business for that without a valuable product, marketing can do nothing (or, that is the same thing “marketing is a routinary activity, aimed only to inform customers about product features”).

The starting point must be an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated business): one estimator is faced with an eventual marketing intangible to be developed by distributor that must be connected to the intangibles developed on the production side. This must be a clear pattern,

\textsuperscript{48} The greater the difference between slim margin and normal margin is the greater the premium must be
\textsuperscript{49} I newly specify that here one must appreciate that the solution is the best way to give a clear and predictable solution to otherwise impossible cases to be ruled in a “perfect” (impossible) way, due to information constraints. Certainty about the rule of law is the prize to be reached at the expense of some analysis simplifications. In my opinion, the first target of OECD guidelines must be to rule real cases with available information in the hands of Taxpayers and Administrations and not to contribute to economic theory! To leave the situation as it’s now is to let that the ALP looses any capacity to produce predictable rules and positive features of its application (incentive to efficiency and equitable division of profits to Countries) are completely offset by that failure about certainty: the supremacy of ALP on unitary rules to split multinational business results is lost!
\textsuperscript{50} For details about the fact that the name was not known (and then successfully developed) see back point 26.
\textsuperscript{51} I newly call back (I beg your pardon) that Horstmann and Markusen, [Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise, 37 Int’l Econ. Rev. 1 (1996)] suggests real behaviors of multinational enterprises in order to limit risks in exploring new markets; the name is not known but some behaviors are targeted to limit risks in the new market (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through “independent” licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market)
\textsuperscript{52} In example 5 of the draft Administration is allowed to split combined profit of producer and distributor but I think that just the example may give more details in that
able to divide cases when it is sufficient to look at the sole distributor side to project a remuneration rule and when this is not correct. Concepts to build such a rule are identifiable in assessing that when marketing costs are put at risk, many times, valuable bottleneck inputs have been created on production side just because, usually, marketing is performed at the end of whole investment process and when the market value of the output is going to be disclosed. This is the sole way to have coherence between the implied profit allocation rule included in Guidelines and the case at focus!

Profits (or losses), in an integrated business, are due to “uncertainty and risks”, and are generated by the fact that resources are to be committed before of having information about output value 53 and so when time for having disclosed the output value is short (marketing at the end of investment process most of risks are to be supposed, at that moment, over 54. I repeat that the rule above is also the model to share integrated profits between associated units that is implied in OECD Guidelines current text, and that I am able to derive from best method rule (and other parts of Guidelines); if I want to change this rule and to apply another one I might explain and motivate the change to have coherence between specific rule and general principles.

Details about the right way to proceed provided in an example would have the sense of giving certainty with a safe behaviour (for firms and Administrations) by some simplifying assumptions; the target is just to allow a solution in difficult cases when available data do not consent a more rigorous analysis; that rigorous analysis is indeed a live option of Guidelines when available data consent it (some concepts to reach the goal are drafted at point 27).

The example 5 correctly concludes (between allowed options) about a profit split, but without the details and concepts I drafted here this cannot be a secure guidance to avoid litigations and leaves open the way to unending discussions!

k) I see problems of inconsistency about the principle of “location savings” present at chapter IX of Guidelines and principles affirmed in example 19 of (intangibles) draft. When a group decides to sell the business (and related intangibles) from an high tax rate company to a lower tax rate company the transfer price is calculated through what would pay for the going to be sold business another (independent) company, located in same Country of the associated buyer (if the associated company is not the sole buyer) and having granted the same (lower) tax rate; therefore when a target return on investment is set net of taxes, the advantages on tax rate of the buyer are economically transferred (as an higher transfer price) to the seller under principles surrounded by location saving. In contrary case, I might explain reasons to derail from the general principle.

l) A further task (see back point 29) of OECD (this is a too long task for these notes) should be targeted in asking that in intragroup contracts the risks are assumed as independent operators really would do while currently net profit level processes tend to give to tested group operators a normal-average profit (which is the result of assuming “normal-average” risks as assumed by the sample of comparables) in any circumstance; when I apply net profit of comparables to the (tested party) group operator (distributor) this last is no more affected by risks (his correct quote -as for distributors, i.e. for credit risks) assumed by group in his individual activity. 55 In other words: the fact that some risks, at arm’s length, are assumed by the group entity whose remuneration is compared to independent firms is practically frustrated when net profit level indicators are used. Indeed also group operators which are functionally comparable to limited risk independent firms may assume some proper risks (coherently with performed function) by a choice (and an

53 See Hines model quoted supra at note 14
54 Please consider that I use the term risk in the sense given by economics and so the fact that a risk is over means (simplifying) that a single result is possible (now near to be actual), that may be positive result (a profit) but also a negative result (a loss).
55 Here some assumptions must due to the fact that the net profit mean (or range) of comparables already includes a mean (or a range) of risks assumed by those operators...... but that the fact resulting in a risk for the group operator when happens may cause further effects on his profit and loss.
Para 2.73 of OECD Guidelines does not give the proper relevance to this case which (seems totally due to judgment of firms while ) is so important about ALP : I think that this aspect, maybe in compliance with current text of para 2.73 of Guidelines, is generally and actually undervalued in a lot of transfer pricing studies (while it might not).

This would really close more net profit level indicators legal processes with the economic principle; I made some specific observations at point 29 of this paper about credit risk and possibility for distributor to be affected by “abnormal” losses on credits as actually realized by his proper activity (his proper customers that are different from customers of comparables) also in a net profit comparison context; considering the example that I proposed, with a net profit indicator, without the care I proposed, the abnormal loss on credit is automatically attributed to producer and not to distributor: this may be correct only if a contract provides so (before of knowing if a real abnormal loss will become an actual fact) and key people of the producer have managed credit risks of distributor customers.

Obviously here it would be necessary to create rules with would allow certainty about requested behaviors to be applied, specially to part when data on comparables allow to apply such a rule and when they do not.

Dear Sirs,

I appreciated a lot the choice of OECD of circulating a well done interim draft on intangibles (safe harbor, timing issues) so that a deep debate on (all these aspects as a whole) may source at an early moment of the enforcing process.

I made the devil advocate about it and I beg your pardon for this role.

In my opinion litigations are widely current on ALP application, at less in some Countries as an 2012 OECD document refers, and (this is my opinion too) they are due to some lacks in Guidelines text that I have (humbly and with public spirit) pointed out in the paper. Legislator must take his historical responsibility (and OECD is historically a judicious and authoritative Legislator) to make that the right rule to apply is made known to Taxpayers and Administrations (this is in compliance with economic ALP or not) in a clearly and predictable mode in advance time of transactions.

Sometimes when available data do not consent enforcing of a simple rule Legislator is in front of an alternative:

• Or he allows that more processes are used by Taxpayers to come to a number (the set transfer price); but in this case, more than one results were ex ante possible and firms cannot be blamed in having chosen one of them

• Or he gives further guidance (also at expense of analysis precision) in a way it’s clear which are narrowed allowed processes to come to set a transfer price.

When rigorous rules allow to understand which associated entities are intangible owners inside a group (or rectius: which associated entities must be affected by general-combined results of the group business) the great part of the job to prevent (illegal) profit shifting by firms is done. Then it’s a good compromise any simplification in calculations associated to more certainty granted to Taxpayers and Administrations in predicting the right rule to apply!

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56 While the reality is that sometimes available data give difficulties in doing that
57 In my opinion, litigations are projected to rise in the future if adjustments to legislative texts are not early taken
58 Dealing Effectively with the Challenges of Transfer Pricing, OECD 2012 page 17
59 The “independent study”, managed at OECD level and with target to monitor ALP application (and not to be the appeal of current litigations), I proposed at previous point 6 would just be aimed to understand if current litigations are mainly focused on the entity to be considered intangible owner or on other issues.
The lack of certainty about the right rule to apply has an high cost in term of lack of growth (due to the procrastination of investments or localization of them in Countries where the said certainty is granted).

I hope the paper may be useful for your future work and in any case I thank you for having given me possibility to express my vision on it.

Kind regards.

Milano, September 14th 2012

Andrea Musselli
September 2012
Taxand

OECD
Joe Andrus
Head
Transfer Pricing Unit
Centre for Tax Policy and Administration
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Dear Joe

Re: Taxand Responds to the OECD Discussion Draft Revision of Chapter VI on Intangibles

Further to the publication of the OECD’s discussion draft on “Chapter VI on Intangibles”, Taxand is pleased to provide combined feedback from around the world.

First of all, we would like to commend the OECD Committee of Fiscal Affairs efforts for its continual improvement and updating the OECD Transfer Pricing Guidelines which is an essential tool for coordinating international taxation in the business community.

There is a general consensus in Taxand that the revised guidance is helpful and provides greater clarity around the principles under which inter-company transactions involving intangibles should be priced. The guidance is also helpful in that it adds valuation techniques based on discounted cash flows to the methods supported explicitly by the Transfer Pricing Guidelines. Our comments are structured in two parts – the first consists of brief comments relating to the proposed text. First, we provide reference to the specific paragraph numbers and offer brief comments or suggest changes to the wording. Second, we provide a slightly more detailed response on three key issues related to the proposed valuation methodology:

- The proposed treatment of taxes in the discounted cash flow analysis
- The determination of an appropriate discount rate
- The implementation of the discounted cash flow analysis.

Part 1 – Section Review Including Suggested Changes to Wording

Section A. Identifying IP. IP definition
We suggest keeping the IP definition from the current OECD TP Guidelines (par. 6.2) as an additional for the draft. Tax scrutiny because of lack of clear definition of IP?

Section A. IP characterisation
We suggest keeping a definition of the category of Intangible (trade intangible, and marketing intangible in Par 6.3) from the current OECD TP Guideline and add definition of other IP categories (soft intangible, hard intangible, routine intangible, non-routine intangible) and we suggest including the list of IP in those categories (as stated in Par 6.4 of current OECD TP Guideline for marketing intangible).

**Section A. IP illustrations**

We suggest providing a clear definition of other type of IP such as Customer List, Customer Relationships, Distribution Channel, Reputational Characteristics.

- **Section A.1.5** – Recommendation to add “It is recognised that accounting and legal definitions will be relevant in many cases and MNEs should not be required to duplicate relevant analysis”
- **Section A.1.8** – considers the concept of ownership and does not distinguish between economic and legal ownership. This may be deliberate; however, it is important to recognise that administrations often attempt to apply the economic ownership argument. In addition, the example provided for a local market not giving rise to an intangible may be challenged by an assessment of economies of concentration giving rise to intangible benefits
- **Section A.2.12** – In reality, a transfer pricing assessment / audit relating to intangibles will include direct tax inspectors as well as economists. Many local regulations specify whether transfer pricing takes precedence over other tax law relating to intangibles and this should be a recommendation to bring additional certainty to the process
- **Section A.4** – this is a strong section and will improve the process of negotiation going forward
- **Section A.4.24** – see comments above on economies of concentration

**Section B (Framed Block)**

This introduction provides an explanation of the OECD WP6. It mentions that legal ownership or bearing costs related to intangible development does not mean that an entity is entitled to the returns related to intangibles. Some multinationals have the approach that bearing the risk based upon agreement, results in ownership of at least the economic ownership of the intangibles. The approach that the OECD seems to be taking is different from that and could cause multinational issues with local authorities based on this draft.

- **Section B** – general comment is that this is a significant improvement on the previous guidance
- **Section B.1.31** – Paragraph 31 and further seem to emphasise that legal ownership, registrations and functions involved in protection of intangibles (eg IP lawyers) have an important role, the examples 1-8 seem to decrease importance; perhaps WP6 could try to be more clear about the value of these functions in section B, rather than in the examples in particular as regards other valuable functions (marketing, R&D)
Section B.1.36 – add “before or at the time transactions leading to the development...”

Section B.2.40 – change “important” to “economically significant” for consistency

Section B.2.40 – WP6 seems to provide some guidance with respect to substance in paragraph 40, leaving the door open to outsource certain activities. Would the OECD be able to provide further clarification on what a minimum substance would be for non-routine entitlement of returns of intangibles? Subsequently, could the OECD provide guidance to which extent functions can be outsourced based on a routine remuneration?

Section B.2.46 – add “borne the relevant costs or reimbursed the relevant costs at a later date for an appropriate amount.”

Section B.2.49 – In paragraph 49 and further, WP6 mentions marketing / distribution activities where the questions comes up as to whether it should be remunerated for services or also share the intangible related returns. When the functions go beyond a normal distributor the share in the intangibles related return could be expressed in a deduction of the purchase price or a decreased royalty. Does the OECD refer here to economically supported adjustments? Additionally, could the OECD more specifically address the relative value of intangible developed over time by any distributor such as customer list?

Section B.3.50 – add “This is not necessarily a static condition and over time, the significance of local efforts (and therefore the entitlement) may increase”.

Section B.4.53 – wording should be “exceptional” not “extraordinary”

Section C. Transactions involving the use of IP Identification and characterisation of the specific controlled transactions involving IP.

Section C.2.66-75 – We recommend that this concept is applied with consistency by Administrations and MNEs. Evaluating assets on a segregated basis can lead to significantly different results.

Section D. general
Arm’s length conditions in IP Cases

Section D.1 – The OECD could include wording about for example claw back clauses in case expectations of future benefits appear to be incorrect. Claw back clauses should only be applied if third parties would have also applied this under the same facts and circumstances

Section D.1.83 – having to compile a maximum price for the transferee and a minimum price for the transferor is going to increase administrative burdens on MNEs and Administrations. Suggest re-wording as “the price in the arm’s length range acceptable to...”
Section D.1.88 – add “in practice, the residual profit split method is often applied where the non-tested party and the tested party use intangibles and are both entitled to intangible related returns.”

Section D.2.108 – After first sentence “(although this may often be the case)”.

Section D.2.110 – provide the example of certain intangibles deemed to have a 5-10 year economic life for accounting purposes whilst the economic reality may be longer (or indeed shorter)

Section D.2.114 – It is often best practice to consider more than one method given the unique nature of many types of intangible

Section D.2.115 – “Equally, a segregated analysis may provide the most reliable result depending on the situation”

Section D.2.116 – provide the example of certain intangibles deemed to have a 5-10 year economic life for accounting purposes whilst the economic reality may be longer (or indeed shorter)

Section D.2.115 – “Equally, a segregated analysis may provide the most reliable result depending on the situation”

Section D.2.116 – “Equally, a segregated analysis may provide the most reliable result depending on the situation”

Section D.2.118 – agreed that in our experience: CUP, RPSM and Valuation techniques should be the key methods for evaluating transfers of intangibles

Section D.2.140-144 – provide an example or consideration of business process analysis and the weighting of functions in the context of a RPSM

Section D.2.153 – “the use of discount rates applied by an MNE in evaluating other assets will often be relevant for the purposes of evaluating intangibles; however, there may be valid economic reasons for a departure based on the facts of the case”

Section D.2.160 – “and including an assessment of key events that are anticipated or that have a degree of certainty such as the securing of long term contracts for sales”.

Section D.4.176 – comment on the inappropriateness / inability to use hindsight in most situations

Part 2 – Brief Discussion of 3 Key Issues on the Proposed Valuation Methodology

The Treatment of Taxes in the Valuation of Intangibles

There is a natural tension arising from the use of valuation methods in a transfer pricing context related to taxes. Section D.4 172 notes that “prices for transfer pricing purposes must typically be determined on a pre-tax basis”. The question that arises is how the guidance in D.4 150 that “the discounted present value of the stream of cash flows attributable to the intangible, after proper adjustment for taxes, is assumed to be the value or arm’s length transfer price of the intangible” aligns with the goal of producing a pre-tax result.

The arm’s length standard, as determined under the methods described in the OECD Guidelines, naturally assumes that taxable income is subject to tax, but it specifically avoids any suggestion that the price a company would pay at arm’s length would reflect the company’s own specific tax attributes. It might be helpful to provide greater clarity on the “proper adjustment for taxes”. For example, the analysis might assume the application of the statutory tax rate, adjusted for any permitted depreciation or amortisation of the intangibles
during the life of the transaction, or the impairment or write-down of the asset at the end of its useful life.

In market transactions at fair market value, the price that a company would be willing to pay for an intangible asset would usually consider the impact of taxation on the income streams or cost savings that would result from owning the intangible. It is possible, although not necessarily the case in all circumstances, that the use of pre-tax cash flows, discounted at pre-tax discount rates, will produce a similar value to the result that would be achieved by discounting after-tax cash flows at an after-tax discount rate. A pre-tax approach would have the merit of being more closely aligned with the approaches applied more generally for transfer pricing purposes. However, this approach would be inconsistent with the valuation approaches used for other tax and commercial reasons, and therefore would present consistency problems. Accordingly, further guidance in this area is requested. In particular, if a pre-tax approach is favoured, then the language of the guidance might be amended to remove the references to “proper adjustments for taxes”. On the other hand, if a post-tax analysis is favoured, then the issues raised in this section will need to be addressed by further guidance. For example, as noted above, such issues as the amortisation of write-down of the intangible need to be addressed.

**Discount Rates**
Sections D.4 163 and 164 suggest against the simple use of a weighted average cost of capital (WACC) that might be applied to the company as a whole. Instead, the sections indicate the need to consider the level of risk inherent in developing and deploying intangibles, and imply that a commensurately higher discount rate would be required. It would be helpful if the guidance provided some comments on the use of debt and equity components in the hypothetical capital structure. In the field of valuation, it is not uncommon to observe the use of typical or industry average debt to equity ratios, and for the cost of debt to be adjusted to an after-tax equivalent rate.

The guidance at D.4 172 reiterates the objective of determining transfer prices on a pre-tax basis, hence requiring that pre-tax cash flows are discounted using pre-tax discount rates. The discussion in the previous paragraph on pre-tax versus post-tax analysis therefore is also relevant here in that it impacts the determination of discount rates, and further guidance on this would be helpful.

**Discounted Cash Flow Analysis**
Given the complexities of the technical issues related to the appropriate implementation of the discounted cash flow analysis, Example 21 is potentially very important in helping readers understand the guidance. We suggest that some significant changes to Example 21 would help to clarify the issues. As presented, the example compares two scenarios which reflect location savings, different tax rates and volume effects resulting from a price change, all of which, we respectfully submit, are external to the valuation of the intangibles. A more appropriate analysis might look at both the buyer’s and seller’s perspectives and compare...
their respective situations using a “royalty relief” approach. This approach is based on the premise that the sale price should reflect the discounted cash flow analysis based on the hypothetical royalty that would be paid by the buyer to the seller if the transaction were to take the form of a licence rather than a sale. The appropriate royalty would be determined following existing transfer pricing guidance.

In addition to clarifying the approach presented in Example 21, it would be helpful if a number of additional examples were added to address other issues and permutations, consistent with the range of examples provided to illustrate other points in the Draft.

**Taxand’s Take**

- The paper will bring some much needed clarity to the issue of transfer pricing intangibles and the suggested changes should help to achieve increased clarity and consistency.
- For a number of issues, we have suggested that further evaluation is needed and updated guidance is required.

We appreciate this opportunity to provide comments to the OECD Committee of Fiscal Affairs and would be pleased to discuss this further and/or to participate in any discussion on these matters.

More information about Taxand is provided as Appendix I. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Please do not hesitate to get in touch with me directly via the contact details below.

Yours sincerely,

Taxand
APPENDIX I

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ABOUT TAXAND
Taxand provides high quality, integrated tax advice worldwide. Our tax professionals - nearly 400 tax partners and over 2,000 tax advisors in nearly 50 countries - grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our collective expertise to provide you with high quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We’re also independent — ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice, responsively.

Taxand has achieved worldwide market recognition. In the International Tax Review’s (ITR) World Tax 2012, over 95% of Taxand locations are ranked top. 35 countries were voted top in the ITR Transaction Tax Survey 2012 and in the ITR Tax Planning Survey 2012. Taxand has received over 40 national awards and 13 regional awards in the ITR European, Americas and Asia Tax Awards since 2009. These include European Private Equity Tax Firm of the Year, European Indirect Tax Firm of the Year, European Tax Policy Firm of the Year, Asia Transfer Pricing Firm of the Year, Asia Tax Policy Firm of the Year, and Latin America Tax Disputes Firm of the Year. Full details of awards and further information about Taxand can be viewed at
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Re: OECD Discussion Draft on Special Considerations for Intangibles

Dear Mr. Andrus:

In 2010, the Committee on Fiscal Affairs (CFA) of the Organisation for Economic Co-operation and Development (OECD) announced a project on the transfer pricing aspects of intangible assets, including a potential revision of Chapter VI of the OECD’s Transfer Pricing Guidelines concerning special considerations for intangibles (OECD Guidelines). The OECD published a scoping paper and held three public consultations with interested commentators. At the consultation in November 2011, representatives of the business community suggested that the OECD release an interim draft of its work for further public comment. The OECD released such a draft (Discussion Draft) on 6 June 2012, and requested public comments. In addition, the OECD announced a public consultation on this Discussion Draft, along with two other transfer pricing-related discussion drafts, to be held in Paris on 12-14 November 2012. On behalf of Tax Executives Institute, Inc., I am pleased to respond to the OECD’s request for comments on the Discussion Draft.

TEI Background

Tax Executives Institute (TEI) was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,000 of the largest companies in Europe, the United States, Canada, and Asia.
General Comments on the Draft

TEI welcomes the OECD’s effort to address the transfer pricing aspects of intangible assets. Transactions between related parties (however defined) have been a vexing issue for tax authorities and multinational enterprises (MNEs) alike, and thus this is an area ripe for clarification and certainty. Regrettably, while the Discussion Draft elaborates on many issues in significant detail, overall it lacks a unifying vision, pragmatism, and consistency. In addition, the draft seemingly contradicts Chapters 1 to 3 and 9 of the OECD Transfer Pricing Guidelines. In particular, the Discussion Draft does not properly reflect the manner in which MNEs derive economic value from their intellectual property (IP). For example, the comparability analysis discussed in the document refers to a particular method and is not based on a value chain (or economic) analysis.

In TEI’s view the OECD Guidelines should recognise that MNEs centralise their critical IP in a particular jurisdiction, or across a few key jurisdictions, for a variety of reasons. These reasons include: basic legal protection (including the ability to sue infringers), centralisation of IP development, funding and administration, risk hedging, a desire to clarify internal business responsibilities, and tax considerations. From a tax perspective, IP concentration simplifies transfer pricing compliance across jurisdictions, reduces the risk of double taxation, and avoids lengthy tax-related disputes over intangible assets generally. In contrast, the Discussion Draft could spawn the dispersion of IP assets and their associated returns across the entire corporate group and, therefore, across many more jurisdictions than where the MNE chooses to locate the legal and/or economic ownership of its IP. The inevitable result would be more transfer pricing disputes between MNEs, the jurisdictions in which they operate and, indeed, even between jurisdictions.

One of the OECD’s main purposes, promotion of free trade, is best served by healthy tax competition among its Member States. It is thus surprising that the OECD would seek to stanch such competition by dictating to MNEs how they should structure themselves.

TEI recommends that the OECD Guidelines strongly encourage tax authorities to conduct a holistic (or “top-down”) analysis of an enterprise’s transfer pricing practices, rather than proceeding on an asset-by-asset basis. That is, tax authorities should first understand and, absent abusive tax planning, accept an MNE’s business model and how its group IP affects transfer pricing policies. Unfortunately, it appears that the Discussion Draft would permit tax authorities to disregard contracts between related parties in an MNE, even absent tax abuse. In general, we recommend that the Draft expand its discussion of how intangible assets fit within the MNE’s global value chain, which in turn requires an understanding of the business environment in which the group operates. While an asset-by-asset (or “bottom-up”) approach may capture the individual resources (intangible or not) of an MNE, it cannot reflect the enterprise’s business as a whole, and thus does not reflect the approach taken by an enterprise from a business (i.e., non-tax) perspective.

In addition, the Discussion Draft contains a number of new provisions that will likely increase compliance costs for MNEs and lead to controversy regarding IP ownership. For example, the Draft promotes the use of the profit split method while staying silent about the transactional net margin method (TNMM). TEI recommends that the TNMM be promoted as
a much simpler and more pragmatic method, especially for benchmarking routine transactions.

Further, the OECD recognises that its members will likely not reach a consensus view on the Discussion Draft. Because dissenting opinions will only add uncertainty to an already difficult area, as well as exacerbate the risk of double taxation, TEI strongly supports the development of a consensus document.

Finally, while the examples in the Discussion Draft helpfully flesh out the meaning of some parts of the OECD Guidelines, we believe the examples should be more detailed. In particular, the facts of the examples should reflect the full value chain of an MNE – that is, the “holistic view” of an MNE’s use of intangible assets across its operations, rather than an asset-by-asset approach.¹

Identifying Intangibles²

The Discussion Draft reflects certain recommendations proposed during the OECD’s 2011 consultation on the definition of intangibles. TEI supports the refinement of the definition of intangible assets to the extent it confirms that intangibles (or IP generally) should be defined as non-tangible assets that can be owned or controlled for use in commercial activities and separately identified.

However, aspects of an enterprise that are related to intangible – or tangible – assets, such as “assembled workforce”³ (sometimes referred to as “workforce in place”) should not be considered an intangible asset, because they cannot be transferred separately from other assets of the MNE. Instead, assembled workforce and similar aspects of an MNE should be considered attributes that influence the value of the MNE’s assets, but should not be intangible assets themselves. It appears that Paragraphs 25 and 26 of the Discussion Draft recognise this fact, but there is no explicit statement that assembled workforce “is not an intangible within the meaning of section A.1,” as is the case with most of the other illustrations of intangible assets in section A.4 of the Draft. Indeed, the Discussion Draft states that separate transferability is not a necessary condition for an item to be an intangible,⁴ suggesting that assembled workforce could be an intangible, at least under certain conditions. TEI recommends that whether assembled workforce is an intangible be explicitly stated in the guidelines.

The Discussion Draft deliberately does not categorise intangibles into certain classes, such as legally protectable assets (“hard intangibles”) and assets that are not legally protectable (“soft intangibles”).⁵ In addition, there is no distinction made between an intangible asset that reflects a routine or easily duplicated process on the one hand, and a unique process with high costs to replicate or other barriers to market entry on the other.

¹ TEI would welcome the opportunity to assist in developing any such examples.
² See Discussion Draft, Section A.
³ See id. at paragraph 25.
⁴ Id. at paragraph 7.
⁵ Id. at paragraph 13.
These distinctions can substantially influence the value of intangible assets, and, hence, the transfer price for those assets across the MNE. Categorising intangible assets would simplify the transfer pricing analysis (e.g., for “routine” intangibles). TEI therefore recommends that the OECD provide detailed examples of how and why MNEs have categorised such intangibles under their specific policies.

The Discussion Draft also fails to reflect the economic differences between group members of an MNE. For example, one member of an MNE may have greater bargaining power or responsibility than another, inasmuch as one member may be an investment center, another member a profit center, and yet a third member a cost center (operating on a “cost-plus” basis). If these members were unrelated parties, the disparity in bargaining power would obviously come into play when setting the price for transactions between them. Such differences are especially important in the intangibles area where, for example, the ability of one member to continue as a going concern depends upon its contractual relationship with another member, which is not an uncommon occurrence in relationships between unrelated parties. We recommend that the OECD take these factors into account in revising the guidelines.

Further, we recommend that a paragraph be added regarding the importance of “know how” to MNEs. Often, highly valuable intangibles can – and do – derive from a single idea, regardless of whether the original idea can be kept secret or be legally protected. The Discussion Draft should reflect this.

In addition, there is no general definition of a “marketing” intangible in the Discussion Draft even though six of the examples (numbers 3 to 8) deal with such intangibles in a distribution context. TEI recommends that the OECD Guidelines include a definition of a marketing intangible so taxpayers will know when these examples apply to their intangible assets.

Paragraph 23 of the Discussion Draft suggests that group synergies are necessarily driven by several entities. TEI submits that this ignores the reality that a parent or principal company is usually the catalyst for group initiatives, e.g., when an MNE has a central procurement entity to make use of combined purchasing power. We recommend that the Discussion Draft include an example whereby the Principal (or Parent) initiates, drives, or encourages those synergies.

Identifying the Parties Entitled to Intangibles Related Returns

The Executive Summary of Section B of the Discussion Draft states that “transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties” and that “neither legal ownership, nor the bearing of costs related to intangible development . . . entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.” The Executive Summary

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6 Paragraph 16 merely describes know how without reflecting on its importance.

7 See Discussion Draft, Section B.

8 Id. at page 12.
notes that this statement “is consistent with other sections of the Guidelines and does not reflect an intention to depart from the principles of Article 9.”

TEI respectfully disagrees, and believes this statement is too broad to be consistent with the arm’s-length principle. In our view, if contractual terms among related parties are consistent with this fundamental principle, they should be respected by taxing authorities regardless of the ex post results. Further, absent evidence of tax abuse, primary consideration should be given to the party that finances, bears the risk, and therefore in most cases economically owns, the IP at issue. While the Discussion Draft states that one factor in allocating intangible related returns should be the “terms and conditions of legal arrangements” among the parties – noting that an additional factor should be the “risks assumed, and the costs incurred” – the Draft appears to give significant – and perhaps controlling – weight to where functions are performed and where (presumably non-intangible) assets are owned. In our view, returns should be allocated to the party that bears the risk of IP development and ownership and not to the party that performs a development service for another party, if that is what the contract between the parties requires (as is the case in many contracts between unrelated parties). A parting acting as a service provider is entitled to a service fee, but not to the residual profit associated with the development of the IP.

To take perhaps the most fundamental example, employers often claim the “intangible related return” to IP developed by an employee, an unrelated party in almost every case. In this relationship, the employee is paid an agreed-upon salary and the employer reaps the rewards of the employee’s efforts – positive or negative – by bearing the cost and risks. Thus, an employee of a pharmaceutical company who develops a cure for cancer will almost certainly not reap the entire rewards from such a discovery; rather, the company will. Similarly, an advertising agency that develops an exceptionally successful slogan or trademark on behalf of an unrelated client would not receive all of the incremental economic benefits attributable to such IP. The reality of these examples notwithstanding, the Discussion Draft suggests that because the employee or advertising agency performed the “functions” in developing such a cure or slogan, the employee or agency should be allocated most (or all) of the “intangible related returns.” Because this is clearly not the case in these unrelated party contexts, it should not be the case for transfer pricing in respect of related parties.

The Discussion Draft also addresses the alignment of functional contributions and financial investment with legal rights, concluding that an entity contractually entitled to IP returns should either have developed, enhanced, maintained, and protected the intangible itself – or should have arranged to have such functions performed under its “control” by independent or associated enterprises (on an arm’s length basis). The alternatives in the Discussion Draft require, however, an unrealistic level of operational control by the IP owner over the intangible-creating activity or functions, thereby spreading the return from such a creation across the MNE group.

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9 Id.
10 Id. at paragraph 29.
11 Id. at paragraph 38.
The OECD should clearly recognise that MNEs often centralise their critical IP in a single entity, or in a limited number of entities, for non-tax business reasons, such as basic legal protection (including infringement lawsuits), centralisation of IP development, funding and administration, risk hedging, and to clarify internal business responsibilities. Of course, tax considerations – including the effective tax rate on returns from IP – also play a part in the decision of where to locate IP ownership. We note that from a tax perspective, centralisation of ownership simplifies transfer pricing compliance around the world, minimises the risk of double taxation, and forestalls lengthy tax-related disputes over intangible assets. In contrast, a “functional analysis” of the development and ownership of intangibles – which the Discussion Draft erroneously asserts in paragraph 11 and generally in section B.1. as being mandatory – significantly complicates the management and compliance costs of transfer pricing for an MNE and will almost certainly lead to double taxation and competent authority disputes as jurisdictions bicker over which function is relatively more important.

Further, the term “control” is used throughout the Discussion Draft in respect of which party bears risk, but it is never clearly defined. More fundamentally, no matter who might control a particular risk, the arm’s-length principle should prevail. The Discussion Draft cross references paragraphs 9.23 through 9.28, which relates to which parties in fact control the relevant functions, but distends the importance of control in determining risk allocation among related parties from that in Chapter IX, which states that “[o]ne relevant, although not determinative, factor that can assist in this determination is the examination of which party(ies) has (have) relatively more control over the risk. . . .” In many cases, an MNE is willing to accept a risk in a contract with an unrelated party (especially when it is able to assess the risk and have the capacity to absorb the risk) even though it does not control the risk itself, and the Guidelines should reflect this fact.

In addition, in a global economy where talent and resources are spread all over the world, outsourcing – to related and unrelated parties – has become ubiquitous. To minimise double taxation, tax disputes, and encourage free trade, the best approach to transfer pricing is to respect the entrepreneurial decision of the IP owner to fund and steer its research and development programs. Thus, funding of intangibles by the “principal” company should remain a key criterion for IP ownership attribution for tax purposes (even with limited operational oversight by such company) since in a market economy a key criterion for determining an entrepreneurial engagement is financial risk. The OECD Guidelines should recognise that the oversight or “control” function can be – and at times (e.g., in the private equity sector) is – outsourced for a fee by the Principal to other parties.

Thus, in our view, any attempt to assess who “controls” a risk in respect of an intangible asset that goes beyond the contractual arrangement between the parties will only lead to disputes between taxpayers and taxing authorities, and, indeed, between tax authorities themselves.

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12 Other business reasons to centralise IP include the ability to globally organise research and development and immediately disseminate upgrades around the world through a “hub and spoke” system.

13 Discussion Draft, paragraph 41.

14 Chapter IX, paragraph 9.20 (emphasis supplied).
Transactions involving the Use or Transfer of Intangibles

In respect of valuing intangibles in their use or transfer, TEI maintains that a “hindsight” analysis should not be conducted. It is rarely the case for contracts between unrelated parties to contain a “re-valuation” clause addressing circumstances where the parties have gotten the price “wrong.” Thus, while many contracts involving the transfer or use of IP between unrelated parties may be contingent on production or utilisation of the relevant IP, the “price” for the IP – even if it is a “per transaction” or “per item” amount – is in most cases set in advance. Certainly, it is rare that a contract between unrelated parties will include a sort of “automatic” re-pricing clause that is triggered where it becomes apparent that one party has gotten the better side of a deal. Because the use of hindsight by tax authorities in revaluing or re-pricing the terms of a contract that were arm’s-length at the time it was negotiated is inconsistent with the arm’s-length principle, it is inappropriate.

The Arm’s-Length Principle

Section D. of the Discussion Draft raises the bar for use of the TNMM method. Unfortunately, this will likely lead to a significant increase in compliance costs for MNEs, or force them to choose other, less reliable transfer pricing methods. In this regard, the Discussion Draft is silent in respect of the TNMM in favor of the transactional profit split method, which often results in higher compliance costs. For example, it is much easier to benchmark the return from routine transactions under the TNMM.

Paragraph 93 of the Discussion Draft states that for “know-how or trade secrets, available legal protections may have a different nature and not be as strong or last as long” as protections provided to more formal intangibles (presumably patents, copyrights, trademarks, etc.). This paragraph should be modified to reflect, among other things, that in an MNE context some intangibles, such as a trade secret, can have an unlimited life and produce non-routine returns indefinitely. (A frequent example of this is the formula for Coca-Cola.) Indeed, in some cases, an MNE may purposefully choose not to seek patent protection for technical know-how so the knowledge can remain completely secret. In these cases, the IP owner should merit permanent, inflation adjusted compensation as long as the intangibles are properly maintained and protected by confidentiality.

In respect of paragraphs 81 to 141, the OECD challenges transfer pricing methodologies that assume all residual profit from transactions after routine returns accrue to the IP owner. In some ways, this contradicts the TNMM, even though that methodology is heavily promoted by new Chapters 1 through 3 of the OECD Guidelines.

In addition, while the reference to the importance of a value chain analysis is welcomed (i.e., as noted, a “top down” or “holistic” approach to the IP of MNEs), the OECD

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15 See Discussion Draft Section C.
16 See id., Section D.
17 See, e.g., paragraph 108 (“caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions . . . should necessarily be allocated to the party entitled to intangible related returns”).
should recognise that the IP centralisation policies of most MNEs almost always lead to one-sided transfer pricing methodologies. Thus, the OECD should modify the statement in paragraph 81 that a “one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles” and restore the TNMM and one-sided approaches.

In respect of paragraph 105, it is cumbersome to refer to the intangible property as defined therein as a “Section D.1.(vi) intangible.” Instead, we suggest using “Non-Comparable Intangible” or, if necessary, “Non-Comparable Value-Adding Intangible.”

In respect of paragraphs 112-13 and 135, while valuing an intangible at its replacement cost or value is sometimes inappropriate, it should be recognised that this is the method of choice when considering so-called process or routine intangibles, i.e., ones that do not drive value for the MNE as a whole. We recommend that the Discussion Draft modify paragraph 113, which currently characterises the use of this method as available in only “some limited circumstances.”

The Discussion Draft should also define what is meant by a “rule of thumb,” as expressed in paragraph 116, to avoid misunderstandings over the use of industry averages, which are a useful tool to verify assumptions, especially where no other comparable can be identified. Indeed, since the draft speaks repeatedly (and, in our view, erroneously) of industry practices in support of recharacterising transactions, it is inappropriate to completely discount the use of industry averages to verify the arm’s-length nature of a transaction. If taxing authorities are permitted to use industry practices to show that a transaction is not arm’s-length, then taxpayers should be allowed to use those same practices to show that a transaction meets this fundamental standard.

TEI submits that paragraph 151 goes too far in asking taxpayers to maintain documentation of “alternative assumptions and parameters” as part of a “sensitivity” analysis. An MNE should only be required to document the assumptions and parameters that it believes are correct and reasonably comparable and not to do what should be the job of tax authorities. The costs of conducting a sensitivity analysis of possible and undefined alternatives and assumptions would almost certainly outweigh any benefits.

Finally, paragraphs 168 through 170 discuss accounting for the tax rates of the transferor and transferee under a projected cash flow analysis of intangible valuation. This is inappropriate. Theoretically, if one unrelated party were aware of the other’s tax rate it might affect the negotiations between them, but such knowledge is rarely present. Indeed, because effective tax rates vary from year to year across MNEs and their operating groups, they likely will have nothing to do with the specific transaction being negotiated.

Comments on the Examples in the Annex

TEI recommends the inclusion in the OECD Guidelines of more realistic and sophisticated examples than those in the Annex. Such examples would assist taxpayers and tax authorities in applying the rules. Further, more realistic and sophisticated examples

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18 TEI would be pleased to assist the OECD in drafting such examples.
would better inform taxing authorities on modern business models of MNEs, mitigating misunderstandings between taxpayers and tax auditors, conserving time and resources for both.\textsuperscript{19}

Most of the examples under chapter VI.B “Identification of Parties Entitled to Intangible Related Returns” begin with an analysis of the functions performed and then summarise how the transaction should be treated for tax purposes. This seemingly goes against the stated premises of the Discussion Draft that contractual arrangements should be the starting point of the analysis.\textsuperscript{20} TEI recommends that the examples describe the contractual arrangements and then discuss whether the contractual arrangements should be respected or disregarded, depending on the circumstances.

Moreover, some examples (such as example 20) refer to “the behaviour of independent enterprises in similar circumstances” (emphasis supplied), instead of making reference to contractual arrangements. A behavioural analysis would constitute a separate, supplementary documentary requirement that would be very difficult to satisfy and give the taxing authorities broad powers to recharacterise transactions. Thus, it is clear that documentary burdens, controversies, and double-taxation cases would increase exponentially if the draft were to continue to focus almost exclusively on functions, with reference to behaviours in the examples, without considering contractual arrangements.

We also recommend providing examples illustrating the full chain of an MNE’s operations rather than just one piece. Those examples should relate to different types of industries and business models and clearly distinguish the respective contributions to the MNE’s IP of all players (Parent/Principal/local affiliates). Where appropriate, the TNMM method should be used instead of the transactional profit split method, especially since the TNMM is the most comparable method in that context.

As for the industries to cover, we suggest

- An industry that is product-driven (i.e., one where the technology is embedded in the product itself) and where the manufacturing, supply chain and sales organisations are more routine
- An industry that sells commodities
- A services industry

The types of business models to cover should include:

- An IP centric policy versus a decentralised IP policy
- A centralised business model (Principal) versus a decentralised business model

\textsuperscript{19} We also note that certain examples that terms such as “goodwill” are sometimes used instead of the more proper “marketing intangibles” (however defined), such as in examples 14 and 15, which can create confusion.

\textsuperscript{20} See, e.g., Discussion Draft, paragraph 30 (“legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns.”).
The additional examples should also outline the evolution of a business model over time within the same MNE and its effect on IP ownership and overall compensation of the intangible.

Another example should underline the importance of central/group initiatives (standard operating procedures, group network, global communication, global ERP, etc.) that do not necessarily constitute IP expenditures per se but enhance the success of the core intangibles. In the same vein, an example should be developed whereby an MNE bundles not only the use of core intangibles, but also the use of central group services that are instrumental to the business, into a single royalty rate.

Conclusion

TEI appreciates the opportunity to comment on the OECD’s Discussion Draft. If the OECD believes our participation in the announced public consultation is warranted, we would be pleased to do so. These comments were prepared under the aegis of TEI’s European Direct Tax Committee, whose Chair is Anna M. L. Theeuwes. If you have any questions about the submission, please contact Ms. Theeuwes at +31 70 377 3199 (or An.M.L.Theeuwes@shell.com) or Benjamin R. Shreck of the Institute’s legal staff, at +1 202 638 5601 (or bshreck@tei.org).

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Carita R. Twinem
International President

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21 TEI has participated in several OECD public consultations regarding transfer pricing, including on 7 November 2011 regarding “Transfer Pricing of Intangible Property: Definitional Approach,” 22 March 2011 regarding “Valuation in a highly uncertain environment,” and 9 November 2010 regarding “Definitional and ownership issues related to intangibles developed through research and development.” TEI also filed comments with the OECD regarding the scope of the intangibles project on 14 September 2010.
OECD INTANGIBLES DISCUSSION DRAFT - COMMENTS

1. INTRODUCTION

I refer to the interim discussion draft issued by the OECD on 6 June 2012 concerning revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions ("the Draft"). Written comments on the Draft are requested to be provided by 14 September 2012. With this document I respectfully submit my comments.

I am currently pursuing a PhD in tax law on certain aspects of transfer pricing of intangibles. I work as a research scholar at the Department of Accounting, auditing and law at the Norwegian School of Economics ("NHH") and at the Norwegian Center for Taxation ("NoCeT") at NHH. The comments below solely reflect my personal opinions on the matters discussed, and do not in any way purport to convey the opinions of NHH or the Norwegian Center for Taxation.

The Draft is comprehensive. I will limit my comments to the following issues:

1.) The identification of intangibles.¹
2.) Certain aspects of valuation of intangibles and uncertainty.²

The identification of intangibles will be commented on below under Section 2.

Certain aspects of valuation of intangibles and uncertainty, namely arm’s length pricing for transfer of intangibles when valuation is highly uncertain at the time of valuation and its relationship to the use of income based valuation methods and the use of hindsight, will shortly be commented on under Section 3.

2. IDENTIFYING INTANGIBLES

2.1 Introduction

The Draft discusses the identification of intangibles in a transfer pricing setting across Paragraphs 5-26. Under Section A.1., general comments on the identification of intangibles are given.

¹ Section A. of the Draft, encompassing Paragraphs 5-26
² In particular Section D4 of the Draft, encompassing Paragraphs 145-178
Pursuant to Article 9 of the OECD Model Tax Convention ("MTC"), where the conditions made or imposed in the use or transfer of intangibles between two associated enterprises differ from those that would be made between independent enterprises, then any profit that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Further, pursuant to Article 3 of the MTC, domestic law of the state applying the treaty will be decisive for establishing the content of "conditions ... in their commercial or financial relations", cf. Article 9 of the MTC. The concept of an intangible asset will therefore in principle rely on internal law of the country applying the treaty.  

The OECD Transfer Pricing Guidelines ("Guidelines") de facto have a significant influence on the interpretation of domestic tax law. Also, the Guidelines provide a unique basis for a common international approach to the issue of identifying intangibles for transfer pricing purposes, thereby reducing the risk of controversy and double taxation.

Chapter VI of the Guidelines on special considerations for intangible property does not contain a definition of intangible assets for transfer pricing purposes. Examples of typical intangible assets are however provided. The document approved by the Committee on Fiscal Affairs on 25 January 2011 on the scope of the OECD project on transfer pricing and intangibles ("Scoping document"), Section D.2, Paragraph 12, describes a series of definitional issues to be addressed by Working Party No. 6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises, through a special Session on the Transfer Pricing Aspects of Intangibles ("WP6 TPI"), among which are:

a.) "The relevance and usefulness in describing the scope of Chapters VI and VIII of the TPG of definitions of intangibles drawn from accounting, financial valuation, and legal literature and other similar sources."6, and

b.) "Relevant factors that should be considered in determining whether or not an intangible is used and transferred and if so how it should be remunerated at arm’s length. Factors to be discussed include, among others, the ability to produce future economic benefits to a business activity, the availability of legal protection and whether a specific intangible can carry value if it cannot be transferred in isolation."7

Items a) and b) will be discussed jointly below under Section 2.2.

2.2 Elements of intangibles

2.2.1. Introduction

A concept of intangibles for transfer pricing purposes should be formed alone on the basis of the particular issues that arise in transfer pricing transactions within a Multi-National Enterprise ("MNE"). Such a concept should not in any way be dependent upon definitions of intangibles applied for purposes other than transfer pricing, such as e.g. accounting definitions or intellectual property law definitions, because definitions from other areas of the law may be based on other considerations than those significant for transfer pricing purposes.

There is clearly a need for a common concept of intangibles for transfer pricing purposes. It would constitute an abusive interpretation to allocate value to an intangible element without clearly defining what intangible asset was involved in the transaction in question. The Draft also states (with regards to aggregation), that "it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions".8 Also,

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3 Also Wittendorff, Transfer Pricing and the Arm’s Length Principle in International Tax Law, p 225 and 615
4 Miyatake, Cahiers de droit fiscal international, Volume 92a, Section 1.6 and 1.7 (p. 21-22)
5 Guidelines, Paragraph 6.3-6.12
6 Scoping document, Paragraph 12, second bullet-point
7 Scoping document, Paragraph 12, third bullet-point
8 Draft, Paragraph 11
disagreements in transfer pricing matters concerning intangibles may be triggered by differing opinions on whether an intangible asset actually exists.

A concept of intangibles for transfer pricing purposes must balance between the need for a dynamic tax concept that efficiently encompasses genuine economic values within an MNE and at the same time provides sufficient clarity as to act as a common platform for interpretation to avoid controversy and double taxation.

A concept of intangibles for transfer pricing purposes should be restrictive, in the sense that the concept should only encompass elements that independent parties would be willing to pay for in arm’s length transactions. Presumably, an independent party would at arm’s length only be willing to pay for something of value. Therefore, value should be the central basis for a compensable transaction for transfer pricing purposes.

In comparison, a key consideration behind the IAS/IFRS accounting approach to defining intangible assets was to avoid the recognition of assets on the financial accounting balance sheet that were too uncertain or had other characteristics (typically not identifiable or controllable) that made the item unreliable as a contribution to future income generating business activities of the enterprise in question. The IAS/IFRS approach is therefore also restrictive, in the sense that the definition of an intangible asset seeks to rule out items that are not fitted to be conveyed to stakeholders in the enterprise as assets that are relevant information for control- or valuation purposes.9

Internal law of most jurisdictions does not contain abstract definitions of intangible assets, and it is common to refer to the Guidelines.10 No abstract formulation or definition of intangibles is drawn up by the Guidelines, as only concrete items (R&D, marketing expenses, know-how and trade secrets) are discussed.11

As pointed to above, the Scoping document states that the relevance and usefulness of “definitions of intangibles...” shall be assessed by WP6 TPI.12 It is stated in the Draft, that the “word “intangible” is intended to address something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities”.13 The Draft goes on to state that rather than focusing on accounting or legal definitions, focus should be on determination of conditions that would be agreed upon by between independent parties for a comparable transaction. However, the language of the Draft concerning “intangible” seems to be influenced by the IAS/IFRS asset definition.

IFRS defines an intangible asset as “an identifiable non-monetary asset without physical substance”.14 This apparently corresponds to the Draft language on “…not a physical asset or a financial asset”, apart from the identifiable criteria. Further, an asset is defined by IFRS as a “resource a) controlled by an entity as a result of past events; and b) from which future economic benefits are expected to flow to the entity.”15 Point a) of the quoted seemingly corresponds to the Draft language on “owned or controlled”.

Therefore, it would seem that the proposed formulation of the content of the term “intangible” in the Draft corresponds to the IAS/IFRS criteria for an intangible asset, with the notable differences that the Draft language apparently does not require the element in question to entail future economic benefits, nor to be identifiable.

The above mentioned elements in the Draft formulation of “intangible” will be discussed further below. The question of whether an intangible item should be able to produce likely future economic benefits before being taken into consideration for transfer pricing purposes will be discussed under

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9 Cf. The Conceptual Framework for Financial Reporting (IASB, September 2010), OB2
10 Miyatake, Cahiers de droit fiscal international, Volume 92a, Section 2.1 (p. 22)
11 Guidelines Chapter VI, Paragraph 6.3-6.12
12 Scoping document, Paragraph 12, second bullet-point
13 Draft, Paragraph 5
14 IAS 38 Intangible assets, Paragraph 8
15 IAS 38 Intangible assets, Paragraph 8
Section 2.2.2. The issues of separate transferability and control will be discussed under Sections 2.2.3 and 2.2.4 respectively.

2.2.2. Future economic benefits

It is a requirement under IAS/IFRS that the element under consideration is expected to generate “future economic benefits” to the enterprise. Pursuant to IAS/IFRS, the future economic benefits from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits from the use of the asset by the enterprise. This requirement is linked to a probability requirement, in that an intangible resource shall only be recognised as an asset if it is probable, i.e. more likely than not, that the expected future economic benefits that are attributable to the resource will flow to the enterprise.

WP6 TPI was to address whether the ability to produce future economic benefits to a business activity was a relevant factor that should be considered in determining whether or not an intangible is used and transferred for transfer pricing purposes, and if so how it should be remunerated at arm’s length. The Draft does not contain a general discussion on the relevance of future economic benefits for transfer pricing purposes.

However, the Draft does state that the identification of an item is separate from the determination of the value of the item or the return attributable to the item under the facts and circumstances of a given case. This statement seems to indicate that an item may very well be identified as an intangible under the language given in the Draft, without it being more probable than not that the item will indeed generate future economic benefits for the enterprise, either through increased income or reduced expenses. In my view, it can be questioned whether such an approach is appropriate.

Firstly, the view of the Draft that the identification of an intangible is separate from the determination of value is not in itself an argument for leaving out a requirement for future economic benefits. Value constitutes the core essence of an asset. Value should therefore be considered as an inherent characteristic of an intangible asset. The main purpose of a requirement for likely future economic benefits in order to qualify as an intangible for transfer pricing purposes would be to force a focus on how the item possibly will generate value for the MNE.

Intangibles are elusive by nature, and it may in practice prove difficult to actually document or in any other may make probable that an item, that at first glance seems valuable, actually is likely to create value for the MNE. E.g. internally generated items, such as a newly developed internal management system or process or business model may in some manner entail future costs savings or income for an enterprise, or at least that may have been the intention of the MNE when implementing the activity. However, the concrete results of such activities it will often not be possible to substantiate so that it may be viewed as likely that the results will ever materialize.

Pursuant to IAS/IFRS on internally generated intangibles, such an item should only be recognized as an asset if the enterprise can demonstrate, among other factors, the technical feasibility of completing the intangible asset so that it will be available for use or sale and how the intangible asset will generate probable future benefits, i.e. demonstrate the market for the output or of the intangible asset, or if only to be used internally, the usefulness of the intangible asset.

In order to carry out such a demonstration, the enterprise must assess the future economic benefits to be generated by the asset on a stand-alone basis, or as a part of a cash generating

16 IAS 38 Intangible assets, Paragraph 7, cf. asset definition
17 IAS 38 Intangible assets, Paragraph 17
18 IAS 38 Intangible assets, Paragraph 21
19 Scoping document, Paragraph 12, third bullet-point
20 Draft, Paragraph 9
21 IAS 38 Intangible assets, Paragraph 57 a) and d)
unit, if the asset will generate economic benefits only in combination with other assets, either tangible or intangible.  

As the Draft does not discuss the usefulness of a requirement for probable future economic benefits, there is also no discussion of what possible guidelines there should be for demonstrating the ability of an item to produce future economic benefits. Comparatively, the IAS/IFRS approach is that the likelihood of both technological and commercial success for the item must be demonstrated.

E.g. if a risky R&D effort has a probability of 60% with regards to finishing a technological sound product, and a 60% probability of being successful from a commercial perspective, then the total probability of the item leading to future economic benefits for the MNE will only be 36%. Pursuant to IAS 38, such an item should not qualify as an intangible asset. It will not necessarily be appropriate to adopt a similar approach for transfer pricing purposes, but it is not obvious why such reasoning should not carry weight also for transfer pricing purposes.

Secondly, the question of how an item will manage to create value for the enterprise should be kept apart from valuation questions such when and at what size, i.e. in which future income periods the benefits will materialize, as well as estimating the concrete amounts. An item may have a theoretical value even if it is more likely than not that the item will fail to generate future economic benefits.

E.g. a risky R&D effort in year 0 will with 95% certainty fail, but there is a 5% probability that the effort will generate 1000 in income in year 1. The expected income from the R&D effort in year 1 will be 50, which discounted by a risk free rate of e.g. 2%, will generate a present value of approximately 49. In this example, there is at the time of the transfer pricing assessment in year 0, a 95% probability that the R&D effort will fail, but the item will have a value, at least in theory. The value of 49 is of course adjusted for the prevailing risk, but should still be regarded as highly speculative, because both the probability estimate and the estimate with regards to amount will be based on highly uncertain assumptions.

In practice it may prove impossible to sell such items in an arm’s length market, i.e. speculative values may be practically illiquid investments. Also, such items may only be of theoretical value for the MNE that invested in the R&D effort, e.g. because the item, upon completion, may only be used in conjunction with other intangibles belonging to the concrete MNE under review.

The question of whether an intangible item should be able to produce likely future economic benefits before being classified as an intangible also has a side to current transfer pricing practice with regards to cross border business restructuring (“CBBR”). It would seem that most countries do not view ordinary business opportunities as having “asset quality”, and therefore that such items should not be subject to compensation if transferred in a CBBR-setting. The distinction between general (not compensable) and special (compensable) business opportunities that some countries, e.g. Austria and Germany, operate with seems to be dependent upon how clear and probable the benefits under the opportunity is to the enterprise in question. Also, the cases described by Kroppen & Silva in the 2011 IFA General Report from the US and Denmark, seems principally to be in line with the above reasoning.

Further, it is stated in the Draft that the functional analysis should identify the “economically significant” intangibles. It is not clarified what is meant by this term. However, from the context is seems reasonable to assume that the identification of economically significant intangibles should take place before the item is actually valued for transfer pricing purposes.

22 IAS 36 Impairment of assets, Paragraph 67 b)  
23 Kroppen & Silva, Cahiers de droit fiscal international, Volume 96a, Section 2.3.3 (p. 40)  
24 Kroppen & Silva, Cahiers de droit fiscal international, Volume 96a, Section 2.3.3 (p. 40), third and fourth Paragraph
By way of summary, it is emphasised in the Draft that the key consideration under Article 9 of the MTC is whether a transaction “conveys economic value from one associated enterprise to another”. In my opinion, where it is more likely than not that an item will not produce any future economic benefits for an MNE, there are strong reasons why such an item should not be treated as an intangible for transfer pricing purposes. Such items should only be taken into consideration in the context of the comparability analysis under Chapter III of the Guidelines.

In my opinion, it should be addressed:

- whether items that are so uncertain that it is not possible to document that it is more likely than not that the item will entail future economic benefits for a MNE should at all be classified as intangibles under the Draft language.
- whether items that are more likely than not to fail with regards to generating future benefits, and therefore could possibly be classified as ordinary business opportunities, could nevertheless qualify as intangibles.
- whether the referral to “economically significant” intangibles entails that there indeed is a requirement for future economic benefits from an item before it could be considered an “intangible” for transfer pricing purposes.

2.2.3. Separate transferability

It is not a requirement under the formulation of “intangible” in the Draft that the item in question is separately transferrable in order for it to qualify as an intangible. This follows from the wording of the formulation of “intangible” and is confirmed below in the Draft where it reads that “… while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.”

Comparatively, IAS/IFRS contain criteria for identifiability in order for an item to qualify as an intangible asset. The purpose of the criteria is to distinguish intangible assets from goodwill. Pursuant to IAS 38, an asset is identifiable if it either is a) separable, i.e. capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged either individually or together with a related contract, identifiable asset or liability, regardless of whether the enterprise intends to do so, or b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. It is therefore clear that separate transferability is not a condition in order for an item to qualify as an intangible asset under IAS/IFRS.

However, as opposed to IAS/IFRS, both goodwill and going concern value shall be treated as intangibles under the Draft. As pointed out in the Draft, goodwill has a wider meaning in a transfer pricing context than it has for accounting purposes. For accounting purposes, goodwill recognised in a business combination is an asset representing the future economic benefits from other assets acquired in a business combination that are not individually identified and separately recognised. In addition to this item, goodwill for tax purposes will according to the Draft also encompass the expectation of future trade from existing customers, as well as possibly also other items. Going concern value is referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets.

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25 Draft, Paragraph 2
26 Draft, Paragraph 7
27 IAS 38 Intangible assets, Paragraph 11 and 12
28 IAS 28 Intangible assets, Paragraph 12
29 Draft, Paragraph 22
30 Draft, Paragraph 21
31 IAS 38 Intangible assets, Paragraph 11 and IFRS 3 Business Combinations, Paragraph 32
32 Draft, Paragraph 21
33 Draft, Paragraph 21
The concept of goodwill and going concern value seems more important from a transfer pricing point of view than it is in accounting. In the latter discipline, goodwill will only materialize in business combinations. However, in transfer pricing, a similar active “trigger” is not necessarily required. E.g. a tax administration may assess that parent company A *de facto* is in possession of goodwill in the form of a good reputation, that is not encompassed by an identifiable intangible, and that subsidiary B benefits from this goodwill in its local business and therefore should be obliged to pay a consideration for this transfer of value from A to B.

In order to avoid controversy and double taxation it is important that the labels of goodwill and going concern value is not used for transfer pricing purposes so that items that for some reason should not be allocated value in a transfer pricing assessment is because it has been viewed to be a part of the vague item which is goodwill or going concern value. As stated in the Draft; “*in a transfer pricing analysis for a matter involving the use or transfer of intangibles, it is important to identify the relevant intangibles with some specificity*”.34

As it stands now, an item may be recognised as goodwill pursuant to the Draft, and thereby also as an intangible, in a situation where the item is neither separately transferrable nor likely to produce future economic benefits for the enterprise. This may lead to controversy in that vague items are claimed to represent goodwill or going concern value and therefore should be included in a transfer pricing assessment. However, a requirement for likely future economic benefits from the goodwill or going concern item in question may to some degree serve as a safeguard against the inclusion of items in a transfer pricing assessment that are inherently particularly vague and significantly difficult to assess or document the potential value of.

In my opinion, it should be assessed:

- Whether it should be likely that goodwill and going concern value will produce future economic benefits for the enterprise before qualifying as “intangibles” under the Draft. I refer to what is said above under Section 2.2.2.

**2.2.4. Control**

Pursuant to the Draft, an intangible must be “capable of being owned or controlled for use in commercial activities”.35 The wording of the control-criteria seems influenced by the IAS/IFRS approach, under which “controlled” is a requirement.36 According to IAS 38, an enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits.37 Further, the capacity of an enterprise to control the future economic benefits from an intangible asset must generally stem from legal rights that are enforceable in a court of law. However, a narrow exception may be made for exchange transactions, e.g. if a customer portfolio has been transferred in an exchange transaction, this may serve as documentation of sufficient control.38

There are immediately differences between the Draft and IAS 38 with regards to the content of the control-criteria.

First, the object of control is defined differently in the two approaches. Under IAS 38, control refers to the ability to obtain the future economic benefits from the resource in question. This has two sides; first, the enterprise must positively be able to enjoy the future benefits, and secondly, the enterprise must be able to restrict others from doing the same. In the Draft, control refers to “*something ... for use in commercial activities*”. The wording of the Draft is unclear. Contextually, it must be assumed that “*something*” refers to an element of apparent value, because the Draft stresses the division between “*something*” on the one side and “*physical asset or a financial asset*”

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34 Draft, Paragraph 11  
35 Draft, Paragraph 5  
36 IAS 38 Intangible assets, Paragraph 8 and 13-16  
37 IAS 38 Intangible assets, Paragraph 13  
38 IAS 38 Intangible assets, Paragraph 16
on the other side. If this interpretation is justified, it should be assessed whether it is appropriate to keep the Draft wording on this point, or whether a new wording which points stronger towards value should be adopted.

Secondly, there seems to be differences with regards to the scope of the control requirement. As mentioned above, under IAS 38 there is only a very narrow exemption from the requirement for legally enforceable rights in the form of documented exchange transactions (and in that case - between independent parties).

The Draft states that "the availability and extent of legal, contractual or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes." It would seem from the latter sentence of the quoted that also items that cannot be protected by the MNE may be classified as intangibles under the Draft, and thereby also be allocated value in a transfer pricing assessment, as opposed to only being taken into consideration in a comparability analysis under Chapter III of the Guidelines.

That seems somewhat contradictory to the Draft’s formulation of "intangible". The Draft also emphasises the importance of distinguishing intangibles from market conditions or other circumstances that are not capable of "being owned, controlled or transferred" by a single enterprise. E.g. the Draft excludes group synergies, market specific characteristics and, at least as a starting point, assembled work force from qualifying as intangibles because such items may not be owned, controlled or transferred by an enterprise. Such items may therefore only be taken into consideration in a comparability analysis for transfer pricing purposes.

It may be that the exemption from the general requirement for control in order for an item to qualify as an intangible under the Draft is motivated by allowing for classification as intangible for the particular group of items described in Paragraph 26 of the Draft. It is stated there that a long term contract making available the services of uniquely qualified employees, cost savings by transfer of existing assembled workforce, as well as knowledge and trade secrets transferred in connection with the transfer or secondment of isolated employees may qualify as intangibles. Such items may therefore only be taken into consideration in a comparability analysis for transfer pricing purposes.

It is obviously a tremendous challenge for WP6 TPI to provide appropriate guidelines concerning talented employees or workforce. In an intangible asset setting, talented individuals are often the direct and significant force behind the creation of intangibles of enormous value, e.g. in the film, music and technology industry. Also, talented individuals may work in teams, so that a particular assembled workforce may have built a considerable "brand value". This is common within several industries, e.g. within the software and games industry. Such teams may in capacity of functioning as one unit have significant inherent value.

However, in general, it does not seem meaningful to view an item, that may unquestionably be of value in and of itself, to be of value to someone that does not have the ability to control who will enjoy the benefits associated with the item in question.

Domestic tax law seems divided with regards to the treatment of the assignment of skilled employees as transfer of intangibles. Comparatively, IAS 38 takes the view that an enterprise usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of intangible assets. The Draft seems to have chosen a split path. As a starting point, control is established as criteria for an item to be considered an intangible. This precludes items such as group synergies, market

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39 Draft, Paragraph 7
40 Draft, Paragraph 5
41 Draft, Paragraph 8
42 Draft, Paragraph 23, 24 and 25 respectively
43 Miyatake, Cahiers de droit fiscal international, Volume 92a, Section 4.2.4 (p. 30)
44 IAS 38 Intangible assets, Paragraph 15
45 Draft, Paragraph 5
specific characteristics and (in most cases) assembled workforce from being characterized as intangibles. Such items will only be taken into consideration in a transfer pricing comparability analysis.46

However, the formulation “The existence of such protection is not, however, a necessary condition for an item to be characterized as an intangible for transfer prising purposes”47 adds significant doubt as to the status of the control criteria. The formulation also seems to go significantly beyond what reasonably can be motivated by the exempted circumstances listed in Paragraph 26 of the Draft. The formulation is also somewhat difficult to reconcile with other statements in the Draft.48

In my opinion, the mentioned formulation should be reconsidered. In the situation described in Paragraph 26 first bullet-point of the Draft, concerning a particular group of uniquely qualified employees, sufficient control may perhaps be construed on the basis of the long term contractual commitment.

The second bullet point, on cost savings for the transferee by taking over an existing assembled work force, has similarities with group synergy effect. The transferee enjoys the effect of systems put in place by the transferor within the same MNE. Such an item may be taken into consideration in a comparability analysis.

The third bullet point under Paragraph 26 of the Draft does not seem to raise any particular questions. The Draft seems clear in that the transfer or secondment of isolated employees should not be regarded as transfer of an intangible. Further, on transfer of know-how and trade secrets in connection with a transfer of an employee, the transfer of know-how and trade secrets constitute transfers of intangible pursuant to the Draft.49 Therefore, in the context of an exemption from the control criteria, the third bullet-point of Paragraph 26 does not seem necessary.

By way of a summary, in my opinion, the control criteria for classifying an item as an “intangible” should be reaffirmed by reconsidering the formulation “The existence of such protection is not, however, a necessary condition for an item to be characterized as an intangible for transfer prising purposes”.

In my opinion, it should be assessed:

- Whether it would be appropriate to reconsider the wording "...something..." (Paragraph 5, first sentence of the Draft).
- Whether it would be appropriate to reconsider the formulation “The existence of such protection is not, however, a necessary condition for an item to be characterized as an intangible for transfer prising purposes” (Paragraph 7, second sentence, of the Draft).

3. ARM’S LENGTH PRICING FOR TRANSFERS OF INTANGIBLES WHEN VALUATION IS HIGHLY UNCERTAIN AT THE TIME OF THE TRANSACTION – INCOME BASED VALUATION AND HINDSIGHT

Transfer pricing methods are described in Chapter II of the Guidelines. The five OECD-recognised methods are the CUP-, resale-, cost plus-, transactional net margin-, and transactional profit split methods.50 These methods also apply for purposes of transfer pricing of intangibles.51 However, in practice, the CUP-, and in particular the transactional profit split method, have proven useful.52

An important modification of the description of pricing methods in the Guidelines with regards to transfer pricing of intangibles is the guidance given for arm’s length pricing when valuation is

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46 Draft, Paragraph 8, 23-25
47 Draft, Paragraph 8, second sentence
48 Especially Draft, Paragraph 8, but also 23-25
49 Draft, Paragraph 16
50 Guidelines, Section 2.13-2.20, 2.21-2.38, 2.39-2.55, 2.56-2.107 and 2.108-2.149 respectively
51 Guidelines, Paragraph 6.13
52 Draft, Paragraph 136 and 140
highly uncertain at the time of the transaction.\textsuperscript{53} Pursuant to this guidance, tax administrations are entitled to assess the transaction in question on the background of what independent enterprises would have done in comparable circumstances.

Thus, if a tax administration finds that independent parties would have insisted on a price adjustment clause to supplement a, presumably fixed, pricing set at the time of the transaction, the tax administration is permitted to impute such a clause.\textsuperscript{54} Corresponding guidelines are also provided for a business restructuring setting.\textsuperscript{55} Pursuant the guidance on business restructuring, a tax administration will be entitled to determine the arm’s length price for the transfer of the intangible on the basis of the adjustment clause or re-negotiation that would be provided at arm’s length in a comparable uncontrolled transaction.

The Scoping document states that “While paragraph 6.20 of the TPG includes a reference to a net present value calculation, it does so as a comparability factor rather than as a pricing method. The WP6 TPI will consider the extent to which financial valuation methods and in particular the Discounted Cash flow method (“DCF”) should be given greater recognition in the TPG.”\textsuperscript{56}

The Draft establishes the position of financial valuation techniques for transfer pricing purposes. This both as supplementary and independent methods for setting an arm’s length price in matters involving the use or transfer of intangibles. The Draft states that “Depending on the circumstances, they may be used either as a part of one of the five OECD approved methods described in Chapter II (e.g. in determining how to split profits as part of a transactional profit split method), or as a tool that can be usefully applied in identifying an arm’s length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions.”\textsuperscript{57}

Where, as the situation often will be, reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified, it is possible to use valuation techniques to estimate the arm’s length price for intangibles transferred between associated enterprises.\textsuperscript{58} Valuation approaches based on discounting estimated future cash flows attributable to the transferred intangible are viewed by the Draft as particularly useful analytical tools.\textsuperscript{59}

Similarly to the Guidelines, the Draft contains guidance on arm’s length pricing for transfers of intangibles when valuation is highly uncertain at the time of the transaction.\textsuperscript{60} Materially, this guidance seems largely equal to the corresponding guidance contained in Chapter VI and IX of the Guidelines.

It may seem somewhat contradictory that the guidance on subsequent adjustment when valuation is highly uncertain at the time of the transaction is carried over from the Guidelines to the Draft in, more or less, its existing form.

A key feature of DCF-valuation is that the inherent risk of projections of future cash flows is either taken into consideration directly when estimating future cash flows, or by using a risk adjusted discount rate. The Draft states that “... because the accuracy of financial projections will depend upon developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.”\textsuperscript{61} With regards to the discount rate, it is stated in the Draft that "the discount rate or rates should reflect

\textsuperscript{53} Guidelines, Paragraphs 6.28-6.35 and examples in Annex to Chapter VI
\textsuperscript{54} Guidelines, Paragraph 6.34
\textsuperscript{55} Guidelines, Paragraph 9.87-9.88
\textsuperscript{56} Scoping document, Paragraph 32
\textsuperscript{57} Draft, Paragraph 109
\textsuperscript{58} Draft, Paragraph 145
\textsuperscript{59} Draft, Paragraph 148
\textsuperscript{60} Draft, Paragraphs 171-178
\textsuperscript{61} Draft, Paragraph 154
the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case”. Therefore, the risk inherent in the projections of future cash flows must be considered in the transfer pricing valuation. This feature seems to separate DCF-valuation from the traditional five OECD-methods described in Chapter II of the Guidelines.

The issue of a possible collision between the guidance on subsequent adjustment of the transfer price when valuation is highly uncertain at the time of the transaction and the use of hindsight seems particularly relevant in light of the Draft’s endorsement of income-based methods for valuation of intangibles, such as DCF-valuation.

Given that DCF-valuation, carried out at the time of the transaction, is based on due diligence and sound judgement in confirming assumptions used and in estimating valuation parameters, pursuant to Paragraph 150 of the Draft and under the guidance of Paragraphs 147-170 of the Draft, it might be argued that any subsequent adjustment of the agreed transfer price constitutes a use of hindsight, precisely because all risk factors that existed, and were foreseeable, at the time of the transaction did indeed form an integral part of the valuation.

In my opinion, it should be assessed:

- whether the guidance given in Paragraphs 171-178 of the Draft should be applicable to transfer prices for transfers of intangibles that were produced using diligent and sound DCF-valuations pursuant to the guidance given in Paragraphs 145-170 of the Draft.

Respectfully yours,

Oddleif Torvik
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Norwegian School of Economics NHH

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62 Draft, Paragraph 162
Attn. Mr. Joseph Andrus  
Organisation for Economic Co-Operation and Development (OECD)  
Head of Transfer Pricing Unit  
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By e-mail  
joe.andrus@oecd.org

13 September 2012

Dear Mr. Andrus,

Transfer Pricing Associates (“TPA”) is pleased to accept OECD’s invitation to share our views on the Proposed Revisions of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions issued on 6 June 2012 (“Discussion Draft”).

TPA supports the OECD’s decision to release the Discussion Draft as an interim draft for public comments. TPA is of the view that the result of previous public consultations at the OECD regarding the topic of intangibles, the published Discussion Draft and subsequent commentary from the business community are all important contributions for Working Party No. 6 in the process of updating Chapter VI.

TPA is especially pleased that the OECD has provided a total of 22 practical examples in the Annex to the Discussion Draft, to replace the current Annex to Chapter VI of the OECD Guidelines. It is our view that these “case study” examples and the anticipated revisions to Chapter VI of the OECD Guidelines will provide more practical guidance to multinational enterprises (MNEs) and tax authorities on how to deal with everyday transfer pricing issues involving intangibles.

Our submission focuses on providing comments on some of the key concepts introduced, as well as addressing particular areas where we believe further work is needed by the OECD. Additionally, we raise a few questions we believe will provide further insight into topics raised by the Discussion Draft.

TPA congratulates the OECD with its initiative, but also encourages the OECD to provide further guidance on the topic of intangibles within a reasonable time frame. Further delays will potentially create unprecedented levels of controversy between MNEs and tax authorities or between tax authorities around the world.
As such TPA will be addressing:

a. implications of changes and new concepts;
b. the approach of evaluating “entitlement to intangible related returns”;
c. valuation methods of the use and transfer of intangibles;
d. areas for further work.

a. Implications of changes and new concepts

1. The Discussion Draft establishes a significant shift from Chapter VI of the OECD Guidelines (2010). As a general note, TPA is of the view that the text of the Discussion Draft provides more direct guidance to practitioners on how to deal with transfer pricing aspects of intangibles. On the other hand, certain paragraphs of the Discussion Draft raise additional questions, and generate ambiguity compared to Chapter VI of the OECD Guidelines (2010).

2. It is our belief that the departure from accounting, legal and tax definitions (i.e. Article 12 of the Model Tax Convention) presented in Paragraphs 5 and 12 of the Discussion Draft has the potential to eliminate important standards and definitions that are typically used by practitioners as a starting point to evaluate an intangible for transfer pricing purposes. This stance by the OECD will likely lead to an increase in controversy between MNEs and tax authorities on intangibles.

3. TPA strongly supports the notion of excluding “market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise” in Paragraph 8 from the definition of intangibles for transfer pricing purposes.

4. The introduction of the four functions related to intangibles (development, enhancement, maintenance and protection) and the four risks related to intangibles (development risk, product obsolescence risk, infringement risk and product liability risk) are providing more explicit guidance to taxpayers on performing a functional analysis. TPA recommends to the OECD to provide more clarity on the level of involvement needed by each of the group companies of an MNE (threshold test) in Paragraph 40 of the Discussion Draft, for a group entity to claim an entitlement to intangible related returns.

5. Paragraph 53 addresses the extra-ordinary circumstances under which tax authorities can disregard the contractual allocations of entitlement to intangible related returns, notwithstanding the fact that the four functions, four risks and intangible related registrations and contractual entitlements (so called ‘cloud of contractual rights’) are fully aligned. TPA is of the view that Paragraph 53 leaves too much room for interpretations from tax authorities’ perspective, with the risk that the majority of cases will be attacked by tax authorities rather than the few ones which are described in a narrow fashion under Paragraphs 1.64 - 1.69 of the OECD Guidelines (2010).
6. The wording under Paragraph 109 indicates that the ‘application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions’. TPA encourages the use of income based methods since these methods enable practitioners to consider more parameters that may affect value and that have economic relevance than other valuation methods. Furthermore, TPA believes that Paragraph 110 rightfully reflects that MNEs should be careful in using valuations for transfer pricing purposes that were actually conducted for IP law, accounting, managerial, anti-trust law and other purposes. However, TPA recommends taking these valuations into consideration whilst conducting a valuation for transfer pricing purposes in order to get a better understanding of the setting in which the valuation for transfer pricing purposes takes place and to allow MNEs to leverage from the sometimes relevant valuations performed for a different purpose.

7. In summary, TPA believes that the analysis to determine entitlement to intangible related returns does increase the complexity and level of variables to be addressed by a taxpayer, before such entitlement is being confirmed and captured in a written documentation for transfer pricing purposes. Therefore, TPA advocates the OECD to provide guidance on the level of detailed analysis required in relatively straight forward cases where intangibles are being used or transferred by one group entity to another, e.g. a single US licensor licenses the right to produce and distribute (based on a patent owned by the US) to its French manufacturer, which subsequently sells these products to third parties in the marketplace. When this particular case results in more than one group entity being entitled to the intangible related returns, the concepts start having an overlap with the concept of cost contribution arrangements/cost sharing agreements and create different outcomes than under the original Chapter VI.

b. The approach of evaluating “entitlement to intangible related returns”

8. The approach of evaluating “entitlement to intangible related returns” is one of the most significant changes introduced in the Discussion Draft. Rather than focusing on balance sheets and ownership of intangibles, the approach centres on profits/losses and cash flows of stakeholders of the intangibles in question. Defining the functions of developing, enhancing, maintaining and protecting an intangible as required to be entitled to a return introduces a change in the paradigm for MNEs in terms of how functions, assets, risks, and costs with respect to intangibles are examined.

9. The introduction of the concept of “entitlement to intangible related returns” by the OECD in Paragraph 29, is laying the foundation for requiring MNEs to fully align the legal/contractual arrangements, the performance of functions relating to an intangible, the risks associated with those functions, as well as the costs borne, in order to receive the recurring benefits of an intangible. TPA believes that the concept of “entitlement to intangible related returns” is an important step in aligning the legal, economic and accounting realities of group companies involved in intangibles. TPA has created a diagram
that provides clarity in this matter. See Appendix I for the determination of which group entities would be entitled to intangible related returns.

10. The emphasis placed on controlling the risks and functions that are related to an intangible begins to align Chapter VI further with the rest of the OECD Guidelines, specifically Chapter IX. The threshold of entitlement aims to establish a standard that could prove to be a key factor leading to the evaluation of which parties within an MNE are entitled to intangible related returns. The introduction of the threshold of responsibility seems to have similar attributes and requirements of the “qualified membership” of a Cost Sharing Agreement (investor’s model/classification). TPA questions whether the complexities introduced here do require OECD to address at the same time the relevant context not only for use/transfer of intangibles (Chapter VI), but also for cost contribution arrangements/cost sharing agreements (Chapter VIII). The “threshold of entitlement” seems to be focused on circumstances that exist prior to any sharing of intangible related returns between related parties (i.e. prior to licensing or cost-sharing). If a cost-sharing participant “invests” in the cost-shared intangibles via an up-front payment, this should entitle him to intangible income going forward in some respects. TPA is of the view that the OECD wording is essentially focused upon situations where rights lie prior to any transaction, so as to better be able to price any proposed transaction. TPA recommends that OECD clarify this position further.

11. In its current form the Discussion Draft does not seem to allow in any way for acknowledgement of a simple financial commitment from the outset as making a party entitled to intangible related returns. For example, if Entity A in Country X and Entity B in Country Y decide to co-fund a brand new research project and the activities are performed by Entity B in their lab; does this allow for Entity A to be recognized as a 50/50 owner if it only funds half of the research from the starting date of the project? In a third party setting Entity A would expect to be entitled to intangible related returns; however, the wording of the Discussion Draft indicates such entitlement would not be present in the above example.

12. The introduction of the ‘control over risk’ theme for intangibles in Paragraph 42 does bring some challenges for MNEs, since it is not always clear whether these risks relate to (1) simply the holding of intangibles by a group entity and/or (2) active management of the four risk categories in Paragraph 43. TPA recommends OECD to clarify its position.

c. Valuation methods and intangibles

13. Due to the complex nature of intangibles, the process of assigning value and pricing intercompany transactions involving the use or transfer of intangibles should be conducted on a case-by-case basis and requires an in-depth analysis of the parties involved, business reasons for the transaction and other important factors. In order to properly price an intercompany transaction TPA recommends to avoid strictly applying one method, but rather having a primary source of reference to determine the value as well as use the other sources to place the value and valuation process in the relevant business context.
14. Rather than looking at every intangible through the same lens, the practitioner, and tax authority alike, should evaluate each intangible as a unique asset and examine factors that differentiate the intangible and contribute to its value. TPA is of the belief that the Discussion Draft provides support for this perspective, specifically in Paragraph 147.

15. TPA is of the view that in performing a valuation analysis of an intercompany transaction involving the use or transfer of intangibles, the focus should not be on utilizing market based comparables as the initial step. Due to the unique nature of intangibles developed within an MNE, there are typically no 100% comparable intangibles in the marketplace that could be used effectively without some or even considerable adjustments. For example, it would be extremely difficult to find a reliable comparable transaction involving same/similar intangibles in the market when testing an intangible that has been internally generated by an entity within an MNE and is being transferred to a related party. On the contrary, various royalty rates references used in industry between third parties are considered a useful complementary reference point, i.e. cannot be rejected if/insofar providing appropriate information to determine the level of intercompany royalty rates.

16. Because of the need for further guidance, TPA recommends the creation of a Communication Protocol, or typical process to perform a transparent and defensible valuation study, similar to the guidance provided in Paragraphs 3.4 and 3.5 of the OECD Guidelines (2010), which provides a typical process for selecting the most appropriate comparables set. This typical process, as outlined in Paragraphs 3.4 and 3.5 of the OECD Guidelines (2010), is already used when performing a database search of one of the available royalty databases in order to determine the quantitative reference points as described under Section 15 above. However, a Communication Protocol/typical process for the intercompany transfer of intangibles does not exist yet. See Appendix II for a sample proposed outline, prepared by TPA, of ten steps of a typical valuation process in case an intangible (or the right to use and/or commercially exploit an intangible, i.e. through a license arrangement) is being transferred by one group entity to another group entity.

17. While Section D of the Discussion Draft allows the application of a variety of valuation methods to be used when no reliable comparables exist, TPA believes that further clarity and guidance is needed in Section D of the Discussion Draft on how to apply specific valuation methods. Although in some countries the legislation is already specific on ranking of valuation methods in the case of an intercompany transfer of intangibles, TPA recommends to the OECD to provide a listing without ranking instead, since - like the traditional transfer pricing methods (CUP, Cost plus, Resale price, TNMM/CPM and Profit split) - rankings would create a bias towards the income based method, which certainly is not always the most appropriate method for valuing a transferred intangible.

d. Areas for further work

18. The Discussion Draft references the importance of “economically significant intangibles” in Paragraph 11, and also introduces the idea that intangible related returns “may be positive,
negative or zero” in Paragraph 28. TPA suggests further clarification by the Working Party when evaluating the Discussion Draft.

19. TPA believes that the concept of “entitlement to intangible related returns” is a step in the right direction by the OECD. However, this introduction may provide further ambiguity among MNEs and tax authorities. It appears that there is a large amount of overlap between the four sets of functions; separating individual functions from one another may become increasingly complex within an MNE. As such, TPA believes that further work is needed by the Working Party with respect to this point.

20. An additional area that should be further clarified is the application of valuation techniques and/or methodologies. As such, TPA would urge the OECD to provide more guidance in Section D regarding the practical application of valuation techniques regarding pricing intercompany transactions involving intangibles. A Communication Protocol/typical process template is attached as Appendix 2.

21. The issue of whether an assembled workforce provides a service or represents a transfer of know-how is also a pressing question for the Working Party. Paragraph 26 of the Discussion Draft attempts to provide an answer to this question; however, TPA is of the view that further work is needed on this subject. TPA refers to Commentary on Article 12, Paragraphs 11-11.6 in the OECD Model Tax Convention on Income and on Capital (July 2010). Paragraph 11.3 states that “The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties.”

TPA and its alliance partners will be pleased to contribute to the further development of updated Chapter VI and other relevant sections of the OECD Guidelines with respect to intangibles.

Yours sincerely,

On behalf of Transfer Pricing Associates¹,

Steef Huibregtse

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¹ For a complete list of Transfer Pricing Associates and Transfer Pricing Associates’ alliance partners please see http://www.tpa-global.com.
Appendix I: Visual Representation of the Threshold of Entitlement to Intangible Related Returns

Note: In case a group entity within an MNE through its FTEs on its payroll is:

i. involved in development / enhancement / maintenance / protection of intangibles,

ii. managing the four types of intangibles related risks, and

iii. has sufficient access to a cloud of contractual rights relating to these intangibles,

an entitlement to intangible related returns exists. The major question is “what is the threshold” definition before entitlement to intangible related returns exists at the level of a group entity.
Appendix II: Communication Protocol

Ten steps for the valuation of intangible assets in the context of an intercompany transaction

Below is a description of the typical process that can be followed when performing a comparability analysis of intangibles that are components of a transaction with a related party when the transaction is an outright transfer of an intangible or involves the license (value in use) of an intangible. This process is considered to be a good practice and is not compulsory, and any other search process leading to the identification of a reliable valuation may be acceptable, as reliability of the outcome is more important than the process. This process, if applied correctly, has the potential to lead towards a more transparent valuation, but completing the steps does not guarantee that the outcome will lead to an arm’s length result.

Step 1: Determine the type of transaction. Evaluate if and insofar the transaction involves a straightforward transfer of an intangible.

Step 2: Functional analysis of the parties involved, including the functions performed, assets used and risks assumed as well as the period or date when the transaction takes place.

Step 3: Determine which intangibles are the object to be transferred and the nature of those intangibles and the risks associated with the intangibles. Determine if there is a need to separately identify each intangible or whether intangibles can be grouped together.

Step 4: Evaluate the parties which are potentially entitled to the intangible related returns, i.e. which group entity/entities is/are acting as the seller of the intangible(s).

Step 5: Identification of internal and external comparables. If comparables exist, apply one of the five methods accepted in Chapter II of the OECD Guidelines (2010). If no reliable comparables exist, apply steps 6 through 9.

Step 6: Evaluate the business case for this transaction and the benefits triggered by the intangibles. In order to determine these benefits one should consider the impact the intangibles have on the expected future cash flows of the business (which could be a direct or indirect impact). Allocate the expected future cash flows attributable to the intangible and assess the risk profile of the intangible taking step 3 into consideration.

The ability to allocate expected future cash flows to an intangible is paramount assuming a going concern situation and taking into consideration the expected lifetime of the intangible.

Some elements to consider:

a. Demand

b. Substitutes

c. Exclusivity

d. Extent and duration of legal protection
e. Geographic scope

f. Economic life of the intangible

g. Development stage

h. The rights to enhancements and revisions

i. Expected future benefits

**Step 7:** Examine both the seller’s and buyer’s perspectives and the major options realistically available to each of the parties involved in the transaction as well as any unique or unusual aspects of the controlled transaction that result from the parties being related. For example, a discount for not being able to trade/transfer the intangible(s) in a ‘free’ market place.

**Step 8:** Selection of the most relevant valuation techniques and the most appropriate transfer pricing method to apply.

**Step 9:** Execution of the valuation techniques and transfer pricing methods.

**Step 10:** Full implementation of the above intercompany transfer of intangibles through drafting / signing intercompany legal agreement(s) and other implementation steps.
COMMENTS SUBMITTED BY TRANSFER PRICING CONSORTIUM

Identifying the OECD’s Transfer Pricing Intangibles

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The OECD Committee on Fiscal Affairs, through its Working Party No.6, has issued on June 6, 2012 a redraft of the July 22, 2010 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The redraft specifically addresses Chapter VI, Special Considerations for Intangibles Property. In essence, the 2012 draft is an interim draft. If the Committee on Fiscal Affairs were to promulgate this material in its present form, it would totally replace the predecessor intangible provisions in the OCED Guidelines. The reader is forewarned that the predecessor provisions contained 39 sections; in contrast, the forgoing provisions contain 267 sections.

The redraft is only partial, and does not represent a complete draft of all of the provisions ultimately expected to form a part of the output for this project. Working Group No. 6 has not addressed the following three transfer pricing facets, but plans to release these changes at subsequent dates:

1. The intangible provisions might have to make necessary modifications to the cost contribution arrangements, Chapter VIII of the Transfer Pricing Guidelines. Note that the United States has promulgated cost sharing provisions. Any attempt to integrate the U.S. cost sharing principles with the OECD intangible provisions, if this were to occur, would extend the timing for such integration.

2. The intangibles provisions fail to address the transfer pricing consequences of various items treated in this draft as comparability factors rather than as being intangibles themselves. These factors include market-specific advantages, location-based advantages, corporate synergies, and workforce issues. The reader should note that these issues remain hot-button issues.

3. The intangible provisions need to address any additional conforming changes to Chapter I through Chapter III pertaining to the arm’s principle, transfer pricing methods, and comparability analysis, and to Chapter VII pertaining to services as affecting Chapter VI.

Two dates are important: providing written comments to Joseph L. Andrus, Head of the Transfer Pricing Unit, Centre for Tax Policy and Administration (joe.andrus@oecd.org), in word format, by September 14, 2012. The public consultation will take place during the week of November 5, 2012 in Paris. This analysis looks at the identifying of OECD’s Intangibles for transfer pricing purposes, the first portion of material by the OECD published on June 6, 2012.

Preliminary Considerations
The drafters make clear the relationship of Article 9 of the OECD Model Tax Convention at Chapter VI of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Article 9 pertains to the taxation of associated enterprises, the legal justification for transfer pricing adjustments in the OECD treaty context. In a broad brush, the draft guidelines address situations in which the conditions made or imposed in the use or transfer of intangibles between associated enterprises differ from those conditions that could be made between independent enterprises. In such an associated enterprise situation, any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not accrued, the tax administration could include in the profits of that enterprise and tax the enterprise accordingly.\textsuperscript{i}

As a general matter, the purpose of this Chapter VI is to provide guidance specifically tailored to determine the arm’s length conditions for transactions that involve the use of transfer of intangibles. Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises. The draft makes clear that Article 9 is not concerned with the assigning of labels to such transactions. The draft focuses on “economic value” and on the “benefit derived” within the Article 9 context. Consequently, “the key consideration,” according to the drafters, is whether a transaction conveys economic value from one associated enterprise to another. In other words, the transaction conveys economic value whether that benefit derives from tangible property, from intangibles, from services, or from other items or activities. The drafters caution that the fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for Chapter VI, does not imply that the item or activity does not convey economic value. In a similar matter, the drafters caution that the fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for Chapter VI, does not imply that the item or activity need not be considered in determining arm’s length prices and other conditions for controlled transactions.\textsuperscript{ii}

The drafters remind us that the principles of Chapter I, Chapter II, and Chapter III of the Guidelines, pertaining to the arm’s length principle, transfer pricing methods, and comparability analysis, apply equally to transactions that involve intangibles and to transactions that do not involve intangibles. As such, as is the case with other transfer pricing matters, the drafters proscribe that the analysis of cases involving the use or transfer of intangibles is to begin with a “thorough comparability analysis,” including a functional analysis. The draft fails to define “thorough comparability analysis,” but does define a functional analysis as to identify the functions performed, assets used, and risks assumed by each relevant member of the multinational (MNE) group. The drafters caution that, in cases involving the use or transfer of intangibles, it is especially important for the multinational enterprise or the tax administration to ground the analysis on the understanding of the MNE’s global business, and on the manner in which the MNE uses the intangibles to add value or to create value.\textsuperscript{iii}

The multinational enterprise or the tax administration, in order to determine the arm’s length conditions for the use or transfer of intangibles, must consider the following facets as part of the comparability analysis and functional analysis:\textsuperscript{iv}

1. The identification of the specific intangibles.
2. The identification of the party or parties that should be entitled to retain the return from the party or the parties derived from the use or transfer of the intangibles.

3. The nature of the controlled transactions, and whether these controlled transactions involve the use of intangibles and/or lead to the transfer of intangibles between the parties.

4. The remuneration that independent parties would pay for the use or transfer of such intangibles.

**Identifying Intangibles**

The OECD, in focusing on identifying the intangibles, would have the intangible run the gamut of preliminary conditions:

- Basic definitions
- Presence of significant economic value
- Complementary nature of a collection of intangibles
- Accounting treatment
- Form of protection
- Separate transferability
- Capability of being owned
- Identification as opposed to valuation
- Separate computation and premium returns
- Existence and transfer
- Specificity requirements
- Prohibition on undifferentiated intangibles

**Basic definitions** The draft guidelines define intangible assets so as to address an asset that is not a physical asset or a financial asset, but an asset that is capable of being owned or controlled for use in commercial activities. A financial asset is any asset that is cash, an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples of financial assets include bonds, bank deposits, stocks, shares, forward contracts, futures contracts, and swaps. The transfer pricing analysis is not to rely on accounting definitions or legal definitions, but on the arrangement itself. The thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

**Presence of significant economic value** The draft guidelines recognize that the accounting treatment of intangibles might differ from the intangibles for transfer pricing purposes. The drafters use as an example the treatment of internally-developed intangibles created through research and development and advertising. The enterprise might reflect such internally-developed intangibles as expensed items rather than capitalized, and not carry these items on their balance sheet. Nevertheless, such intangibles may carry “significant economic value” – the
transfer pricing criterion. As such, the enterprise might need to consider these items for transfer pricing purposes. vi

Complementary nature of a collection of intangibles An enterprise might create an “enhancement to value” from the “complementary nature of a collection of intangibles” when the enterprise exploits these items together. The draft guidelines point out that the enterprise might not reflect these items on the balance sheet. The drafters fail to define the term “complementary nature of a collection of intangibles” in the “enhancement to value” context or to provide examples. As transfer pricing practitioners, we strongly suspect that the drafters are referring to workforce in place as an example of such a complementary nature of a collection of intangibles.

Accounting treatment The drafters to the guidelines expend considerable effort to ascertain whether an item is to be considered an intangible for transfer pricing purposes under Article of the OECD Model Tax Convention. The characterization of this item might change for accounting purposes, but the terminology will not determine the result. The drafters would create a wide swath in categorizing the item. The determination by a multinational enterprise or by a tax administration that they are to regard an item as an intangible for transfer pricing purposes does not determine or follow its characterization for general tax purposes, i.e., as an expense or as an amortizable asset.

Form of protection The drafters recognize the importance for “forms of protection,” but then, having recognized the importance of the protection forms, diminish the importance of these protection forms. The form of protection refers to legal protection, contractual protection, or other forms of protection, to the availability and extent of these protections, and to returns that the enterprise can expect. The drafters make clear that the existence of such protection does not, in itself, create a necessary condition for an enterprise to characterize the intangible as an intangible for transfer pricing purposes. vii

Separable transferability The drafters recognize that the enterprise might or might not identify intangibles separately and then transfer these intangibles on a segregated basis. In contrast, the enterprise might transfer these intangibles only in combination with other assets. As a result, the separate transferability is not a necessary condition for an enterprise to characterize an item as an intangible for transfer pricing purposes.

Capability of being owned The drafters would impose the capability of being owned as a threshold requirement to intangible treatment. Market conditions and other circumstances are not capable of being owned, controlled, or transferred by a single enterprise. As such market conditions or other circumstances are not intangibles for transfer pricing purposes. In contrast, features of a local market that are within the “capability of being owned” threshold might affect the determination of the arm’s length price for a particular transaction. These facets include the features of the local market, such as the level of disposable income in that market or the size and relative competitiveness of the market. The enterprise is to take these facets into account in a comparability analysis, but these items are not intangibles for purposes of Chapter VI. viii
Identification as distinct from valuation The drafters make clear that the identification of an item as an intangible is separate and distinct from the determination of the value of the item or return that is attributable to the item under the facts and circumstances of a given case. Intangibles can account for either a large part or small part of the MNE’s “value creation,” depending on the industry sector and on other facts specific to a particular case. ix

Separate compensation and premium returns The drafters emphasize that the enterprise can group certain intangibles, and that not all intangibles deserve separate compensation in all circumstances. Further, not all intangibles give rise to premium returns in all circumstances. As an example, an enterprise performs a service using non-unique know-how, and other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, the facts and circumstances dictate that the know-how does not justify the allocating a premium return to the enterprise, i.e., the premium over and above normal returns to the functions the enterprise performs.

Existence and transfer The drafters suggest that the enterprise take care in determining whether or when an intangible exists, and whether the enterprise has used or transferred the intangible. In this regard, not all research and development expenditures produce or enhance an intangible. Not all marketing activities result in the creation of an intangible or an enhancement of an intangible.x

Specificity requirements The drafters suggest that the enterprise identify the relevant intangibles “with some specificity.” The draft guidelines, however, fail to define the scope of the “some specificity” standard. Nevertheless, the enterprise is to apply the “some specificity” requirement to achieve the following:

- Pursue functional analysis that should identify the “economically significant” intangibles as issue,
- Pursue functional analysis that should identify the manner in which these intangibles contribute to the creation of the value in the transactions under review,
- Pursue functional analysis that should identify the manner in which these intangibles interact with other intangibles, with tangible assets, and with business operations to create value.

Prohibition on undifferentiated intangibles The drafters recognize that it might be appropriate to the enterprise to aggregate intangibles for purposes of determining arm’s length conditions, whether for the use or the transfer of the intangibles in certain cases. Nevertheless, it not sufficient for the enterprise to suggest that “vaguely specified or undifferentiated receivables” have an effect on arm’s length prices or on other conditions. The drafters call for a “thorough functional analysis,” including an analysis of the importance of identified economically significant intangibles in the MNE’s global business to support the determination of arm’s length conditions.xi

Limitations and Exclusive Use
The drafters of the intangible regulations are emphatic that this transfer pricing guidance applies to these provisions exclusively, and these draft guidance are not to apply for other tax purposes. In this regard, the drafters refer to Article 12 of the Model Tax Convention on Income and Capital, which addresses the taxation of royalties. Thus, for example, the Commentary on Article 12 contains a detailed discussion of the definition or royalties, paragraphs 8 through 19 under that Article. Article 12 contains a definition of royalties. The draft guidance makes clear that the Article 12 definition of “royalties” is not intended to provide any guidance whether, and if so at what price, the independent parties would remunerate the transfer of intangibles. The drafters make clear that Article 12 is not relevant for transfer pricing purposes.

Further, the draft regulations make clear that the manner in which an enterprise characterizes a transaction for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subjected to withholding tax under Article 12. To emphasize this point, the drafters take the position that the concept of “intangibles” for transfer pricing purposes, on one hand, and the definition of “royalties” for purposes of the Article 12 of the OECD Model Tax Convention, on the other hand, are two different notions. The drafters take the position that there is no need to align these concerns.

The drafters recognize that there might be situations in which a payment made between associated enterprises might be regarded as not constituting a royalty for purposes of Article 12. Nevertheless, the enterprise might treat these payments for transfer pricing purposes as a payment made in remuneration for intangibles to which the principles of this intangibles chapter apply. The difference between these results occurs as to certain payments related to goodwill or to ongoing concern value. The difference between these results occurs when a payment is properly treated as a royalty under Article 12 of a relevant treaty, but the payment cannot be made in remuneration for intangibles for purposes of this intangibles chapter. This disparity can occur concerning technical services. The drafters make clear that the rules and definitions in the intangibles chapter have no relevance for customs purposes.

Categorization of Intangibles

Historically, multinational enterprises and tax administrations have sought to categorize intangibles when addressing transfer pricing issues. The multinational enterprises and tax administrations would describe the categories of intangibles and then apply these definitions. The drafters have abandoned this scheme altogether.

The multinational enterprises and tax administrations had made the following delineations:

- between trade intangibles and marketing intangibles,
- between “soft” intangibles and “hard intangibles,”
- between routine and non-routine intangibles, and
- between other classes and categories of intangibles.
The drafters make clear that the approach in the new intangibles chapter for determining arm’s length prices in cases involving intangibles does not turn on these categorizations. Accordingly, the drafters caution that the intangible Guidelines do not attempt to delineate various classes or categories of intangibles.xiii

Illustrations Concerning Intangibles

Multinational enterprises and tax administrations typically consider various items when undertaking transfer pricing analysis involving intangibles. The drafters use the enumerated examples to clarify the identification of intangibles, but the drafters do not intend these illustrations to be comprehensive or to provide a complete listing of items that might or might not constitute intangibles:

- patents
- know-how and trade secrets
- trademarks, trade names, and brands
- licensing and similar limited rights in intangibles
- goodwill and ongoing concern value
- grouping synergies
- market specific characteristics
- assembled workforce

This listing is incomplete. Numerous items not included in this listing of illustrations might be intangibles for transfer pricing purposes. The drafters suggest that each country adapt the illustrations to the specific legal and regulatory environment that prevails in that country. Furthermore, the user of this analysis should view these illustrations in the context of the comparability analysis, including functional analysis, of the controlled transaction. The user of this analysis should pursue this analysis with the objective of better understanding how intangibles, and items the enterprise does not treat as intangibles, contribute to the “creation of value.”xiv

Patents

The drafters define the term “patent” to mean “a legal instrument that gives exclusive rights to its owner to use a given invention for a limited period of time within a specific geography.” The drafters recognize two types of patents, pertaining to a physical object or to a process. The enterprise often develops patentable inventions through risky and costly research and development activities. The drafters do recognize that, in some circumstances, small research and development expenditures can lead to highly valuable patentable inventions.

The drafters visualize the developer of a patent seeking to recover its development costs, and earning a return, through one or more of the following:

- by the sale of products covered by the patent
- by licensing others to use the patented invention, or
- by an outright sale of the patent.
The patent gives the user exclusivity. That exclusivity allows the patent owner to earn premium returns in some circumstances from the use of the invention. In other cases, an owner having a patented invention might provide cost advantages the owner’s competitors would not have. Patents are intangibles for transfer pricing purposes.\textsuperscript{xv}

**Know-how and trade secrets**

The drafters define know-how and trade secrets as “proprietary information or knowledge that assist or improve a commercial activity” but the owner of the know-how and trade secrets does not register for protection in the manner of a patent or trademark. Such know-how or trade secrets generally consist of “undisclosed information” of an industrial, commercial, or scientific nature arising from previous experience, where such experience has practical application in the operation of an enterprise.

The value of the know-how and the trade secrets, according to the drafters, is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or the trade secret. The owner might be able to protect the confidential nature of the know-how and trade secrets in some degree by the following:

- under unfair competition laws or other similar laws
- under employment contracts
- by economic and technological barriers to competition.

Know-how and trade secrets are intangibles for transfer pricing purposes.\textsuperscript{xvi}

**Trademarks, trade names, and brands**

The drafters define a trademark as “a unique name, symbol, logo, or picture” that the owner might use to distinguish its products or services from those of other entities. Countries typically establish a registration system to reflect these proprietary rights. The registered owner of the trademark can exclude others from using this trademark in a manner that would create confusion in the marketplace. An enterprise may continue the trademark registration if the enterprise continues to use the trademark and appropriately renews its registration.

An enterprise can establish a trademark for goods or services. The enterprise can apply the trademark to a single product or service, or to a line of products or services. Trademarks are most familiar at the consumer market level, but users of trademarks can encounter these trademarks at all market levels. Trademarks are intangibles for transfer pricing purposes.\textsuperscript{xvii}

A trade name might or might not be the name of the enterprise. Such a trade name might have the same “force of penetration” as a trademark. The law might permit the owner of the trade name to register the name as some specific form similar to a trademark. The consumer might be able to recognize the trade names of certain MNEs. Enterprises might use trade names
in marketing a variety of goods and services. Trade names are intangibles for transfer pricing purposes.\textsuperscript{xviii}

The drafters use the term “brand” interchangeably with the terms “trademark” and “trade name.” In other contexts, consumers view a brand as a trademark or trade name imbued with social and commercial significance. A brand might constitute a combination of intangibles, including among others, trademarks, trade names, consumer relationships, reputational characteristics, and goodwill. The drafters inform us that it might sometimes be difficult or impossible for the enterprise to segregate or separately transfer the various intangibles contributing to brand name. A brand name might consist of a single intangible, or a collection of intangibles, for transfer pricing purposes.\textsuperscript{xi}

**Licensing and similar limited rights in intangibles**

The drafters recognize that parties commonly transfer rights to use intangibles by means of a license or similar contractual arrangement, whether written, oral, or implied. The users of this license might limit these rights as field of use, term of use, geography, or in other ways. Such limited rights in intangibles are themselves intangibles for transfer pricing purposes.\textsuperscript{xx}

**Goodwill and Ongoing Concern Value**

The drafters fail to ascertain a universal definition of “goodwill.” Instead, the drafters acknowledge that an enterprise can use the term “goodwill” to reflect a number of different concepts. Consider the following:\textsuperscript{xxi}

- In some accounting and business valuation contexts, the term “goodwill” represents the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible assets and intangible assets.
- In other accounting and business valuation contexts, the term “goodwill” represents the representation of the future economic benefits associated with business assets that the enterprise does not individually recognize or separately recognize.
- In other contexts, the term “goodwill” reflects the expectation of future trade from existing customers.

In a similar fashion, the drafters fail to define the term “ongoing concern value.” According to the drafters, this term “sometimes” refers to the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. The use of the term “sometimes” in this context suggests that other definitions are available, but that the drafters failed to use these alternative definitions.

The drafters provide that “it is generally recognized that” goodwill and ongoing concern value are assets that the enterprise cannot segregate or transfer separately from other businesses. The business restructuring OECD Guidelines discuss the related notion of the transfer of all of the elements in an ongoing concern in connection with the restructuring.
The drafters step away from those two objectives, and relinquish the goal of ascertaining these two crucial definitional concepts: xxii

- the precise definition of goodwill for transfer pricing purposes, and
- the precise definition of ongoing concern value for transfer pricing purposes.

The drafters acknowledge that enterprise uses the terms “goodwill” and “ongoing concern value” to describe an important and monetarily significant part of the compensation that independent parties pay to each other when they transfer some or all of the assets of an operating business. The drafters acknowledge that similar transactions might occur between associated enterprises, and suggest the enterprise use such value in determining the arm’s length price. It might be necessary for the enterprises to transfer a reputational value by means of a trademark or other license in determining an appropriate royalty.

The enterprise, in assuring that it takes into account such goodwill and ongoing concern value, is to treat these amounts as intangibles for transfer pricing purposes. Nevertheless, the drafters caution that such treatment does not imply, however, that the enterprise can derive the residual measures of goodwill for some accounting purposes or for business valuation purposes as being appropriate measures of the price the enterprise would pay for the transferred business or licensing rights. The enterprise might take into account these measures together with their associated goodwill and going concern value as independent parties would ascertain these amounts. Again, the drafters caution that, in most instances, accounting and business valuation measures of goodwill and of going concern value are not relevant for purposes of transfer pricing analysis.

**Group Synergies**

The drafters address the concept of “group synergies” in ascertaining intangibles, but fail to define that “group synergies” term. The drafters acknowledge that “in some circumstances” group synergies contribute to the level of income the MNE group earns, but the drafters fail to define what circumstances would be to evoke these conditions. The drafters do acknowledge that such group synergies can take many different forms, including the following:xxiii

- streamlined management,
- elimination of costly duplication of effort,
- integrated systems,
- purchasing power,
- other similar measures.

This “group synergies” concept has two defects, both of which the drafters ignore:

- The scope of the group synergy is in flux. The drafters give no guidance in ascertaining when the group synergy begins – or ends.
- The drafters provide no guidance as to measure the scope of the group synergies.

The drafters, rather than addressing the specifics of the group synergies provisions,
provide that such features may have an effect on the determination of arm’s length conditions of controlled transactions. Instead, the drafters would have us address group synergies for transfer pricing purposes as being “comparability factors,” but the drafters give us no guidance as to how we would able to ascertain these comparability factors. The drafters would have us escape the further analysis of group synergies on the basis that a single enterprise does not own or control the group synergies, and as a consequence, these intangibles are not within the scope of the transfer pricing provisions. We contend, however, that each enterprise might have its own specific streamlined management, duplication of effort, integrated systems, purchasing power and the like, and as a consequence, owns the intangible, making it relevant for transfer pricing purposes.

**Market Specific Characteristics**

The drafters make clear that the specific characteristics of a given market might affect the arm’s length conditions in that market. In this regard, the drafters use the example of the high purchasing power of households in a particular market. Such high purchasing power might affect the prices the consumer pays for certain luxury goods. The drafters provide other examples of market-specific characteristics that might affect the prices the consumer pays for specific goods and services in a particular market, such as:

- Low prevailing labor costs,
- Proximity to markets,
- Favorable weather conditions, and
- Similar facets

These facets may affect the prices the customer pays for specific goods and services in a particular market. Nevertheless, an individual enterprise does not own, control, or transfer such market-specific characteristics. As such, such items are not intangibles for transfer pricing purposes. Instead, the enterprise is to take such items into account in its transfer pricing analysis only through its required comparability analysis. Such market-specific characteristics are not intangibles that the enterprise is to take into account for transfer pricing purposes. See the comparability analysis provisions of Chapter III and the location savings in 9.148-9.153.

**Assembled Workforce**

The drafters recognize that some businesses are successful in assembling a uniquely qualified cadre of employees or an experienced cadre of employees. The existence of such an employee group, through its assemblage of the cadre of employees, might affect the arm’s length price for services the employee group provides. Alternatively, the existence of such an employee group, through its assemblage of the cadre of employees might affect the efficiency with which the enterprise produces the services. The drafter fails to address the impact of the assembled workforce issue for transfer pricing purposes, and instead the enterprise would ordinarily take such assembled workforce factor into account in a comparability analysis.

The drafters realize the following facets concerning the assembled workforce:
1. Contractual rights and obligations might be intangibles for transfer pricing purposes. As such, a long-term contractual commitment to make available the services of a particular group of uniquely qualified employees might constitute an intangible in a particular circumstance.

2. The transfer of an existing assembled workforce might provide a benefit to the transferee. The assembled workforce could save the transferee the expense and difficulty of hiring and training a new workforce. As such, the existing assembled workforce might affect the compensation required in connection with the transaction.

3. The transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of the intangible. Nevertheless, as a factual matter, such transfer might result in the transfer valuable know-how or trade secrets for which compensation might be required in arm’s length dealings.

The drafters would rely on the specific facts of the case to determine the issue, i.e., the detailed functional analysis to control the transfer pricing outcome.

Commentary

It is our view that drafters have highlighted a number of salient transfer pricing intangible issues, but the drafters have failed to address solutions and parameters, such as to group synergies, for example. Further, the drafters would have the enterprise rely on a comparative analysis of factors that do not exist in practice.
Ascertaining Parties Entitled to Intangible—Related Returns
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The OECD Committee on Fiscal Affairs, through its Working Party No.6, has issued on June 6, 2012 a redraft of the July 22, 2010 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The redraft specifically addresses Chapter VI, Special Considerations for Intangibles Property. The first portion of this redraft, which we addressed previously, focused on the identifying of the intangibles. The second and third portions, which we address today, focus on the identification of the parties entitled to intangible-related returns, and on transactions involving the use or transfer of intangibles.

The draft intangible transfer pricing guidelines are uniformly of the view that transfer pricing outcomes should reflect the functions performed, assets used, and risk assumed by the parties. Neither legal ownership related to the intangible development nor the bearing of costs related to the intangible development, whether taken separately or together, entitles an entity within the MNE group to retain the benefits or returns as to the intangibles. The drafters make clear that this view of transfer pricing is consistent with other sections of the Guidelines. Nevertheless, the drafters fail to substantiate this consistency. The drafters further make clear that this view of consistency does not reflect an intention to depart from the principles of Article 9 of the Model Treaty, the taxation of associated enterprises. As transfer pricing practitioners, it is our view that the purposes for retaining of the benefit rule in the draft guidelines are vague and not specific.

The drafters suggest the returns from the intangibles should follow the contributions to ascertain the value of the intangibles. The enterprise could require the compensation of the various functions, assets, and risks of the MNE members with the objective of being consistent with the intangible value they create. This “consistency of value” approach, however, appears to be fraught with difficulty when multinational enterprises or tax administrations apply this approach. The drafters request that businesses comment as to whether the formulation contained herein successfully communicates the economic principles at issue. Alternatively, other approaches might more clearly convey the message that the enterprise should determine returns that are attributable to intangibles within the MNE group based on relevant functions, assets, and risks.

The Identification Process

After the enterprise identifies the intangible, the drafters postulate that the enterprise is to make a second threshold inquiry when a transfer pricing analysis involves the use or the transfer of intangibles. The enterprise is to determine its entitlement for intangible-related returns for transfer pricing purposes on the basis of the analysis of the relevant facts and circumstances present in a particular case. The drafters warn that, depending on the facts, more
than one party to a transaction involving the use or transfer of intangibles might be entitled to intangible–related returns as to a given intangible or to different intangibles. xxvii

The intangible – related provisions in Chapter VI which are attributable to a particular intangible are the “economic return from business operations” where these operations involve the intangible. The enterprise, in ascertaining the economic return from business operations, is to deduct the following amounts to determine the return: xxviii

- The costs and expenses related to the relevant business operations.
- Returns to business functions, assets other than the particular intangible in question, and the risks, taking into account appropriate comparability adjustments. The drafters fail to define “appropriate comparability adjustments” in this context, and fail to provide a database analysis that could result in such a comparability adjustment.

The drafters caution that, in a particular circumstance, intangible-related returns as to an intangible might be positive, be negative, or zero. The drafters fail, however, to provide examples.

The goal of the intangible provisions is to ascertain which members of a MNE group are entitled to intangible-related returns as to this intangible. The enterprise is to consider the following factors: xxix

1. The terms and conditions of the legal arrangement, including relevant registrations, licensing agreements, and other relevant contracts.
2. Whether the activities of the enterprise align with the “allocation of entitlement,” i.e. by
   a. The activities that the enterprise performs consist of the functions the enterprise performed, the assets the enterprise used, and risks the enterprise assumed, and the costs incurred the enterprise by members of the MNE group.
   b. The activities of the intangibles consist in the developing, the enhancing, the maintaining, and the protecting of the intangibles.
   c. The enterprise is to reflect the allocation of entitlement to intangible-related returns in the relevant registration and contracts.
3. The issue becomes whether the enterprise compensates the intangible on an arm’s length basis under relevant circumstances. In other words, the issue becomes whether other members of the MNE group are entitled to intangible-related returns under the relevant registrations and contracts. In this regard, the enterprise is to consider whether services it rendered in connection with the developing, enhancing, maintaining, and protecting the intangibles provide such compensation.

Registration and Contractual Arrangements

The drafters recognize that legal registrations and contractual arrangements are the starting point for the enterprise in determining which members of an MNE are entitled to
intangible-related returns. The enterprise might be able to ascertain the terms of transaction in written contracts or in correspondence and/or in other communication between the parties. There might be situations in which no written terms exist. In such an event, the enterprise is to deduce the contractual relationships of the parties from their conduct and from the economic principles that generally govern relationships between independent enterprises.

The drafters recognize that, from a legal perspective, the enterprise might be able to protect the right to use some types of intangibles under specific intellectual property laws and under specific registration systems. Intangibles subject to such a legal and a registration system include patents, trademarks, and copyrights. In general terms, the registered legal owner of such intangibles has the exclusive legal and commercial right to use such intangible. The registered legal owner has the right to prevent others from using the intangible. The enterprise can grant these rights for a specific area and/or a specific period of time.

The drafters also realize that specific intellectual property registration systems will not protect certain intangibles. Nevertheless, the intangibles are legally protected against unauthorized appropriation or imitation via unfair competition legislation or through other enforceable laws, or by means of employment contracts. This category of intangibles includes the following: trade dress, trade secrets, and know-how. Such intangibles include intangibles that are not protected under any applicable law.

The drafters would have us recognize that both the conditions of available protection under the applicable law and the availability of protection under applicable law can vary from country to country. Local law is frequently determinative. For instance, depending on local law, the availability of legal protection may be subject to the continued commercial use of the intangible. Alternatively, the availability of legal protections might depend on the timely renewal of registrations.

The drafters acknowledge that it is often the case that an entity that is entitled other parties from using the intangibles will enter into contracts that make available to others the full or partial rights to these intangibles. The enterprise can limit a license or other grant of partial rights in a number of ways. These ways include the geographic scope, the time period, or class of products. The enterprise can grant these rights on an exclusive basis or on a non-exclusive basis.

The drafters provide that such contracts might impose restrictions on the rights provided:
- The use of the intangible,
- The exploitation of the intangible,
- Reproduction of the intangible,
- Further transfer of the intangible, and
- Further development of the intangibles.

The drafters postulate that the enterprise would be assessing the respective
entitlements of the MNE group to the intangible-related returns. In this regard, the drafters postulate that it is important for the enterprise to examine the specific terms of such agreements, and the restrictions the agreements impose, if any.

The transfer pricing objective is to align the relevant registrations and contractual arrangements with the conduct of the parties with the entity entitled to use the intangible under applicable law and relevant contracts. As a general matter, the enterprise seeks to align the relevant registrations with the conduct of the parties. Such an entity is entitled to use the intangible and to exclude others from using the intangibles under applicable law and related contracts. That entity is entitled to intangible-related returns as to that intangible for transfer pricing purposes. A different situation applies to a license or a similar arrangement, such as through geographical scope, time period, or class of products. The enterprise can grant the rights on an exclusive basis or a non-exclusive basis. The enterprise can grant limitations on these rights as to the use, exploitation, reproduction, and further transfer of intangibles. The enterprise, in assessing the respective entitlements of the members of the MNE group to intangible-related returns, can examine the specific terms of such arrangements and on the restrictions these agreements impose.xxxv

The drafters suggest that legal registrations and relevant contracts form the beginning point for an analysis for which members of an MNE group are entitled to intangible-related returns. Because legal restrictions and relevant contracts are the starting point, the drafters conclude that it is good practice for associated enterprises to document in writing their decisions to allocate significant rights in intangibles. The drafters would have associated enterprises document their decisions before the enterprise effectuates these decisions through the development, the enhancement, the maintenance, or the protection of the intangibles.xxxvi

Functions, risks, and costs relating to intangibles

The process here is for members of the MNE group to evaluate the extent to which the members are entitled to intangible-related returns. The drafters emphasize the importance of the enterprise in examining the conduct of the parties. The goal is to ascertain whether the parties’ conduct is aligned with the terms of the legal registrations and contracts, or whether the parties’ conduct indicates that that the parties have not followed the legal forms and contractual terms.

The enterprise is to evaluate whether the alignment that an enterprise asserts in a contractual claim is entitled to claim all or part of the intangible-related returns attributable to an intangible. Such activities include the conduct of the parties, the examination of functions, risks, and costs where such activities are related to the development, enhancement, maintenance, and protection of the intangibles as is necessary. The drafters visualize that the enterprise would be evaluating the alignment between a contractual claim to entitlement to all or part of the intangible-related returns where these activities are related to the intangible and to the conduct of the parties. The conduct of the parties would consist of the examination of the
functions, risks, and costs where these activities are related to the development, enhancement, maintenance, and protection of the intangibles as necessary. xxxvii

The drafters acknowledge that there might be situations in which the conduct of the parties might not align with the terms of the legal registrations and contracts. In those situations, it might be appropriate for the enterprise to allocate all of the intangible-related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to the development, enhancement, maintenance, and protection of the intangibles. The drafters would apply the best evidence rule in ascertaining the conduct of the parties, i.e., the best evidence concerning the true allocation of entitlements to intangible-related returns.

**Functions**

The drafters assume that the conduct of the parties might align with the terms of the registrations and contracts. In such an event, the member of the MNE group contractually entitled to intangible-related returns will undertake the following: xxxviii

- Perform the functions related to the development, enhancement, maintenance, and protection of the intangible, or
- Arrange to have such functions to be performed under its control by independent enterprises or by associated enterprises dealing on an arm’s length basis.

The drafters acknowledge that an enterprise might transfer intangibles. In such a situation, the transferee is to look to the alignment of contractual rights and conduct. The transferee is to perform or control the functions following the transfer.

The drafters contemplate that the enterprise is to examine the specific functions of the enterprise in evaluating the enterprise’s entitlement to intangible-related returns. Such functions depend on the particular facts of the case. The enterprise is to focus on the functions that lead to the development of intangibles, including the following: xxxix

- Research and development functions leading to the development and enhancement of product-related intangibles.
- Marketing functions leading to the development and enhancement of trademarks and related intangibles.

Such functions will be especially important in evaluating which members of an MNE group are entitled to intangible-related returns. The drafters comment that functions that are related to preserving the legal protections the law accords to intangibles, and the intangible defense against infringement, are similarly important.

The drafters would have the enterprise eschew the physicality of functions the enterprise could perform. The drafters conclude that “it is not essential” that the party claiming entitlement to the intangible-related returns physically perform all of the enterprise’s functions.
Such functions relate to the development, enhancement, maintenance, and protection of its intangibles through the enterprise’s employees. \textsuperscript{xii}

The drafters recognize that, in transactions that take place between independent enterprises, the enterprise might outsource some of its functions to other independent entities. Yet one member of an MNE group might claim entitlement to intangible-related returns. Such an enterprise could similarly expect to retain, in some cases, on the part of either independent enterprises or associated enterprises transacting - on an arm’s length basis – to perform certain functions that relate to the development, enhancement, maintenance, and protection of the intangibles.

A separate provision applies when the enterprise aligns its functions with claims to intangible-related returns in contracts and in registrations. In such a situation, the entity claiming entitlement to intangible-related returns will physically perform, through its own employees, the important functions relating to the development, enhancement, maintenance, and protection of the intangibles. The drafters provide a partial enumeration of functions. Such functions might include the following:

- The design and control of research and marketing programs,
- Management and control over budgets,
- Control over strategic decisions regarding intangible development programs,
- Important decisions regarding intangible defense and the protection of intangibles, and
- Ongoing quality control over the functions that an independent enterprise or associated enterprises might perform.

The threshold standard as to these functions is that these functions might have “a material effect” on the value of the intangible.

The enterprise might retain associated enterprises to perform functions that are related to the development, enhancement, maintenance, or protection of intangibles. In that event, the enterprise might align contractual entitlements and functions. The party or parties claiming contractual entitlement to the intangible-related returns is expected to exercise control over the performance of those functions and associated risks. The party or parties are expected to bear necessary costs required to support the performance of the function, and are expected to provide arm’s length compensation to any associated enterprise physically performing a relevant function. The tax administration is to assess whether the member of the MNE group claiming entitlement to intangible-related returns in fact controls the performance of the related functions. The drafters would have the multinational enterprise and the tax administration apply 9.23 through 9.28 of the Guidelines as to the meaning of “control” in this context. \textsuperscript{xii}

**Risks**

The drafters contemplate that the conduct of the parties would align with the terms of the registrations and contracts. In such an event, the member or members on the MNE group
entitled to intangible-related returns will bear and control the risks associated with the intangibles. The risks associated with the intangibles include the development, enhancement, maintenance, and protection of the intangibles. The enterprise might transfer such intangibles. The transferee bears and controls the risks where the transferee aligns the contractual rights and conduct when the transfer takes place. The drafters would have the multinational enterprise and the tax administration apply 9.23 through 9.28 of the Guidelines as to the meaning of “control” in this context.xlii

Certain type of risk might have more importance in considering the entity or the entities entitled to intangible-related returns:xliii

1. Risks related to the development of intangibles, including the risk that the costly research and development or marketing activities will prove to be unsuccessful,
2. The risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles,
3. Infringement risk, including the risk that the defense of intangible rights or the defense against other persons’ claims against infringement, may prove to be time-consuming and/or costly, and
4. Property liability and similar risks transferred to products and services based on the nature of the intangible.

The drafters would have the enterprise focus on the causality of the event. “It is especially important,” according to the drafters, to reach this decision in assessing the degree of alignment between the enterprise’s contractual allocations of the entitlement to intangible-related returns among members of the MNE group and the members’ conduct. The enterprise would focus on this degree of alignment to determine whether costs incurred when relevant risks come into fruition are in fact borne by the entity claiming entitlement to intangible-related returns.

An arrangement might not have the requisite level of alignment between the actual conduct of the parties and the contractual allocation of the intangible-related returns. There is no such requisite level of alignment where there is a mismatch between the contractual allocation among associated enterprises. The alignment process looks to the entitlement to intangible-related returns and the allocation among those associated enterprises as to related risk-associated costs. xliv The principles of 9.10 through 9.46, the special considerations for risks, apply in assessing which members of the MNE group bear the risks associated with the entitlement to intangible-related returns. xlv

Costs Related to the Development, Enhancement, Maintenance, and Protection of Intangibles

The drafters contemplate that the parties would align their conduct with the terms of the registrations and contracts. When such an alignment does take place, the costs that the enterprise incurs to develop, enhance, maintain, and protect intangibles should be borne by the member or members of the MNE group claiming entitlement to intangible-related returns. The drafters focus on causality, and visualize that it would be important for the enterprise in
evaluating the entitlement to the intangible-related returns to consider which entities have borne the relevant costs. The drafters would provide the enterprise with a partial solution to this inquiry. In some circumstances, the enterprise’s bearing the relevant costs might involve the providing arm’s length compensation to associated enterprises for functions the associated enterprises performs under the control of the member of the MNE group claiming contractual entitlement to intangible-related returns.\textsuperscript{xlvii}

The drafters seek to differentiate and emphasize the bearing of costs, on one hand, from the entitlement to intangible-related returns, on the other hand. “It is important to recognize” that the bearing of costs related to the development, enhancement, maintenance, and protection of intangibles does not, in and of itself, create an entitlement to intangible-related returns.\textsuperscript{xlvii}

**Arm’s Length Compensation**

The drafters address the arm’s length compensation for functions that are performed by associated enterprises where these functions relate to the development, enhancement, maintenance, or protection of intangibles. In this regard, the drafters speak of the “one condition” for concluding that the contractual and other arrangements of the MNE group are related to the entitlement to intangible-related returns. The “one condition” is that the activities are aligned with the conduct of the parties. The associated enterprises perform functions related to the development, enhancement, maintenance, or protection of the intangibles. The associated enterprise might not claim entitlement to intangible-related returns. Instead, the enterprise must be provided with arm’s length compensation for the functions they perform.

The drafters would have the enterprise assess whether it fully compensates associated enterprises in situations in which the enterprise retained these associated enterprises to perform functions related to the development, enhancement, maintenance, and protection of intangibles on an arm’s length basis. In this analysis, it is necessary to consider both the compensation paid and the level of activity undertaken. The enterprise, in making this analysis, should refer to both the level of the activity and the compensation received by comparable uncontrolled entities performing similar functions in assessing whether the compensation the enterprise provides is consistent with the arm’s length principle.\textsuperscript{xlviii}

The drafters would have the enterprise undertake various common situations in ascertaining arm’s length compensation. Such situation can occur where associated enterprises other than the members of the MNE group perform these marketing functions. These members, under their legal registrations and contracts, are entitled to intangible-related returns where these returns are attributable to trademarks and to related customer-oriented intangibles, such as marketing arrangement or a distribution arrangement.

The drafters recognize that, in such a case, it is necessary to determine how to compensate the marketer/distributor for its activities. The categorization of the marketer/distributor is important here. On one hand, the enterprise should compensate the
marketer/distributor as a service provider, i.e., for providing promotion and distribution services, or, on the other hand, the enterprise should share in the present and future intangible-related returns attributable to the trademarks and related intangibles.\textsuperscript{xlix}

The analysis of the service provider situation versus the return sharing situation requires the enterprise assess the obligations and rights and imply the following:

- by the legal registrations and by agreements between the parties,
- by the compensation the enterprise provides for the functions, risks, assets, and costs incurred by the parties, and
- by the compensation the enterprise provides for the functions, risks, assets, and costs of the marketer distributor.

The drafters frequently postulate “no change” situations, that “it will often be the case” that the return on marketing functions, risks, assets, and costs will be “sufficient and appropriate.” The drafters, however, fail to provide parameters for such sufficiency and appropriateness. The drafters view the distributorship situation as being clear, i.e., a “relatively clear case.”

Such a distributor might act merely as being an agent. The enterprise reimburses the distributor for its promotional expenditures. The enterprise, in claiming entitlement to intangible-related returns, directs and controls its activities by claiming entitlement to intangible-related returns as to trademarks and related intangibles. In such a situation, the distributor ordinarily would be entitled to compensation appropriate to the agency activities alone. That distributor would not bear or control the risks associated with the development of the trademark and other intangibles. As such, the distributor would not be entitled to share in any intangible-related returns.\textsuperscript{1}

The drafters recognize that there might be situations in which the distributor actually bears the cost of its marketing activities. The situation might occur when there is no arrangement for the owner to reimburse the expenditures. In that situation, the issue is the extent to which the distributor is able to share the potential benefits deriving from the functions, assets, risks, and costs, whether currently or in the future.

The drafters provide a general rule concerning arm’s length transactions. The arm’s length transaction is the ability of a party, where that party is not the registered owner or the legal owner of the trademarks and related intangibles, to obtain the benefits of marketing activities that increase the value of these intangibles. This accretion in value depends principally on the substance of the rights of that party.

The drafters provide us with an example of this accretion in value. Such a distributor might have the ability to obtain benefits from its functions performed, its assets used, its risks borne, and its costs incurred in developing the value of the trademark. The distributor acquires these benefits from its turnover and market share, where the distributor has a long-term contract of sole distribution rights for the trademarked product. In such cases, the distributor
should determine its share of benefits based on what an independent distributor would obtain in comparable circumstances.

The drafters recognize that, in some cases, a distributor might incur marketing costs, incur risks, or perform functions that are beyond those costs, risks, or functions that an independent distributor with similar rights might incur or perform, doing so for the benefit of its own distribution activities. In such a case, an independent distributor might obtain a share of the intangible-related returns of the owner of the trademark or related intangibles. The independent distributor might have a share of the intangible-related returns through a decrease in the purchase price of the product, or a reduction in the royalty rate, in order to compensate the distributor for its functions, assets, risks, and costs.\textsuperscript{\text{li}}

The principles set out in the foregoing paragraphs also apply in the following situations:

- The performance of research and development functions by a member of an MNE group under a contractual arrangement with an associated enterprise that claims entitlement to intangible-related returns.
- In situations in which a member of an MNE group provides manufacturing services on behalf of an associated enterprise that claims entitlement to intangible-related returns, and the manufacturing service provider engages in functions that might lead to process or product improvements.\textsuperscript{\text{lii}}

Disregard of Transactions, Registrations, and Contracts

Paragraphs 1.64 – 1.69 of the Guidelines discuss “extraordinary circumstances;” according to the drafters, the recognition of the “actual transactions undertaken.” The tax authorities can disregard contractual allocations of the enterprise’s entitlement to intangible-related returns. The tax authorities can take this action notwithstanding the fact that the registrations and contractual entitlements are fully aligned with the functions, risks, and costs related to the development, enhancement, maintenance, and protection of the intangibles.\textsuperscript{\text{liii}} In this regard, see the role of contractual terms and other parts of these Guidelines, 9.164-9.167.

Transfer Pricing Adjustments in Cases Involving Entitlement to Intangible-Related Returns

The drafters summarize the intangible provisions when a party is entitled to intangible-related returns. The enterprise, to be entitled to intangible-related returns, must meet three standards in substance:\textsuperscript{\text{livi}}

- Perform and control “important functions” related to the development, enhancement, maintenance, and protection of the intangibles and the control of other related functions performed by independent enterprises or associated enterprises that the enterprise compensates on an arm’s length basis. Quite regrettably, the drafters fail to define the scope of the term “important functions.”
- Bear and control the risks and costs related to developing and enhancing the intangible.
Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible-related returns.

A party might be allocated intangible-related returns under contacts and under registrations. Such a party might:

- Fail to perform and control important functions
- Fail to control other related functions performed by independent or associated enterprises
- Fail to bear and control relevant risks and costs.

In such situations, the parties performing and controlling all or part of such risks will be entitled to all or part of the intangible-related returns.

As a general matter, when the relevant functions, risks, and costs are aligned with legal registrations and the terms of relevant contracts, the tax authorities should generally respect the allocation of entitlement to intangible-related returns. The tax authorities should make this determination on the basis of that contractual allocation of intangible-related returns. Transfer pricing adjustments may be appropriate where such risks, functions, and costs are not in alignment with contractual allocations. The enterprise can allocate part or all of such intangible-related returns to the parties performing such functions and bearing such risks. The examples in the draft guidelines illustrate the application of these principles.

Transfer Involving the Use or Transfer of Intangibles

The drafters take the approach that the enterprise must address a third threshold at the beginning of any transfer pricing analysis of controlled transactions involving the use or transfer of intangibles. The thresholds are the following:

- Identifying with specificity the intangibles involved in a particular transfer pricing matter,
- Identifying which member or members of the MNE group are entitled to intangible-related returns arising from the use or transfer of such intangibles,
- Identification and proper characterization of the specific controlled transactions involving intangibles

The drafters provide that Chapter I in the Guidelines, the Arm’s Length Principle, applies in identifying and characterizing transactions involving the use or transfer of intangibles. Nevertheless, the drafters caution that the characterization of a transaction for transfer pricing purposes has no relevance for determinations under Article 12 of the OECD Model Tax Convention, the taxation of royalties. As transfer pricing practitioners, it is our view that the drafters have failed to address the consequences of such disparity in treatment.

The drafters specify that there are two general types of transactions in which the “identification and examination” of intangibles will be relevant for transfer pricing purposes. The drafters fail to enumerate the two types of transactions in this context, but indicate that the
These two categories are intangibles in connection with sales of goods or services, and intangibles connected with the transfers of intangibles.

Transactions Involving the Use of Intangibles in Connection with Sales of Goods or Services

The drafters here address two categories of transactions. In the first case, intangibles that the enterprise might use in connection with controlled transactions in situations. Here using the intangible in situations in which there is no transfer of the intangible or the rights in the intangible. For example, one or both parties to controlled transaction might use intangibles in connection with the manufacture of goods sold to an associated enterprise, either in connection with the marketing of goods purchased from an associated enterprise, or in connection with the performance of services on behalf of associated enterprise. The enterprise is to clearly specify the nature of such transaction. The enterprise is to identify any intangibles that one of the party uses in connection with such a controlled transaction. The enterprise is to take the following into account:

- these intangibles into taken into account in the comparability analysis, including the functional analysis,
- the selection and application of the most appropriate transfer pricing method for that transaction, and
- the choice of the tested party.

The following example illustrates the need of the enterprise to consider the use of intangibles by a party to controlled transaction involving a sale of goods:

- Assume that a car manufacturer uses valuable proprietary patents to manufacture cars.
- The car manufacturer than sells the cars to associated distributors
- Assume the patents significantly contribute to the value of the cars.
- The manufacturer of the car should take into account the patents and the value that they contribute to the car in the comparability of the transaction,
  - Consisting in the sale of cars by the car manufacturer to its associated distributors,
  - In selecting the most appropriate transfer pricing method for the transactions, and
  - In selecting the tested party.
- The associated distributors purchasing the cars do not, however, acquire any right in the manufacturer’s patents.
- In such a case, the manufacturer uses the patents in manufacturing, and the patents might affect the value of the cars, but the manufacturer does not sell the patents themselves.

Consider another example as to the use of intangibles in connection with a controlled transaction.
• Assume that an exploration company has acquired or developed valuable geographical geological data and analysis.
• Assume that an exploration company has acquired or developed sophisticated explanatory software and know-how.
• Assume further that the exploration company uses those intangibles in providing exploration services to an associated enterprise.
• The exploration company should take these intangibles into account as to the following situations:
  o In the comparability analysis of the service transactions between the exploration company and the associated enterprise,
  o In selecting the most appropriate transfer pricing method for the transaction, and
  o In selecting the tested party.
• The exploration company uses the intangibles in the performance of services, but the exploration company does not transfer these services when the associated enterprise of the exploration company does not acquire any rights in the exploration company’s intangibles.

Transactions Involving Transfers of Intangibles

The drafters here address two categories of transactions. In the second case, the owner of the intangibles might transfer the intangible in a controlled transaction. Such a transfer might encompass all of the rights in the intangibles in question, e.g. a sale of rights, or the transfer might encompass limited rights, e.g. a license or similar transfer of rights to use an intangible which might be subject to geographical restrictions, limited duration, restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop these rights.\textsuperscript{xii}

The drafters caution that, in transactions involving the transfer of intangibles or rights in intangibles, “it is essential” for the enterprise “to identify with specificity” the nature of the intangibles and the rights in intangibles that enterprise shifts between associated enterprises. The law or contractual arrangements might impose limitations on the enterprise’s rights to transfer the intangible. In that event, it is necessary to identify the nature of such limitations and on the full extent of the rights transferred.\textsuperscript{xiii}

The enterprise might restrict the use of an intangible, whether through a license or similar arrangements, as to the further development of a new intangible or for new products. These restrictions are often of significant importance in a transfer pricing analysis. Accordingly, the drafters view the identifying the nature of a transfer of rights in intangibles as being important. The goal is to consider whether the transferee receives the right to use the transferred intangible for the purpose of future product development.

The drafters would have the enterprise consider transactions between unrelated parties. In such unrelated party situations, the transferor / licensor might retain the full right to any enhancement of the licensed intangible the parties might develop during the term of the license. In other unrelated party situations the transferee /licensee retains the right to any
enhancements it may develop, either for the term of the license or in perpetuity. The nature of any limitations on the further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancement, can affect the value of the rights transferred. This situation could impact the comparability of two transactions involving otherwise identical or closely comparable intangibles.\textsuperscript{lxiv}

Paragraphs 1.52 -1.54 address the scope of contractual terms within the context of the arm’s length principle. Paragraphs 1.64-1.69 address the scope of recognition of the actual transactions undertaken within the context of the arm’s length principle. Both sets of provisions apply in identifying the specific nature of a transaction involving a transfer of intangibles, in identifying the nature of any intangibles transferred, and in identifying any limitations imposed by the terms of the transfer on the use of these intangibles. The drafters provide an example under paragraphs 1.52-1.54: The tax authority need not respect a written specification that a license is not-exclusive, or is of limited duration, if such specification is not consistent with the conduct of the parties.\textsuperscript{lxv}

Transfers of Combinations of Intangibles

An enterprise can transfer intangibles, including limited rights in intangibles, individually or in combination with other intangibles. Two related issues often arise in considering transactions involving transfers of combinations of intangibles.\textsuperscript{lxvi} The first of these transfers involves the nature and economic consequences of the interactions between different intangibles. The second of these transfers involves the assurance that all enterprise has identified the intangibles that it is has identified.

The first of these transfers involves the nature and economic consequences of the interactions between different intangibles. The drafters would have the enterprise consider that some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately. The drafters then conclude that it is important for the enterprise to identify the nature of the legal and economic interactions between intangibles that the enterprise transfers in combination.\textsuperscript{lxvii}

The drafters provide an example of transfers of combinations of intangibles. For example, a pharmaceutical product might have associated with it three or more types of intangibles.

- The enterprise might protect the active ingredient by one or more patents.
- The product might have gone through a testing process.
- A governmental regulatory authority might have issued an approval to market the product in a given geographic market.
- The governmental regulatory authority might have specifically approved the indications based on that testing.
- The enterprise might have tested the product under a particular trademark.
- These intangibles might be extremely valuable in combination.
- These intangibles might have must less value in isolation.
For example, the trademark without having the patent and regulatory marketing approval might have much less value:

- The enterprise cannot sell the product without the patent and regulatory approval.
- The enterprise cannot exclude the generic competitors without the patent.

Similarly, the value of the patent might be much greater once the enterprise obtains regulatory market approval than would be case in the absence of marketing approval. The drafters include that the interactions between each of these classes of intangibles, as well as with parties incurred the risks and costs associated with securing the intangibles, are therefore very important in performing a transfer pricing analysis with regard to a transfer of the intangibles. The drafters reach the conclusion that it is important for the enterprise to consider the relative contribution of the value creation, especially where different associated enterprises hold rights in the intangibles used.

The second of these transfers involves the assurance that all enterprise has identified the intangibles being transferred. The drafters suggest that the intangibles might be so intertwined that it is not possible, as a subjective matter, to transfer one intangible without transferring the other intangible. The drafters postulate that it might be the case that a transfer of one intangible would imply the transfer of other intangibles. In such cases, it might be important for the enterprise to identify all of the intangibles that the enterprise makes available to the transferee as a consequence of an intangibles transfer. The enterprise should apply the contractual provisions of paragraphs 1.52-1.54 in this regard. Similarly, the drafters suggest that it is important to the enterprise to identify situations in which the taxpayers or the tax authorities might seek to artificially separate intangibles that, as a matter of substance, the enterprise cannot separate.

Transfers of Intangibles in Connection with Other Business Transactions

In some situations, the enterprise might transfer intangibles in combination with other tangible business assets, or in combination with services. The drafters suggest that it might be important in such a situation for the enterprise to determine whether the enterprise has transferred intangibles in connection with the transaction. The drafters further suggest that it would be important for the enterprise to have identified the transaction and take the transfer into account in the transfer pricing analysis.

The drafters suggest that it might be both possible and appropriate in some situations for the enterprise to separate transactions in tangible goods or services from the transfers of intangibles, or rights in intangibles, for conduction of a transfer pricing analysis. In those situations, the enterprise should disaggregate the price of package contract in order to confirm that each element of the transaction is consistent with the arm’s length principle. In other situations, the transactions might be so closely related that it would be difficult for the enterprise to segregate tangible goods or service transactions from the transfers of intangibles.
In a business franchise agreement, the enterprise might be able to combine transfers of intangibles with other transactions. Under such a business franchise agreement, one member of a MNE group might agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee. However, the drafters caution that the nature of the services and intangibles made available under such arrangement are sufficiently unique that the enterprise cannot identify reliable comparables for the entire service/intangible package. In such a situation, it might be necessary for the enterprise to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. The drafters warn the enterprise that interactions between various intangibles and services might enhance the value of the intangibles and services.

The drafters caution that, in other situations, the providing of a service and the transfer of one or more of the intangibles might be so intertwined that it is difficult for the enterprise to separate the transactions for purposes of a transfer pricing analysis. For example, the enterprise might be able to combine some transfers of rights in software with an undertaking by the transferor. This undertaking might include periodic updates to the software. The drafters caution that in situations in which services and transfers of intangibles are intertwined, the determining of arm’s length prices on an aggregate basis might be necessary.

The drafters emphasize that the characterization of the transaction as providing products or services, or the transfer of intangibles, or a combination of both does not necessarily dictate the use of a particular transfer pricing method. For example, a cost plus approach will not be appropriate for all service transactions. Further, not all intangible transactions require complex valuations or application of the profit split methods. The drafters conclude that the facts of each specific situation, and the results of the required functional analysis, are to guide the manner in which the transactions are combined, characterized, and analyzed for transfer pricing purposes, as well as the selection of the most appropriate transfer pricing method in a particular case. The ultimate objective, according to the drafters, is to identify the prices and other conditions that the enterprise would establish between unrelated persons in comparable transactions.

Examples 12 through 17 pertaining to Chapter VI in the Guidelines address these issues.
Conducting a Comparability Analysis for Intangibles

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The OECD issued a discussion draft comprising new intangible transfer pricing guidelines on June 6, 2012. These provisions would significantly change the transfer pricing rules for these intangibles if the OECD promulgates these provisions. These provisions would impact Chapter VI of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, promulgated on July 2010.

The discussion draft addresses the identifying of intangibles, the identification of parties entitled to intangible-related returns, and the transactions involving the use or transfer of intangibles. The drafters expend considerable effort in ascertaining arm’s length conditions in cases involving intangibles. There are four facets of this inquiry:

- Conducting a comparability analysis in a matter involving intangibles
- Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles
- Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services
- Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles

This analysis addresses only the first of these four facets.

Determining Arm’s Length Conditions in Cases Involving Intangibles

The drafters visualize that it should be possible for an enterprise to identify arm’s length conditions for its relevant transactions. The enterprise would meet the following three preconditions:

- the enterprise identifies the relevant transactions that involve the intangibles,
- the enterprise specifically identifies the intangibles involved in these transactions,
- the enterprise identifies the entity or entities which are entitled to intangible-related returns as to those intangibles.

The drafters postulate that the enterprise would apply Chapter I, Chapter II, and Chapter III of the Guidelines as to the intangibles. The drafters would apply these rules in determining arm’s length conditions in which these transactions involve the use or the transfer of intangibles. Here, however, the drafters rely heavily on the nine-step comparative process set out in paragraph 3.4. The drafters assert that, “in particular,” this nine-step process “can be helpful” in identifying arm’s length conditions for transactions that involve the use or transfer of intangibles. The drafters would have the enterprise consider the following additional five facets:

- the identifying of intangibles,
the identification of parties entitled to intangible-related returns,
transactions involving the use or transfer of intangibles,
conducting a comparability analysis in a matter involving intangibles,
selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

Paragraph 3.4 is clear that the nine step process is “considered an accepted practice but is not a compulsory one.” Nevertheless, despite that statement in the existing regulations, the drafters seek to impose a different cast on the situation by eliminating this crucial precept. In essence, the drafters have ignored the non-compulsory nature of paragraph 3.4.

The drafters would have the enterprise undertake these five additional steps “as an essential part” of applying the principles of Chapter III to conduct a comparability analysis under the process described in paragraph 3.4. As transfer pricing practitioners, we question the pervasive “helpfulness” of paragraph 3.4. Further, we challenge the drafter’s assertion that the enterprise must apply these five steps as “an essential part” of applying the principles of Chapter III.

Nevertheless, the drafters would partially limit the almost blanket façade they provide to enterprise relationships, to diminish the nature of these potentially unique intangibles. The drafters recognize that the enterprise sometimes can find it difficult to apply the principles of Chapter I, Chapter II, and Chapter III to controlled transactions involving the use or transfer of intangibles. The drafters do recognize that intangibles might have a “special character,” which the drafters fail to define, in complicating the search for comparables. In some cases, the presence of this “special character” of these intangibles makes it difficult for the enterprise to determine value at the time of the transaction.

The drafters do recognize that, for wholly-legitimate reasons, due to the relationship between the associated parties, they might structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. In this regard, see paragraph 1.11, addressing members of an MNE group that face “different commercial circumstances” than do independent enterprises. The provisions for arm’s length intangibles describe “special considerations” that might arise in applying the principles of Chapter I, Chapter II, and Chapter III to determine the arm’s length conditions for controlled transactions involving the use or transfer of intangibles.

As transfer pricing practitioners, it is our view that paragraphs 77 and 78, taken together, would vitiate many of the accomplishments of the July 2010 revision of the Guidelines. There the drafters took care to realize that there are “some significant cases in which the arm’s length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles (our emphasis), and/or the provision of specialized services.” In light of these situations, the Guidelines made clear that “solutions exist to deal with such difficult cases, including the use of the transactional profit
split method described in Chapter II, Part III of these Guidelines in those situations where it is the most appropriate method in the circumstances of the case.”

**Conducting a Comparability Analysis in a Matter Involving Intangibles**

The Transfer Pricing Guidelines address specific provisions that provide guidance in applying the arm’s length principle:\[xxx\]
- Comparability analysis
- Factors that determine comparability
- Characteristics of property or services
- Functional analysis
- Contractual terms
- Economic circumstances
- Business strategies

These paragraphs contain principles the enterprise is to consider and recommend in following a comparability analysis. The principles described in those sections of the Guidelines apply to controlled transactions involving the use or transfer of intangibles.\[xxxii\]

The enterprise is to apply Guideline principles that related to the content of the comparability analysis and to the process of the comparability analysis when applied to a transaction that involves the use or transfer of intangibles. The drafters mandate that the enterprise’s transfer pricing analysis must consider the options “reasonably available” to each of the parties to the transaction. The enterprise is to apply other options realistically available to the parties within paragraph 9.59 through 9.64 of the business restructuring provisions in making this determination.\[xxxiii\]

Each party to the transaction needs to consider the options available to it. The party must consider the perspective of each of the parties. The drafters specifically provide that a one-sided analysis does not provide a sufficient basis for evaluating a transaction involving the “use or transfer” of intangibles.\[xxxiv\]

The drafters would seek to “reign in” the dual concept approach. The drafters do recognize that is important for the enterprise to consider the perspectives of both parties to the transaction in conducting comparability analysis. Nevertheless, the enterprise should not use the specific business circumstances of one of the parties to dictate an outcome that is contrary to the “realistic available options” of the other party. For example, a particular associated enterprise might lack the resources to effectively exploit the transferred intangible. The drafters would not expect the transferor in this situation to accept a price for the transfer of an intangible that is lower than its realistically available options, including making no transfer at all. In a similar manner, the transferee should not expect to accept a price for the transferred intangible where this transfer would make it impossible for the transferee to anticipate earning a profit using the intangible in its business. The transferee should reject this outcome as it would be less
favorable to the transferee than its realistically available option of not engaging in the transfer at all.\footnote{\text{\textsuperscript{lxxxv}}}

The enterprise might be able to identify the price for a transaction that is consistent with the realistically available options for each of the parties. The drafters conclude that the existence of such prices is consistent with the assumption that an MNE group seek to optimize resource allocations, at least on an after-tax basis. Situations can arise in which the transferor has a minimum price, based on its realistically available options, that exceeds the transferee’s minimum price, based on its realistically available options. The drafters suggest that it might be necessary for the enterprise to ascertain whether it should follow one of the following events:\footnote{\text{\textsuperscript{lxxxvi}}}

- The parties could disregard the actual transactions under the second circumstance enumerated in paragraph 1.65. Here the arrangements the parties made in relation to the transaction, viewed in their totality, differ from those transactions that independent enterprises would have adopted in a commercially rational manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.
- The parties might consider whether to apply the principles of paragraphs 9.34 – 9.38, pertaining to the difference between making a comparability adjustment and the parties not recognizing the risk allocation in the controlled transaction.
- The parties might consider whether commercial legislation or case law applies indemnification rights under paragraph 9.122.
- The parties might consider whether the parties should otherwise adjust the conditions for the transactions.

This discussion highlights the importance of the enterprise’s taking all facts and circumstances into account in the comparability analysis.

**Intangibles as a Comparability Factor Involving the Use of Intangibles**

The drafters recognize that the general comparability analysis rules of paragraphs 1.33-1.63 and the comparative analysis provisions of Chapter III apply to guide the comparability analysis. Beginning with that premise, the drafters recognize the enterprise’s use of intangibles involving the sale of goods or the performance of services might raise challenging comparability issues.\footnote{\text{\textsuperscript{lxxxvii}}}

The drafters recognize that, in a transfer pricing analysis, the most appropriate transfer pricing method might be the resale price method, the cost-plus method, or the transactional net margin method. The drafters comment that, in these situations, the enterprise often selects the less complex of the parties to the controlled transaction as the tested party. In many cases, the enterprise can determine an arm’s length price or the level of profit for the tested party without the enterprise needing to value the intangibles it is to use in connection with the transaction. The enterprise might determine an arm’s length price or the level of profit for the tested party without the enterprise needing to value the intangibles it is to use in connection with the
transaction where only the non-tested party uses the intangibles. However, the drafters do recognize that the tested party might use intangibles. The tested party might be entitled to the intangible-related returns with respect to such intangibles notwithstanding its relative lack of complexity. Similarly, parties seeking to use potential comparable uncontrolled transactions might use intangibles. In such situations such as these, it becomes necessary for the enterprise to consider the intangibles the tested party uses, and by the parties potentially comparable uncontrolled transactions as being one comparability factor in the analysis.

Consider the following example: A tested party is engaged in the marketing and distribution of goods the tested party purchases in controlled transactions. That tested party might have developed trademarks and related intangibles in its geographic area of operation. These developed trademarks and related intangibles might include customer lists and consumer relationships. The tested party might also have developed advantageous logistical know-how or software or other tools that it uses in conducting its distribution business. The drafters suggest that the enterprise consider the impact of such intangibles on the profitability of the tested party in conducting a comparability analysis.

The drafters recognize that there might be many cases in which the tested party uses such marketing and distribution intangibles. In such a situation, parties to these comparable controlled transactions might have the same types of transactional data at their disposal. Consider the distribution company case: An uncontrolled enterprise that is engaged in providing distribution services in the tested party’s industry might also have knowledge of potential customers and contacts with potential customers. Such an uncontrolled enterprise might have its own effective logistical systems and in other respects might have similar intangibles to the tested party. When this is the case, the drafters suggest that the level of comparability might be sufficiently high that the enterprise can rely on prices paid or margins earned by potential comparables. The parties can rely on these amounts as an appropriate measure of arm’s length compensation for both the functions performed and the intangible owned by the tested party.

The transfer pricing analysis would not require any comparability adjustments where the tested party and the potential comparables have similar comparables. The situation might be difficult when the tested party and the potential comparables have and use these intangibles in the business context. In those situations, the enterprise might have to make comparability adjustments or to revert to a different transfer pricing method. Such intangibles include the following pursuant to section D.1.(vi) intangibles:

- An intangible that is not similar to intangibles that the enterprise uses, or that makes the intangible available to parties for potentially comparable transactions.
- An intangible whose use in the business operations is expected to yield greater future benefits that what the enterprise would expect to receive in the absence of the intangible. The use of the intangible in business operations include the manufacturing, the providing of services, marketing, sales, or administrative activities.
- An intangible whose use or transfer the enterprise would remunerate in dealings between independent parties.
The drafters suggest that it is appropriate that taxpayers and tax administrations exercise restraint in rejecting potential comparables in situations in which either of the parties suggests comparables potentially comparable transactions or from the tested party. As a general matter, the enterprise should not generally reject potential comparables on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill.

The drafters recognize that the identified transactions or companies might otherwise be comparable. In that situation, these identified transactions might provide the enterprise with the best available indication of the arm’s length pricing. Nevertheless, these transactions might provide the existence and use by either the tested party or the by parties as to potentially comparable transactions of relatively insignificant intangibles. The drafters suggest that the enterprise should disregard potentially comparable transactions on the basis of the existence and use of non-comparable intangibles only where the enterprise can clearly and distinctly use the non-comparable intangibles in question and where these intangibles manifestly are section D.1.(vi) intangibles.

**Comparability of Intangibles and Rights in Intangibles**

The drafters, in examining the comparability of intangibles and in the rights in intangibles, provide three suggestions:

1. The drafters suggest that the enterprise consider the comparability of the intangibles themselves where the transactions involve the use of transfer of intangibles, or the rights to intangibles. The enterprise might consider the CUP method as being the most appropriate transfer pricing method. In such an event, the enterprise needs to evaluate the comparability of the transferred intangible in potentially comparable uncontrolled transactions.

2. The drafters suggest that intangibles might often have unique characteristics. As a result, these intangibles might have the potential for generating returns and for creating future benefits that differ widely. The drafters suggest that the enterprise’s grant of rights to use intangibles might have important limitations. Concomitant with these rights, these limitations might have a direct and important bearing on the price that such enterprise might pay for such rights.

3. The drafters suggest the enterprise conduct a comparability analysis as to a transfer of intangibles or rights in intangibles. In undergoing such a comparability analysis, the drafters view as being essential the consideration of the “unique features” of the intangibles and the specific terms of the transfers. Such unique features might include the nature of any limitations on the rights of the transferee to use the intangibles following the transfer.
The drafters set forth a description of seven special features for intangibles where these features might prove important in a comparability analysis. This list of seven special features is not exhaustive. The enterprise might consider that applying additional or different factors might be an essential part of a comparability analysis:

a. Exclusivity
b. Extent and duration of legal protection
c. Geographic scope
d. Useful life
e. Stage of development
f. Right to enhancements, revisions, and updates
g. Expectation of future benefits

Exclusivity

The determination of whether the rights in intangibles which are relevant to a particular transaction are exclusive or non-exclusive can be an important comparability consideration. Certain intangibles allow the party being entitled to intangible-related returns to exclude other parties from using the intangible – the nature of the exclusivity process. A patent, for example, grants the enterprise an exclusive right to use the invention covered by patent for a number of years. A particular party might have a degree of market power, or market influence, if this party controlling the intangible rights can exclude other enterprises from the market, or the party can exclude these enterprises from using intangibles that provide the party with a market advantage.

In contrast, a party having non-exclusive rights to the intangibles cannot exclude all competitors. Such a party having non-exclusive rights will not be able to exclude all competitors and this enterprise will generally not have the degree of market power or influence. The drafters suggest that the enterprise consider the exclusive or non-exclusive nature of the intangibles or the rights intangibles in connection with the comparability analysis.

Extent and Duration of the Legal Protection

The drafters recognize that the extent and the duration of the legal protection of the intangibles which are relevant to a particular transaction can be an important comparability consideration. Here the drafters seek to delineate intangibles:

- Legal protections that an enterprise achieves, where these protections are associated with certain intangibles, can prevent competitors from entering into the competitor’s particular market.
- For other intangibles, such as for know-how or trade secrets, available legal protections might have a different nature, and these protections might not be as strong or last as long.

Certain intangibles might have limited useful lives. The drafters acknowledge that duration of these legal protections can be important for these intangibles. After all, the duration of the intangible rights might affect the expectation of the parties to transaction as to the future
benefits that are available to the intangible. The drafters provide such an example: An enterprise has two patents. The two otherwise comparable patents do not have equivalent value if one patent expires at the end of year one, but the other patent expires only after ten years.

Geographic Scope

The drafters acknowledge that the geographic scope of the intangibles, or the rights to the intangibles, would have an important comparability consideration. For example, a global grant of rights to the intangibles might be more valuable than a grant that is minted to one country, or to a few countries, depending on the following variables:

- The nature of the product
- The nature of the intangible
- The nature of the markets in question

Useful Life

The drafters recognize that many intangibles might have a limited useful life. The nature of the legal protections and the duration of the legal protections can affect the useful life of a particular intangible. The rate of technological change in the industry and the development of new and potentially improved products can affect the useful life of some of the intangibles. In some situations, the enterprise could extend the useful life of a particular intangible.

The drafters anticipate that the enterprise would be able to undergo a comparability analysis, and does in fact create such comparability analysis. The drafters take the approach that it would be important for the enterprise to consider the useful life of the intangibles in question. In general, other things being equal, the longer the better. Intangibles that the enterprise expects market advantages to accrue for a long period of time will be more valuable than similar intangibles providing such advantages for a shorter period of time. The drafters suggest that the enterprise consider the use being made of the intangible in evaluating the useful life of these intangibles. For example, an enterprise uses an intangible as a base for research and development. The commercial life of the current generation product line might not be the relevant inquiry in relying on that product line.

Stage of Development

The drafters recognize that, in conducting a comparability analysis, it might be important for the enterprise to consider the stage of development of particular intangibles. An enterprise might often transfer an intangible in a controlled transaction at a point in time before the enterprise has fully demonstrated that the intangible will support commercially viable products. Consider this stage of development issues in the pharmaceutical industry. Here the enterprise acquires a patent for chemical compounds. The enterprise transfers the patents, or the rights to use the patents, in controlled transactions, as well as the enterprise transferring further research, development, and testing. The enterprise might transfer these rights well in advance of
the time when this process demonstrates that the compound constitutes a safe an effective
treatment for a particular medical condition.\textsuperscript{c}

The drafters take a “certainty rules” approach. They make clear that, as a general rule,
intangibles that relate to products having established commercial viability will be more valuable
than otherwise comparable intangibles which relate to products whose commercial viability is
yet to be established. The drafters visualize the enterprise as conducting a comparability analysis
involving partially-developed intangibles. As part of this comparability analysis, the drafters
would have the enterprise evaluate the likelihood that future development might lead to
commercially significant future benefits.

The drafters touch upon the enterprise’s use of industrial averages regarding the risks
associated with future development, suggesting that the use of these averages might be helpful
to such evaluations. The drafters, however, fail to consider the facets of the averaging process,
including the following:

- The selection of companies the enterprise is to consider
- The averaging mechanism
- The “range” approach in ascertaining the average

The drafters specify that the enterprise should always consider “the specific
circumstances” of any individual situation. The drafters fail to ascertain what these “specific
circumstances” might be.\textsuperscript{i}

Right to Enhancement, Revisions, and Updates

The drafters view the rights of the parties as to the future enhancements, revisions, and
updates as to the intangibles as being an important consideration in a comparability analysis
involving such intangibles. The drafters recognize that products protected by intangibles can
become obsolete, or the products can become uncompetitive in a relatively short period of time
in the absence of the continuing development and enhancement of the intangibles.

Having access to updates and enhancements can be important to the owner of an intangible.
This access can be the difference between the enterprise deriving a short-term advantage, on
one hand, and deriving a longer-term advantage, on the other hand. The drafters suggest that it
is necessary for the enterprise to consider, for comparative purposes, whether or not a
particular grant of rights as to the intangibles includes access to enhancements, revisions, and
updates as to the intangibles. As transfer pricing practitioners, we find drafters’ goal to be
appropriate; the practicalities of achieving this goal is a different matter.\textsuperscript{ii}

The drafters would have the enterprise go further in comparing the right to
enhancement, revisions, and updates, i.e., the question of whether the transferee of the
intangibles obtains the right to use the intangibles in connection with research the transferor
directs to developing new and enhanced intangibles. The drafters provide such an example of
research rights. The enterprise’s right to use an existing software platform as a basis for its
developing of new software products can shorten its development times. Having the right to the
existing software platform can make the difference between being the first to market the item with a new product or application, on one hand, or being forced to enter a market already occupied by established competitive products, on the other hand. The drafters suggest that the enterprise, in applying comparability analysis techniques as to intangibles, consider the rights of the parties as to these intangibles in developing new and enhanced versions of its products.

**Expectation of Future Benefits**

The drafters recognize that each of the foregoing comparability considerations has consequences. These consequences impact the expectations of the parties to a transaction regarding the future benefits that the enterprise is to derive from the intangibles in question. The drafters recognize that the enterprise might find that there is a significant discrepancy between the anticipated future benefit of using one intangible as opposed to another. If such a significant discrepancy does occur, the drafters would view as being “difficult” for the enterprise to consider the results as being sufficiently comparable to support a “comparables-based transfer pricing analysis” in the absence of reliable comparability adjustments.

The drafters suggest that it is important for the enterprise to consider the actual and potential profitability of the products, as well as on the potential products that are based on the intangible. The drafters reiterate to the reader an obvious point: intangibles that provide a basis for high-profit products or services are not likely to be comparable to intangibles that support products or services that have only industry-average profits. As a result, the enterprise, in conducting the comparability analysis, should take into account any factor that materially affects the expectation of the parties to a controlled transaction in obtaining future benefits from the intangible.

**Risk Comparison in Cases Involving Intangibles**

The drafters suggest that the enterprise consider the existence of risks, doing so where these risks pertain to the likelihood of the enterprise obtaining future economic benefits from the intangibles. The drafters would take this risk approach in conducting a comparability analysis where intangibles are present. The drafters enumerate four specific risks:

- Risks related to the future development of the intangibles
- Risks related to product obsolescence and the depreciation of intangibles
- Risks related to infringement of the intangible rights
- Product liability and similar risks related to future use of the intangibles

The drafters would have the enterprise consider the preceding risks, among others, in evaluating whether intangibles or combinations of intangibles are comparable.

*Risks related to the future development of the intangibles* Risks that pertain to the future development of intangibles include an evaluation of the intangibles themselves:

- Whether the intangibles relate to commercially viable products
- Whether the intangibles might support commercially viable products in the future
- The expected cost of required future development and testing
• The likelihood that such development and testing will prove successful
• Similar considerations
• Development risk is particularly important in situations involving partially-developed intangibles

*Risks related to product obsolescence and the depreciation of intangibles* Risks that pertain to product obsolescence and the depreciation of intangibles includes the enterprise’s evaluation of the likelihood that competitors will produce products or services in the future where these products or services would materially erode the market for products that are dependent on the intangibles that the enterprise is analyzing.

*Risks related to infringement of the intangible rights* Risks that relate to infringement of intangible rights include an evaluation of the likelihood that competitors might claim that products based on the intangibles infringe on their own intangible rights, and an evaluation of the likely costs of defending against such claims. The risk as delineated also includes the enterprise’s evaluation of the likelihood that the holder of the intangible rights could prevent competitors and others from infringing upon the enterprise’s intangibles. Such a risk includes the risk that counterfeit products could erode the profitability of the relevant markets.

**Comparability Adjustments in Regard to Intangibles**

Paragraph 3.47 through 3.54 relate to comparability adjustments within the confines of Chapter III, Comparability Analysis. These comparability adjustment provisions pertain to transactions involving the use or transfer of intangibles. The drafters recognize that differences between intangibles can have significant economic consequences. The enterprise might have difficulties in adjusting for these differences in a reliable manner.

There might be a reason to believe that the computation of the adjustment is not reliable. In such a situation, the intangibles that the enterprise compares for comparability adjustment purposes are in fact not sufficiently comparable to support a valid transfer pricing analysis. The drafters suggest that these distortion situations might occur in various situations, particularly in situations in which enterprise’s amounts that are attributable to the comparability adjustment represent a large percentage of the compensation for the intangible.

Most importantly, the drafters do recognize that the enterprise might not be able to make reliable comparability adjustments. In such an event, it might be necessary for the enterprise to select a transfer pricing method that is less dependent on the identification of the comparable intangibles or on comparable transactions.⁷⁶⁸vi

The drafters suggest the importance of comparables and the sources of comparables. They state that comparability process and the possibility of making comparability adjustments are “especially important” in considering potential comparable intangibles and considering royalty rates. The drafters visualize the enterprise drawing data from commercial data bases, or from proprietary compilations of publicly available license agreements, or from similar data. The
enterprise needs to sufficiently detailed data to permit the enterprise to evaluate the specific features of the intangibles that the drafters describe in conducting a comparability analysis. \textsuperscript{cvii}

**Section D.1.(vi) Intangibles**

The drafters recognize that the enterprise might have to make comparability adjustments or might have to revert to a different transfer pricing method in special situations. Such intangibles include the following pursuant to section D.1.(vi) intangibles: \textsuperscript{cviii}

- An intangible that is not similar to intangibles that the enterprise uses, or that makes the intangible available to parties for potentially comparable transactions.
- An intangible whose use in the business operations is expected to yield greater future benefits that what the enterprise would expect to receive in the absence of the intangible. The use of the intangible in business operations include the manufacturing, the providing of services, marketing, sales, or administrative activities.
- An intangible whose use or transfer the enterprise would remunerate in dealings between independent parties.
Selecting the Most Appropriate Transfer Pricing Method for Intangibles

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International practitioners often view the OECD transfer pricing Guidelines as being expository. These practitioners will then be surprised to know the OECD draft Guidelines for intangibles, D.3, are didactic instead. Consider the following five potential directives for intangibles:

- Restricting the use of the residual profit split method in the intangibles context.
- Limiting the application of the “conservative estimate” concept.
- Restricting the intangible development cost method.
- Curtailing replacement cost valuation, including for first mover advantage, situations when the intangible might carry legal protections or might carry exclusivity characteristics, and for partially-developed intangibles.
- Opposing the rules of thumb.

Background

As background, the OECD issued a discussion draft comprising new intangible transfer pricing guidelines on June 6, 2012. These provisions would significantly change the transfer pricing rules for these intangibles if the OECD promulgates these provisions. These provisions would impact Chapter VI of Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, promulgated on July 2010.

The discussion draft addresses the identifying of intangibles, the identification of parties entitled to intangible-related returns, and the transactions involving the use or transfer of intangibles. The drafters expend considerable effort in ascertaining arm’s length conditions in cases involving intangibles. There are four facets of this inquiry:

- Conducting a comparability analysis in a matter involving intangibles
- Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles
- Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services
- Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles

This analysis addresses only the second of these four facets.

The Selection Process

Paragraph 2.1 through paragraph 2.11 of the Guidelines addresses the selection of the most appropriate transfer pricing method in the circumstances of the case. The drafters make clear that the principles “apply fully” to cases involving the use or transfer of intangibles.
Nevertheless, the drafters specify that the enterprise consider the presence of three broad factors in selecting transfer pricing methods under the Guidelines:

- The nature of the intangibles,
- The difficulty of identifying comparable uncontrolled transactions for all intangibles, and
- The difficulty of applying certain transfer pricing methods in cases involving intangibles.

The drafters would have us focus on the fact that enterprises that structure transactions in different ways might have similar economic consequences in applying the principles of paragraphs 2.1 through 2.11 to matters involving the use or transfer of intangibles. The drafters provide an example that illustrates this principle: The performance of a service that is using intangibles might have very similar consequences to a transaction that involves the transfer of an intangible, or the transfer of the rights in the intangible. In selecting the most appropriate transfer pricing method in connection with a transaction that involves the use or transfer of intangibles, the drafters would have us focus on economic consequences of the transactions rather than on the arbitrary label the enterprise might use.

Residual Profit Split Method

The drafters caution against abuses of the residual profit split method in matters involving the use or transfer or intangibles. Taxpayers might too readily assume that one party has all residual profit from transaction after the routine functional returns. Such a taxpayer might all too quickly allocate the residual to the party that is entitled to intangible-related returns. As transfer pricing practitioners, we find the drafters’ comments concerning the residual profit split as being well-founded. Specifically, we are cognizant of the uncertain area between routine functions and residual functions.

Functional Analysis

The drafters would have the enterprise select the most appropriate transfer pricing method based on functional analysis. This functional analysis is to provide a clear understanding of the MNE’s global business processes. Further, this functional analysis is to specify how intangibles interact with other functions, assets, and risks that comprise the global business.

The drafters suggest that the enterprise’s functional analysis should identify other factors that lead to the enterprise’s value creation. Such functional analysis factors might include the following:

- The risks borne
- The specific market characteristics
- Location
- Business strategies
- MNE group strategies
- Other factors
The drafters would base the enterprise’s selection of the most appropriate transfer pricing method on any adjustments incorporated in that transfer pricing method that the enterprise selects based on comparability analysis. The method should appropriately reflect all of the relevant factors that materially contribute to the creation of value. Thus, this analysis should not merely reflect intangibles and routine functions.\textsuperscript{cxii}

**Use of Valuation Techniques**

The drafters suggest that an enterprise might consider applying financial valuation techniques in two situations:

- Cases involving the use of intangibles in connection with sales of goods or services, and
- Cases involving transfers of intangibles, or the rights in the intangibles.

The drafters suggest that the enterprise might be able to use such financial valuation techniques in either of two ways:

- As part of the five OECD-approved transfer pricing methods described in Chapter II of the Guidelines, e.g., in determining how the enterprise can split profits as part of a transactional profit split method, or
- As a tool that the enterprise can usefully apply in determining the arm’s length price.

**Financial Valuation Techniques**

Specifically, among the discussion of financial valuation techniques, the drafters discuss one subset of these financial valuation techniques, e.g., income-based valuation techniques. The drafters view these income-based techniques as being “particularly useful” when the enterprise properly applies these techniques, and when the enterprise makes appropriate assumptions.\textsuperscript{cxiii} The enterprise would premise such income-based valuation techniques on the calculation of the discounted value of projected future cash flows. Section D.3. of the draft, determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services, and Section D.4 of the draft, determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles, provide further guidance to the enterprise regarding the application of valuation techniques for transfer pricing purposes.

The drafters recognize that some valuation techniques might be useful analytical tools in matters involving the use or transfer of intangibles. Nevertheless, the drafters recognize that the enterprise should use caution in applying such valuation techniques. The drafters would place heavy emphasis on the enterprise’s “assumptions and other motivations,” asserting that “it is important” for the enterprise to consider the assumptions and other motivations that underlie particular applications of the valuation techniques.
The drafters, in addressing such assumptions and other motivations, provide such an example, the application of the “conservative estimate” concept. The enterprise might base its valuation assumptions in favor of conservative estimates of value as reflected in its balance sheet. The drafters suggest that such “inherent conservatism” might lead to definitions that are too narrow for transfer pricing purposes. Such valuation approaches might not be consistent with the arm’s length principle. The drafters urge caution on the part of the enterprise that accepts valuations performed for accounting purposes in ascertaining arm’s length prices or values. Unless the enterprise undertakes a thorough examination of the underlying assumptions, the enterprise should be cautious in using these assumptions.

**Purchase Price Valuation Allocation**

The drafters express their strong dislike for purchase price valuation allocations that an enterprise might use for accounting purposes as to these intangibles. The drafters include that such valuations of intangibles contained in such purchase price allocations “are not relevant” for transfer pricing purposes.\(^{cxiv}\)

The drafters would have the enterprise apply a purpose-driven approach in considering the purpose for which the enterprise conducts the valuation. The drafters have an ambivalent approach to valuations that enterprise conducts for business purposes. These valuations might be “either more or less relevant” than valuations conducted purely for tax purposes, depending on the circumstances.\(^{cxv}\)

**Use of Transfer Pricing Methods Based on Intangible Development Cost**

The drafters take a strong stance against the use of the intangible development cost method for transfer pricing purposes. The drafters describe the intangible development cost method as the providing of valuation techniques to estimate the value of the intangibles based on the cost of intangible development plus a return. The rationale against the intangible development cost method is that there is “little reason” for the enterprise to believe that that there is “any correlation” between the cost of the developing intangibles and their value or their price once the enterprise develops these intangibles. The drafters would have us usually avoid the use of financial valuation techniques based on the cost of the intangible development.\(^{cxvi}\)

Nevertheless, the drafters would accept the intangible development cost method in limited circumstances. Here the enterprise can propose valuations of intangibles based on the estimated cost of reproducing or replacing the intangible. The drafters appear to limit the viability of the intangible development cost approach to non-unique intangibles: “Such approaches may sometimes have valid application with regard to the development of non-unique intangibles used for internal business operations (e.g. internal software systems).”

**Replacement Cost Valuation**
The drafters challenge the application of the replacement cost method as a valuation technique for transfer pricing purposes. According to the drafters, such replacement cost valuation methods “raise serious comparability issues” where intangibles related to products sold in the marketplace are at issue.

The drafters address time delays and address deferred development impacting the value of the intangibles. The first mover advantage might affect valuation and timing, providing a significant first mover advantage in having a product on the market at an early date. As a result of this first mover advantage, second and later identical products, and their supporting intangibles, that the enterprise develops in future periods will not be as valuable as the same original product and its supporting intangibles available currently. In such a first mover advantage situation, the estimated replacement cost does not provide a valid proxy for the value of an intangible transferred currently.

The drafters challenge the application of the replacement cost method when the intangible might carry legal protections or might carry exclusivity characteristics. In such situations, the drafters comment that an analysis based on replacement cost will not reflect the value to the enterprise of being able to exclude competitors from using the intangible.

Further, the drafters challenge the application of the replacement cost method in terms of partially developed intangibles. The drafters take the position that cost-based valuations generally are not reliable when the enterprise applies such cost-based valuations in the case of partially-developed intangibles for transfer pricing purposes.

Use of More than One Transfer Pricing Method

As a general matter, the Transfer Pricing Guidelines permit the enterprise to select more than one transfer pricing method. These matters apply involving the use or transfer of intangibles. In this regard, see,

- Paragraph 2.11, stating that the arm’s length principle does not require the application of more than one method for a given transaction, but permitting a flexible approach in difficult cases.
- Paragraph 3.58, permitting a range of figures in determining the arm’s length range.
- Paragraph 3.59, raising the issue reliability in the case of substantial deviations.

Aggregation of Transactions

The drafters point out that paragraphs 3.9 through 3.12, the evaluation of a taxpayer’s separate and combined transactions, and paragraph 3.59, the substantial deviation and excessive range, provide guidance regarding the aggregation of separate transactions for transfer pricing analysis purposes. These aggregation rules apply fully to cases involving the use or transfer of intangibles. The drafters acknowledge that it is often the case that the enterprises use or transfer intangibles in combination with other intangibles, or in combination with transactions involving the sale of goods or services. In such situations, it might well be that the
most reliable transfer pricing analysis will consider the interrelated transactions in the aggregate, as necessary, to improve the reliability of the analysis. cxix

Application of Rules of Thumb

The drafters take a strong stand against applying rules of thumb in cases involving the use or transfer of intangibles, whether to determine a correct transfer price or to allocate intangible-related returns between a transferor and a transferee of rights in the intangibles context. The drafters make clear that an enterprise’s application of a rule of thumb “does not provide an adequate substitute for a complete comparability analysis” that the enterprise is to conduct under the principles of Chapter I, Chapter II, and Chapter III of the Guidelines. Accordingly, the drafters seek to discourage the enterprise’s application of a rule of thumb to divide intangible-related returns between, for example, the licensor and the licensee. cxx
Connecting Intangibles to Goods or Services

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The OECD issued a draft revision of Chapter VI of the Transfer Pricing Guidelines, the Special Considerations for Intangibles, on June 6, 2012. This draft addresses four facets:

A. Identifying Intangibles
B. Identification of Parties Entitled to Intangible Related Returns
C. Identification using the use or transfer of Intangibles
D. Determining Arm’s Length Conditions in Cases Involving Intangibles

The fourth of these facets, the Determining Arm’s Length Conditions in Cases Involving Intangibles, is the most complex, involving the following:

1. Conducting arm’s length conditions in cases involving intangibles
2. Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles
3. Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services
4. Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles.

This analysis addresses the D.3 issues, the determining of arm’s length prices for transactions that involve the use of intangibles in connection with sales of goods or services. These provisions contain guidance for the enterprise in determining arm’s length prices and other conditions for a controlled tangible transaction that involves the sale of goods or services. The drafters would apply these provisions in situations in which one or both parties use the intangible in connection with the transaction.

The drafters view issues that pertain to intangibles connected to goods or services as being within two categories. In both cases, the enterprise undertakes a comparability analysis, under which the comparability analysis includes a functional analysis:

1. In the first category of cases, the comparability analysis, including its functional analysis, reveals that the enterprise has sufficiently reliable comparables that would enable the enterprise to permit the determination of arm’s length conditions for the transaction using a transfer pricing method based on comparables.
2. In the second category of cases, the comparability analysis, including its functional analysis, fails to identify reliable comparable transactions. One or both parties to the transaction might directly cause the failure to provide reliably comparable uncontrolled transactions in situations in which these intangibles are section D.1.(vi) intangibles.

The drafters provide two pricing approaches to these categories, i.e.,
• Situations in which the reliable comparables exist
• Situations in which the reliable comparables do not exist

Section D.1.(vi) Intangibles

The drafters delineate three categories of intangibles for purposes of the Chapter VI provisions. \textsuperscript{cxxiii} These intangibles are the following:

(i) An intangible that is “not similar” to the intangibles that the enterprise uses, or makes available to parties, as to potentially comparable transactions. The drafters fail to address the preconditions as to similarity of the intangibles they would require.

(ii) The enterprise would use the intangible in its business operations, e.g. in manufacturing, the providing of services, in marketing, in sales, or in administration. The enterprise would expect to yield greater future benefits from the intangible that the enterprise would expect in the absence of the intangible.

(iii) Independent parties would expect to remunerate the enterprise for its dealings.

Situations in which the Reliable Comparables Exist

The drafters anticipate that the enterprise would be able to identify reliable comparables notwithstanding the fact that one or both of the parties to controlled sale of goods or services uses intangibles. The transaction might involve the use of intangibles that the enterprise undertakes in connection with a controlled sale of goods and services where such reliable comparables are present. Depending on the specific facts, any of the five enumerated transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method. \textsuperscript{cxxiv}

Importance of Section D.1.(vi) Intangibles

One or more of the parties to a controlled transaction might commonly address the use of intangibles that the enterprise uses in connection with the sale or goods or services. In some circumstances, the enterprise might use the other party’s intangibles that tested party would use in comparing uncontrolled transactions. The drafters acknowledge that the intangibles that the tested party uses in connection with the transaction might become section D.1.(vi) intangibles. \textsuperscript{cxxv}

Section D.1.(ii) addresses intangibles as being a comparability factor in transactions involving the use of intangibles. The drafters would have the enterprise apply these principles in determining whether the tested party’s intangibles would rely on identified comparable transactions, or whether the tested party would require the enterprise to apply comparability adjustments. The presence of D.1.(vi) intangibles would require the enterprise to make comparability adjustments, or to adopt a transfer pricing method that is less dependent on comparable uncontrolled transactions. As a general matter, when the tested party uses intangibles that are not section D.1.(vi) intangibles, the enterprise might be able to provide a
reliable basis for determining arm’s length conditions through prices paid or received, or through margins or returns earned by the parties to comparable uncontrolled transactions.\textsuperscript{cxvvi}

**Comparability Adjustments**

The drafters specify that paragraph 3.47 through paragraph 3.54 address comparability adjustments, and provide guidance related to these comparability adjustments. The draft refers also to paragraph 103, but that provision does not exist. The drafters specify that this guidance applies to matters involving the use of intangibles in connection with controlled sales of goods or services.\textsuperscript{cxvii}

Situations might arise where the enterprise needs to make comparability adjustments, perhaps because of differences in the intangibles the tested party uses in controlled transaction and because of the intangibles that a party uses to determine potentially comparable transactions. The enterprise might face difficult factual questions in situations such as these in quantifying reliable comparability adjustments. These comparability issues require the enterprise to thoroughly consider the relevant facts and circumstances, and to consider the available data regarding the intangibles that the enterprise uses on prices and profits.

The drafters acknowledge that there might be situations in which the enterprise’s impact on price differs because of the nature of the intangibles the enterprise uses. Such differences might be material and are not subject to accurate estimation. In that event, it might be necessary for the enterprise to utilize an alternative transfer pricing method. Such alternative pricing method should be less dependent on the identification of reliable comparables compared with other method, as section D.3.(ii) of this draft discussed.\textsuperscript{cxviii}

The drafters call to attention that the enterprise might have to comparability factors other than for the differences in the nature of the intangibles. The enterprise might require such comparison in matters involving the use of intangibles in connection with a controlled sale of goods and services. In particular, the enterprise might require comparability adjustments for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies, and similar factors. The drafters comment that such factors might not be intangibles, as Section A of the Chapter defines that term. These factors might nevertheless have important effects on arm’s length prices in matters involving the use of these intangibles.\textsuperscript{cxix}

**Situations Where Reliable Comparables Do Not Exist**

The drafters acknowledge that, in some situations, the comparability analysis, including the functional analysis, might reveal that the enterprise has no reliable comparable uncontrolled transactions. The enterprise would be unable to use this comparability analysis to determine the arm’s length price for controlled transactions involving the use of these intangibles. The lack of comparability might occur because one or both parties to controlled transaction are section D.1.(vi) intangibles that one or both parties utilizes to determine the controlled transaction. In
such a situation, reliable comparability adjustments are not possible. Reliable comparables might not exist because of a lack of available data regarding potentially comparable transactions involving the use or transfer of intangibles, or from other causes. The drafters take the position that, notwithstanding the lack comparables, it might be possible for the enterprise to determine the arm’s length price for the controlled transaction.

The drafters would exempt paragraph 1.65 situations from this general rule as to the treatment as to lack of comparability situations. Paragraph 1.65 situations apply to the following relationships:

- Situations in which the economic substance of a transaction differs from its form.
- The arrangements differ from those that independent enterprise would have undertaken.

Determining the Price that Uncontrolled Parties would have Agreed upon

The drafters acknowledge that the enterprise might not have sufficient information to identify reliable comparable uncontrolled transactions. In such situations, the arm’s length principle requires the enterprise to use another transfer pricing method to determine the price that uncontrolled parties would have agreed under comparable circumstances. The enterprise, in making such determinations, is to consider the following:

- The functions, assets, risks, of the respective parties to the transaction.
- The business reasons for engaging in the transaction.
- The perspectives of each of the parties to the transaction, and the options realistically available to each of the parties to the transaction.
- The market advantages conferred by the intangibles, especially including the relative profitability of products and services, or potential products or services, related to the intangibles.
- Other important factors, such as locational advantages and market differences.

The drafters implicitly assume that the central focus of the transfer pricing mechanism is the identifying prices that the uncontrolled parties would have agreed upon under comparable circumstances. The drafters, however, point out that it is often essential for the enterprise to carefully identify idiosyncratic aspects of the controlled transactions in situations where these situations arise by virtue of the relationship of the parties.

The drafters make clear the Transfer Pricing Guidelines do not require that an associated enterprise structure its transactions in precisely the same manner as what unrelated parties might have done. Nevertheless, the drafters are suspicious of non-typical transactions. The drafters suggest each party take into account the effect of the profits that the enterprise would have accrued at arm’s length, taking into account the structures of these prices and other conditions that the parties would have agreed between uncontrolled parties under comparable circumstances.

Application of the Profit Split Methods
The drafters recognize that they might be able to apply transactional profit split methods to determine an arm’s length allocation of profits for the sales of goods and services involving the use of intangibles in situations in which the enterprise cannot identify reliable uncontrolled transactions. The drafters refer to one such circumstance, specifying that the enterprise’s use of transactional profit split methods might be appropriate in situations in which both parties to the transaction make unique and valuable contributions to the transaction.

The drafters make reference to paragraph 2.109. In our opinion, the drafters’ comments are fully appropriate in making this reference. The drafters, however, failed to make reference to paragraph 1.9. We view this reference to paragraph 1.9 as being fully applicable to the issues at hand. In addition, the drafters fail to come to grips with applicability of the profit split methods in the context of determining arm’s length conditions in cases involving intangibles, e.g., paragraph 77 of the draft, pertaining to the comparability analysis. It is our view that paragraph 128 of the draft accurately reflects the appropriate transfer pricing methodology; in contrast, paragraph 77 would distort the meaning of the 2010 Transfer Pricing Guidelines.

The transactional profit split method provisions contained in paragraphs 2.108 through 2.145 contain guidance that the enterprise is to consider in applying these transactional profit split methods. The drafters provide that this guidance is fully applicable to matters involving the use of intangibles in connection with the sale of goods or services in controlled transactions.

The drafters would have the enterprise, in applying a profit split method in a case involving the use of intangibles, to take care in ascertaining the following facets:

- Identifying the intangibles in question
- Evaluate the manner in which those intangibles contribute to the creation of value
- Evaluate other income-producing functions, risks, and assets

The drafters warn that the making of vague assertions as to the existence and use of unspecified intangibles will not support a reliable application of the profit split method.

**Use of Valuation Techniques**

The drafters suggest that the enterprise utilize transfer pricing methods or utilize valuation techniques where these methods or techniques are not dependent on the identification of reliable comparable uncontrolled transactions to determine arm’s length conditions for the sale of goods or services. This suggestion would apply where the enterprise uses intangibles in connection with the transaction. The enterprise can select an alternative method to reflect the goods or services sold, and the contributions that intangibles and other factors make to the creation of value.
Transactions Involving the Transfer of Intangibles or the Rights to the Intangibles: 
Determining Arm’s Length Prices

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This analysis addresses the fourth of four provisions that pertain to the Determining of Arm’s Length Conditions in Cases Involving Intangibles, i.e., the determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles, section D.4. The OECD designed this draft with a view toward replacing Chapter VI, Special Considerations for Intangibles, which the OECD promulgated in July 2010. These measures contain guidance enabling the enterprise to determine arm’s length prices in a controlled transaction that involves the transfer of intangibles or the rights to the intangibles. The reader should be aware that section D.4 reflects internal inconsistencies. For example, paragraphs 77 and 171 reflect an independent enterprise approach that fails to reflect the transactional net margin method enunciated in paragraphs 1.9 and 2.109 in the July 2010 regulations.

The drafters visualize two categories of transactions as arising:

1. In the first category of cases, the data permits the enterprise to discern the existence of comparability analysis, including the functional analysis. The results of this analysis provides the existence of sufficiently reliable comparables to permit the enterprise to determine the arm’s length conditions for a transaction that uses a transfer pricing method based on comparables.

2. In the second category of cases, the comparability analysis, including the functional analysis, fail to provide the enterprise with reasonably reliable comparable transactions.

The material below describes two transfer pricing approaches to these cases:

Identifying Comparable Uncontrolled Transactions

The drafters make clear that, depending upon the specific facts, the enterprise might apply any one the five OECD transfer pricing methods described in Chapter II as being the most appropriate transfer pricing method to the circumstances of the case. The drafters would follow this approach where the transaction involves the controlled transfer of intangibles or would involve the controlled transfer of rights in the intangibles. There might be other situations in which other alternatives might be appropriate.

The drafters, while acknowledging that the enterprise can select one the five enumerated transfer pricing methods, eschew certain of these enumerated methods, applying “extreme caution”
• The drafters discourage the valuation of intangibles on the basis of mark-ups over development cost because such a method is unlikely to provide the enterprise with an accurate measure of value. Here the drafters refer to paragraphs 112 and 113.

• The drafters have determined, a priori, in most situations that an enterprise that applies the resale price method is unlikely to have selected the most appropriate transfer pricing method for determining the arm’s length price for intangibles or for the rights in intangibles.

The drafters would move forward in pre-selecting the transfer pricing method in the case of intangibles. The drafters pre-select two transfer pricing methods that are “most likely to prove useful in matters involving the transfers of intangibles or rights in intangibles:”

• The CUP method, and

• The transactional profit split method.

As experienced transfer pricing practitioners, we agree with the drafters’ analysis.

The drafters suggest a special rule for the enterprise in utilizing the CUP method. Particularly, under the CUP method, the enterprise should consider applying the comparability of the intangibles, or the rights in intangibles transferred in the controlled transaction, and in the potential comparable uncontrolled transactions. The drafters suggest that the enterprise consider the comparability factors described in paragraphs 1.38 through 1.63, the factors determining comparability as to the CUP method. The drafters take the approach that such matters described in D.1. of the discussion draft, in conducting a comparability analysis in a matter involving intangibles, are of particular importance in evaluating the comparability of specific transferred intangibles and the rights in intangibles, and in making comparability adjustments, where possible.

The drafters recognize that, the MNE group might acquire intangibles from unrelated parties, and then transfer these intangibles to members of the MNE group in a controlled transaction immediately following the acquisition. In such a case, the drafters recognize the amount the enterprise pays for the acquired intangible will usually represent a useful comparable for determining the arm’s length price for the controlled transaction under the CUP method. The enterprise is to make appropriate adjustments for acquired assets not transferred.

The drafters conclude that, depending on the circumstances, the third party acquisition price in such situations will have relevance in determining arm’s length prices and other conditions for the controlled transaction. These situations would apply even if the enterprise acquires the intangibles indirectly through an acquisition of shares, or where the price paid for the third party for such shares or assets exceeds the book value of the acquired assets.

Situations in Which Reliable Comparables are Not Available

The drafters recognize that there might be situations in which the enterprise cannot identify the information it receives regarding reliable comparable uncontrolled transactions. In such situations, the enterprise is to apply the principles of paragraphs 126 and 127, determining
the price that uncontrolled parties would have accepted. The enterprise is to apply the paragraphs 126 and 127 to the extent that these transactions involving transfers of intangibles to the same extent as these transactions would apply to transactions involving the sale of goods or services.

**Application of the Profit Split Methods**

The drafters acknowledge that the enterprise can apply a transactional profit split method “in some circumstances.” The drafters, however, fail to identify what such circumstances might be. As a general matter, the enterprise is to utilize a transactional profit split method to determine the arm’s length conditions for a transfer of intangibles or rights to intangibles where it is not possible for the enterprise to identify reliable comparable transactions.

Paragraphs 2.108 through 2.145 contain guidance the enterprise is to consider in applying the transactional profit split methods. The drafters make clear that the enterprise is to apply this guidance to matters involving the transfer of intangibles or to the rights in the intangibles.

**Application of Profit Split Methods in Connection with License Transactions**

The drafters provide that the enterprise can “often” utilize a transactional profit split method to evaluate the respective contributions of the parties to earning combined income. Regrettably, the drafters fail to delineate what these circumstances would be to evaluate these parties. As a general matter, the enterprise can apply the transactional profit split method where the enterprise transfers limited rights in the intangibles in a license, or in a similar transaction, and the enterprise cannot identify reliable comparable uncontrolled transactions.

The drafters look to profit contributions made available by the licensor or other transferors, focusing on profit contributions concerning the rights of the intangibles. These rights would be one of the factors contributing to the earning of income following the transfer. However, the enterprise would have to consider other factors. In particular, the enterprise would have to specifically consider the functions performed by the licensee/transferee and the risks assumed by the licensee/transferee in such analysis, as well as other relevant factors.

The drafters would have the enterprise carefully consider the attention that it can provide in such analysis in two respects:

- considering the terms of the transfer on the use of the intangibles by the licensee/transferee, and
- considering the rights of the licensee/transferee to use the intangibles for purposes of research and development.

Further, it might be important for the enterprise to consider assessing appropriate
Intangible related returns of the licensee for the purpose of enhancing these licensed intangibles. The drafters conclude that the allocation of income in such analysis would depend on the findings of the functional analysis. The information the enterprise provides would include an analysis of the relevant risks assumed. Nevertheless, the drafters caution that the enterprise should not assume that it can allocate all of the residual profit, after functional returns, to the licensor / transferor in a profit split analysis related to a licensing arrangement.

drafters conclude that the allocation of income in such analysis would depend on the findings of the functional analysis. The information the enterprise provides would include an analysis of the relevant risks assumed. Nevertheless, the drafters caution that the enterprise should not assume that it can allocate all of the residual profit, after functional returns, to the licensor / transferor in a profit split analysis related to a licensing arrangement.

Application of Profit Split Methods in Connection with Transfers of Full Rights in Intangibles

The drafters specify that an enterprise might be able to apply profit split methods in connection with the sale of full intangible rights. The drafters view having a full functional analysis as being an essential element of such analysis, as is the case with other applications of the profit split method. The parties are to consider the functions that the enterprise and other parties perform, the risks that the enterprise and other parties assume, and the assets that the enterprises and other parties use.

The drafters recognize that the enterprise might develop a profit split based on projected revenues and expenses. In such a situation, the drafters suggest that the enterprise take into account accurate projections as described in paragraphs 154-158 of the discussion draft, the accuracy of financial projections. The drafters take the approach that the enterprise can characterize some valuation techniques as being applications of a profit split method.

Application of Profit Split Methods in Connection with Transfers of Partially Developed Intangibles

The drafters address the issue of applying a profit split analysis to transfers of partially developed intangibles. Some practitioners suggest the application of a profit split analysis in situations such as these. Under this analysis, the enterprise would examine the relative value of the contributions that each party makes to the development of the intangibles. The enterprise would look to the value of the contributions made both before making the intangibles and after making these intangibles.

The enterprise, in applying this profit split approach, might seek to amortize the transferor’s contribution to the partially-developed intangible over the asserted useful life of that contribution. This profit split process presupposes that the enterprise would make no further development of the intangible. The drafters comment that the enterprise would base such profit split methods on projections of cash flows, and on benefits that the enterprise expects at some future date. Such future date would follow the date off the transfer, and would take place after the enterprise assumes the successful completion of further developed intangibles.

The drafters conclude that such an approach to profit split methods made in connection with transfers of partially developed intangibles is unlikely to readily yield a reliable estimate of the contributions of the parties to the creation of income in years following such transfers. The
The drafters caution that the enterprise would need to take various factors into account, and that enterprise might find these factors difficult to apply. Such factors would include the following:

- the relatively riskiness and the value of research contributions, made before and after the transfer
- the relative risk, and the value of that risk, for other development activities the enterprise carries out both before and after the transfer
- the useful life of the intangibles
- the amortization rate for various contributions to the intangible value
- assumptions regarding the time at which the enterprise might introduce speculative new products
- the value of the contributions other than intangibles that the enterprise might make as to the ultimate generation of profit.

The drafters caution that the making of income and cash flow projections in such profit split methods can be especially speculative in connection with transfers of partially developed intangibles. While not seeking to disallow the use of the profit split method in the context of partially-developed intangibles, the drafters call to question the results of this process, stating that the enterprise can combine these factors to “call the reliability of such analysis into serious question.”

**Use of Valuation Techniques**

The drafters recognize that there might be situations in which the enterprise does not have identified reliable comparable uncontrolled transactions. In such situations, the enterprise might find it possible to use valuation techniques to estimate the arm’s length price for the intangibles that the enterprise transfers between associated enterprises.

When an enterprise does use such valuation techniques in a transfer pricing analysis, the enterprise must apply such valuation techniques in a manner that is consistent with the arm’s length principle, and with the principles of these Guidelines. In particular, the enterprise should reflect the principles contained in Chapter I, Chapter II, and Chapter III of the Guidelines. The drafters make clear that the following principles apply fully to situations where the enterprise uses valuation techniques in a transfer pricing analysis:

- Principles related to realistically-available options, paragraph 1.34, ascertaining transactions that are alternatives that are more clearly attractive
- Perspective of the parties
- Attribution of risk, paragraphs 9.10 through 9.46, the special considerations for risks. The drafters exclude the reference to Compliance Issues, paragraph 9.47.
- Aggregation of transactions, paragraphs 3.9 through paragraph 3.12, the evaluation of a taxpayer’s separate and combined transactions.

The drafters make clear that the enterprise is to apply the “normal rules” for selecting transfer pricing methods, and should determine when the enterprise should apply these methods pursuant to paragraphs 2.1 through 2.10. Regrettably, the drafters fail to enumerate or
to explain the scope of such “normal rules.” The drafters conclude that the enterprise should apply these techniques pursuant to sections A, B, C, D.1, and this D.2 of this chapter VI, applicable where the enterprise considers such of the valuations. 

The drafters limit the scope of these valuation issues in the transfer pricing context. Thus, it is not the intention of these Guidelines to set forth a comprehensive summary these valuation techniques that valuation professionals utilize. In attempting to limit the scope of these valuation issues in the transfer pricing context still further, the drafters provide that it is not the intention of these Guidelines to endorse, or to reject, one or more sets of valuation standards that valuation or accounting professionals use. Similarly, the drafters provide that it is not the intention of these Guidelines to describe in detail one or more sets of valuation standards, or to describe the methods that might be especially suitable for use in transfer pricing analysis.

Nevertheless, the drafters can conclude that the application of such techniques can be useful tools in a transfer pricing analysis where the enterprise cannot obtain such reliable comparable uncontrolled transactions. The enterprise is to take into account these following valuation techniques:

- The Guidelines
- The specific facts of the case
- Generally accepted valuation practices
- The validity of the enterprise’s assumptions underlying the valuation and the assumptions that underlie the valuation and consistency of these assumptions with the arm’s length principle.

The drafters then raise the issue of the reliability of valuation techniques where these techniques are based on intangible development costs. See paragraphs 112 and 113, the use of transfer pricing methods based on intangible development costs.

The drafters suggest that the enterprise apply valuation techniques that estimate the discounted value of projected cash flows which are attributable to the transferred intangible or to other intangibles. The drafters suggest that the enterprise that applies these methods can use them as “particularly useful analytical tools.” The drafters caution that “there are many variations of these valuation techniques.” The variations of these situations are based on the discounted value of the projected cash flows.

The drafters then implicitly seek to define the general parameters for such valuation techniques. In general, the enterprise is to project the anticipated revenue that it is to produce determined for a given business over the useful life of the intangibles the enterprise is to value. The enterprise, after beginning with these revenues, is to deduct the estimates of the projected cost of goods sold and operating expenses. Through this deduction, the enterprise would obtain as its yield an estimated projection of operating income over the anticipated useful life of the intangible. The enterprise is to deduct from the projections of operating income the estimates of
cash flows that are attributable to business activities, or the assets, other than the intangible being viewed.

The drafters address the specific nature of these cash flows. Depending on the specific facts, the enterprise can deduct cash flows which include projected routine functional returns as well as projected income that is attributable to other activities, to attributes, and to other intangibles. The enterprise is to discount the resulting residual stream of projected cash flows that are attributable to the intangibles being discounted. The goal for the enterprise is to calculate the present value of the stream of intangible-related cash flows.

The enterprise is to select a discount rate or discount rates that it uses in calculating present values of the stream of projected cash flows. Such a discount rate is to reflect both the time value of money and the risk that the future cash flows might not materialize for the enterprise. Both parties might need to calculate the discounted present value of the streams of cash flows attributable to the intangible from the perspective of both parties to the transaction, based on the facts and circumstances of the individual case.

The drafters appear to mandate that all of the parties thereto would have one common interest rate. In these cases, the arm’s length price will fall somewhere within the range of both values. The parties, in determining the common interest rate, are to take into account taxes the enterprise must pay in respect of this transaction. 

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Specific Areas of Concern in Applying Methods that are Based on the Discounted Value of Projected Cash Flows

The drafters, in addressing valuation techniques, comment that it is important for the enterprise to recognize that estimates of value based on such techniques can be highly volatile. As such, small changes in one or more of the assumptions underlying the valuation model, or in one or more the valuation parameters, can lead to the enterprise having extreme swings in the intangible that the model produces. The drafters warn that a small percentage changes can each have a profound effect on the ultimate valuation of the discount rate, such as:

- a small percentage change in the discount rate,
- a small percentage change in the growth rates the parties assume in producing final projections, or
- a small change in the assumptions regarding the useful life of the intangible.

The drafters caution that the volatility in determining the discounted value is compounded when the parties simultaneously make two or more valuation assumptions or parameters. The drafters further caution that the reliability of the intangible the enterprise produces using a valuation model is highly dependent on the reliability of the underlying assumptions and estimates on which it is based, and on the due diligence and judgment the enterprise exercises in confirming assumptions an in estimating valuation parameters.
The drafters encourage the enterprises and tax administrators making use of these valuation techniques in determining arm’s length prices for intangibles to explicitly set out each of the relevant assumptions they make as to the following:

- in creating the valuation model
- in describing the basis of selecting the valuation parameters

The enterprise or the tax administrators should be prepared to defend the reasonableness of such assumptions and valuation parameters. The drafters suggest that the enterprises and the tax administrators undertake this valuation approach because of the importance of the underlying assumptions.

The drafters would go further with this discounted value approach, and suggest a good practice standard for taxpayers relying on valuation techniques. The drafters suggest that the taxpayers present, as part of their transfer pricing documentation, “some sensitivity analysis” reflecting the consequential change in estimated intangible value produced by the model when the party adopts alternative assumptions and parameters. The drafters, however, fail to define the term “some sensitivity analysis.”

The drafters would have the taxpayer, in assessing the reliability of the valuation model, examine the taxpayer’s assumptions and valuation parameters that the taxpayer undertakes for different non-tax valuation purposes. See paragraph 111, concerning the purposes of the valuation. The drafters have reached the determination that “it would be reasonable” for a tax administration to request an explanation as to any inconsistency the enterprise makes in the valuation of an intangible the enterprise undertakes for transfer pricing purposes, and for the valuations the enterprise undertakes for any purpose. For example, it would be appropriate for the tax administration to make such requests in the following situations:

- The enterprise uses high discount rates for a transfer pricing analysis where such enterprise routinely uses lower discount rates when it evaluates possible mergers and acquisitions.
- The enterprise asserts that particular intangibles have short useful lives, but the enterprise uses the projections made in other business contexts. Such projections show products that are related to these intangibles produce cash flows that expand the cash flows in years beyond the useful life that the intangible has been asserting for transfer pricing purposes.

The drafters identify “some of the concerns” that the enterprise should take into account in evaluating “certain important assumptions” that underlie model calculations based on discounted cash flows. As transfer pricing practitioners, we view the drafter’s term “some of the concerns” and “certain important assumptions” as being too broad based, leaving to the reader the question of whether these issues would or would not be part of these concerns. The drafters point out that these concerns are important for the enterprise in evaluating the reliability of the particular application of a valuation technique, but drafters fail to provide viable standards here.
Accuracy of Financial Projections

The drafters focus on the reliability of a valuation intangible. The drafters assert that the process of having the enterprise use discounted cash flow valuation techniques is highly dependent on the accuracy of the projections of future cash flows. Alternatively, the drafters assert that the process is highly dependent upon the income on which the enterprise is to base its valuation. The drafters are quite certain that it is essential for taxpayers and for tax administrators to examine carefully the assumptions that underlie the projections of both future revenue and future expense. There are two facets to this approach.

- The drafters recognize that the accuracy of the financial projections will depend on developments in the marketplace such that are both unknown and unknowable at the time the enterprise undertakes the valuation.
- Further, the drafters recognize that valuations might be speculative.

The drafters focus specifically on the evaluating process as it affects financial projections. The drafters recognize that the source of the projections and the purpose of the projections can be particularly important. The drafters do recognize that, in some cases, taxpayers might regularly prepare financial projections for business planning purposes. Enterprises might use such analysis for the management of the business, in making business and investment decisions. The drafters provide a general behavioral rule: it is usually the case that projections prepared by the enterprise for non-tax business planning purposes are more reliable than projections the enterprise prepared exclusively for tax purposes, or projections the enterprise prepared exclusively for purposes of a transfer pricing analysis.

The drafters would have the enterprise consider the length of time the projections would cover, as this fact is especially important in evaluating the reliability of the projections. The drafters caution that the enterprise’s projections of cash flow or income far into the future is “especially perilous.” The drafters use a rule of thumb, that future distance counteracts accuracy. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

The drafters turn to the importance of the enterprise in applying “an established track record” in making financial projections. The issue becomes, then, whether the intangibles and the products or services to which the enterprise relates have an established track record of financial performance. The drafters would require caution on the part of the enterprise: “caution should always be used in assuming that past performance is a reliable guide to the future.” As the drafters point out, many factors are subject to change.

Nevertheless, the drafters do not eschew past results, stating that past operating results can provide “some useful guidance” as to the “likely future performance” of products or services that rely on intangibles. Nevertheless as transfer pricing practitioners, we find the “some useful guidance” standard and the “likely future performance” standard to be uncertain. The drafters seek to avoid speculative inquires: They would diminish in scope and projections the enterprise
makes as to products and services that they have not introduced to the market. Those products and services are inherently less reliable than products or services with some track record.\textsuperscript{clxii}

The drafters address highly uncertain valuation issues. The enterprise might consider that the projections that enterprise relies on for valuation purposes are unreliable or are speculative. In such a situation, the enterprise should turn to section D.4.(vi), which regards situations in which valuation is uncertain at the time of the transaction.\textsuperscript{clxiii}

**Assumptions Regarding Growth Rates**

The drafters note the importance of growth rates in the context of developing a cash flow projection. The drafters, however, would have the enterprise or the tax administration look to “some cash flow projections,” leaving the enterprise or the tax administration with a level of uncertainty. The drafters would have the enterprise look to the projected growth rate. The drafters comment that “often” the enterprise would project its future cash flows on its current cash flows. Alternatively, the enterprise might develop its cash flow projections on assumed initial cash flows after the product introduction. In the case of partially developed intangibles, the enterprise could expand that reference to a percentage growth rate. The drafters suggest that the enterprise consider the basis for the assumed growth rate.

The drafters are cautious about the manner in which the enterprise makes its growth rate projections, stating that it is unusual for the revenues that particular product derives to grow at steady rate over a long period of time. The drafters would have the enterprise be cautious in “too readily accepting simple models containing linear growth rates.” The enterprise might not be able to justify such linear growth rates on either its experience with similar products and markets, or by making a reasonable evaluation of likely future conditions. The drafters expect that the enterprise, in making a reliable application of a valuation technique based on projected cash flows, would examine the likely pattern of revenue and expense growth, based on industry and company experience with similar products.\textsuperscript{clxiv}

**Discount Rates**

The drafters conclude that the discount rate or the discount rates than the enterprise uses in converting a stream of projected cash flows into a present value amount is a “critical element” of a valuation model. Such a discount rate is to take into account the time value of money and the risk or the uncertainty of anticipated cash flows. The drafters recognize that small variations in selected discount rates can generate large variations in the calculated value by using these techniques. Accordingly, the drafters conclude that “it is essential” for taxpayers and for tax administrations to give close attention to the analysis the taxpayers and tax administrations would perform and the assumptions they have made. The goal for the enterprise or for the tax administration is to select the discount rate or discount rates for the valuation model.\textsuperscript{clxv}
The drafters make clear the enterprise or the tax administration would be unable to find a single measure for ascertaining a discount rate, where that rate is appropriate for transfer pricing purposes in all instances. The drafters seek to limit, and perhaps disparage, the IRS’s valuation approach, which weighs heavily on Weighted Average Cost of Capital (“WACC”). The drafters take the approach that neither taxpayers nor tax administrations should assume that a discount rate that is based on the WACC approach, or on any other measure, should always apply in the transfer pricing analysis context, where the determination of appropriate discount rates is important. In other words, the drafters would require the taxpayer or the tax administration to “earn” the WACC approach rather than to take this valuation approach for granted. The drafters would have the enterprise or the tax administration evaluate the specific conditions and risks that are associated with the facts of the given case. In particular, the enterprise or the tax administration would access the cash flows in question in determining the appropriate discount rate. clxi

The drafters would have the taxpayer and the tax administration realize that intangibles might be among the most risky components of a taxpayer’s business. This analysis might affect the determining of interest rates and the evaluating the discount rates in some instances. This situation is likely to affect intangibles that are associated with the valuation of intangibles that still in development, among the most risky components of a taxpayer’s business.

The drafters would have the taxpayer and the tax administration realize that certain of their businesses are inherently more risky than are other enterprises. Further, some cash flow streams are inherently more volatile than other cash flow streams. The drafters provide an example of these differences: The likelihood that an enterprise will incur a projected level of research and development expense might be higher than the likelihood that the enterprise might generate a projected level of revenues. As a general matter, the drafters would have the enterprise ascertain the discount rate, or the discount rates. The drafters would have the enterprise ascertain these amounts in terms of the level of risk for the overall enterprise and for the expected enterprise’s volatility of the various projected cash flows under the circumstances of each individual case. clxii

The enterprise or the tax administration can take certain risks into account, whether in arriving at financial projections or in calculating the discount rate. The drafters caution the enterprise and the tax administration to avoid double discounting for risk. clxiii

Useful Life of intangibles and Terminal Values

The drafters recognize that the enterprise or the tax administration might premise the valuation techniques on the projection of cash flows, where such cash flows are attributable to the intangibles determined over the useful life of the intangibles in question. In circumstances such as these, the enterprise’s determination of the useful life of the intangible will be “one of the critical assumptions” that support the valuation model. clxiv
The drafters caution that the enterprise’s projected useful life of particular intangibles is a question of fact. The enterprise is to ascertain these results on the basis of all of the relevant facts and circumstances. The drafters, however, fail to define what these facts and circumstances might be.

As a general matter, the drafters provide that the enterprise can ascertain the useful life of an intangible by taking into account the following:
- By taking into account the nature of the legal protections the intangible affords, and
- By taking into account the duration of the legal protections the intangible affords.

The rate of technological changes in which the enterprise is a part can affect the useful life of the intangibles. The drafters expect the enterprise to observe the principles of paragraph 95 and paragraph 96, pertaining to useful life, in estimating the useful life of intangibles for purposes of applying a valuation technique.

The drafters address timing issues. Timing is an important facet of useful life and terminal value because, in some circumstances, either or both situations might apply:
- the enterprise might have intangibles that contribute to the generation of cash flows in years after the enterprise no longer has legal protections, or
- the enterprise ceases to market the products.

These timing issues become important in situations in which one generation of intangibles form the base for the development of future generations of intangibles and for the development of new products. The drafters touch upon the lurking depreciation issue – stating that it might be the case that the enterprise should properly attribute some portion of the development of cash flows from projected new products to otherwise-expired intangibles where such products cease to exist. On the other hand, the drafters take the position that, while some intangibles have an indeterminate useful life at the time of valuation, those facts, standing on its own, do not infer that the enterprise to attribute nonroutine intangibles in perpetuity.

Assumptions Regarding Tax Rates
The drafters suggest that the purpose of the cash flow valuation technique might be to isolate the enterprise’s projected cash flows that the enterprise would associate with an intangible. In such a situation, it might be necessary for the enterprise:

- to evaluate the effect of future income taxes on projected cash flows, and
- to quantify the effect of future income taxes on projected cash flows.

Two issues arise in this regard:\textsuperscript{clxxiii}

The first tax rate issue addresses the comparison the enterprise faces between post-tax rates and pretax rates. The enterprise typically applies discounted cash flow annual financial projections, which the enterprise determines on post-tax basis. However, the drafters would postulate that the enterprise “must typically” determine its prices for transfer pricing cash flow purposes on a pre-tax basis. Regrettably, the drafters fail to ascertain the parameters of the “most typically” determination.\textsuperscript{clxxiv} The drafters suggest that the enterprise would need to make appropriate adjustments for the purposes of:

- ensuring the internal consistency of the discounted flow model, and
- ensuring the ultimate determination of the arm’s length prices on a pre-tax basis.

The second tax rate issue questions whether the enterprise’s relevant tax rates that the enterprise takes into account in performing a discounted cash flow analysis bases its valuation on the rates applicable to the transferor or to the transferee. The drafters would eschew a standardized tax rate approach. Instead, the drafters suggest that the enterprise apply an approach that takes into account the particular facts of the case, including the specific situations that impact the transferor and the transferee. These facets dictate that the parties should “dictate adjustments to be made,” to take account of tax impact on valuation.

The drafters would have the enterprise take into account the perspectives of both parties to the transaction in this regard. The parties are to consider how unrelated parties might account for the relative tax advantages or the relative tax disadvantages each faces in this regard as to the transaction. The parties were to consider how the unrelated parties might account for the relative tax advantages or the relative tax disadvantages the transferee faces following the transfer in determining the arm’s length price.\textsuperscript{clxxv}

Highly Uncertain Valuation

The drafters describe the intangibles process. This process might be applicable to an enterprise in ascertaining the arm’s length price for transfers of intangibles when valuation of the intangibles is uncertain at the time of the transaction. Regrettably, the drafters fail to delineate the scope of the highly uncertain valuation issues. The drafters, then, fail to describe the characteristics of an intangible that might make its value highly uncertain from a valuation standpoint.

Most regrettably, the drafters in this draft fail to add to the existing knowledge concerning “highly uncertain valuation issues.” These drafters seek to have enterprises and tax...
administrations ignore the carefully thought out transactional profit split transfer pricing procedures in paragraph 1.9 and paragraph 2.109 of the July 2010 Guidelines, procedures that paragraph 140 through paragraph 148 reflect. These intangibles, by virtue of their highly uncertain valuation, are unique. Instead, the drafters would have the enterprise or the tax administration expend time and effort in their quest for comparables.

The drafters acknowledge that such intangible property might have a “special character” that might complicate the search for comparables. Regrettably, the drafters fail to ascertain what such a “special character” might be. In some situations, the drafters acknowledge that the presence of highly-uncertain intangibles might make it difficult for the enterprise to determine market value at the time of the controlled transaction involving the property.

The drafters acknowledge that the issue becomes how the enterprise is to determine arm’s length value at the time the transaction is highly uncertain. The drafters would resolve this inquiry, both for the taxpayer and the tax administrations, by referring to the activities undertaken by what independent enterprise would have done in comparable circumstances. The goal here is to take into account the valuation uncertainty that takes place in the pricing of the transaction. Here the drafters refer to paragraph 9.87 and 9.88 in the July 2010 Guidelines, intangibles transferred at a point in time when the intangible does not have an established value.

Focusing on the “independent enterprise” concept, the drafters suggest that the enterprise might undertake a variety of steps, steps analogous to what an independent enterprise might take, to deal with the issue of high valuation uncertainty when the enterprise prices a transaction. One possibility that the enterprise could use is to ascertain the anticipated benefits as a means for establishing the price at the outset of the transaction. The enterprise, in ascertaining these benefits, is to take into account all relevant factors.

The enterprise, in determining the anticipated benefits, would have the enterprise or the tax administration rely on the results of independent enterprises, taking these results into account to the extent that subsequent developments are foreseeable and predictable. The drafters will accept the enterprise’s financial valuation techniques to some degree, asserting that the enterprise’s use of these techniques, particularly those techniques based on the discounted value of projected cash flows, might be “helpful tools” in assessing anticipated benefits, as described above. Nevertheless, the drafters comment that the presence of uncertainty as to an intangible’s value might compound the issue because of the uncertainties that arise regarding critical parameters and assumptions in the valuation analysis.

The drafters acknowledge, however, that independent enterprises might find that the projections of anticipated benefits are “sufficiently reliable” for the enterprise to fix the pricing for a transaction at the outset of these projections. Regrettably, the drafters fail to elaborate on the “sufficiently reliable” standard. The enterprise might reserve the right to make further adjustments.
The drafters acknowledge the opposite situation, where independent enterprises might not find that the pricing based on anticipated benefits alone provides the enterprise with an adequate protection against the risks that high uncertainty might pose in valuing the intangible property. The drafters here suggest a business response rather than suggesting a tax result. In such situations, independent enterprises, might adopt shorter-term arrangements, or might include price adjustment clauses in the terms of the agreement. Such an independent enterprise might take such action to protect itself against subsequent developments that might not be predictable. For example, an independent enterprise might agree to a royalty rate increase when the sales of the licensee increase.

The drafters acknowledge that an independent enterprise might determine to bear its own risk, the risk of unpredictable subsequent developments, to a certain degree. Such an independent enterprise would normally undertake a joint understanding. Such a joint understanding might be that if such major unforeseen developments change the fundamental assumptions upon which the enterprise and the tax administration determine the result, the result would be the renegotiation of the pricing arrangements by mutual agreement of the parties.

For example, as to this joint understanding, the parties might undertake such renegotiation at arm’s length if a party’s royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the licensee’s incentive to manufacture or sell the drug at all. In that case, the parties might renegotiate the agreement. As a note of caution, the drafters point out that whether the parties would renegotiate the arrangement at all would depend on the facts and circumstances.

The drafters would have the tax administrations evaluate the arrangements made by independent enterprises where the pricing of controlled transaction involving intangible property is highly uncertain at the outset. Thus, for example, independent enterprise might have fixed the pricing based upon a particular projection. In that situation, the tax administration should use the same approach in evaluating the pricing. The drafters postulate that the tax administration is not to use hindsight in making projections. The tax administration, could for example, inquire into whether the associated enterprise made adequate projections, taking into account all the developments that are reasonably foreseeable without using hindsight.

The drafters recognize that a tax administration might find it difficult to establish what profits on the part of the enterprise were foreseeable at the time that transaction was entered into. The profitability analysis is more difficult for the tax administration where a taxpayer is uncooperative. Consider the following scenario:

- A taxpayer transfers intangibles to an affiliate at early stage of its own process.
- The enterprise sets a royalty that does not reflect the subsequently demonstrated value of the intangible for tax purposes or for other purposes.
- The enterprise later takes the position that it was not possible at the time of the transfer to predict the subsequent success of the product.
The drafters, in addressing a case such as this, could take the approach that subsequent developments might prompt a tax administration to inquire as to what independent enterprises would have done. The tax administration would rely on information reasonably available at the time of the transaction. In particular, the drafters would have the enterprise or the tax administration consider the following inputs:

- Whether the associated enterprises intended to make projections and did make projections. The process assumes the independent enterprises would have viewed the projections as being adequate, taking into account the reasonably foreseeable developments, and in light of the risk of unforeseeable developments.
- Whether independent enterprises would have insisted on some additional protections against the risk of the high uncertainty in valuation.

The drafters recognize that independent enterprises might have insisted on a price adjustment clause in comparable circumstances. The drafters suggest that the tax administration be permitted to determine the pricing on such a clause. Again, returning to the independent enterprise approach, the drafters suggest that independent enterprises might have considered the unforeseeable subsequent developments as being so fundamental that their occurrence would have led to prospective renegotiation of the pricing of a transaction. In such a situation, developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

The drafters recognize that tax administrations might not be able to conduct an audit of a taxpayer’s return until several years after the enterprise has filed the return. In such a case, it is the view of the drafters that a tax administration would be entitled to adjust the amount of the enterprise’s consideration as to all open years, up to the time the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set the pricing.

**Form of Payment**

The drafters take the position that taxpayers have substantial discretion in defining the form of payment for transferred intangibles. As to transactions between independent parties, the drafters conclude that “it common to observe” that payments for intangibles take form of a single lump sum. The drafters then comment that “it is common to observe” that payment for intangibles take the form of periodic payments over time.

The drafters conclude that the enterprise can structure arrangements between the parties either a series of installment payments fixed in amount, or might take the form of contingent payments. Such contingent payments depend on the level of sales or products supported by the intangibles, or on profitability or some other factor. The drafters would have the enterprise or the tax administration reflect the taxpayers agreements the parties entered into with regard to the form of payment. The drafters would give preference to paragraph 1.64
through paragraph 1.69, the recognition of actual transactions undertaken, it reflecting these payments.

The drafters would have the enterprise evaluate the taxpayer agreement provisions relating to the form of payment. The drafters comment that the parties might entail certain payment forms having greater levels or risk or lesser level of risk to one of the parties. The parties might reflect such a contingency. A payment form that is contingent on future sales might involve greater risk to the transferor than a payment form that calls for either a single lump payment at the time of the transfer, or calls for a series of fixed payments, because of the contingency.

The drafters make clear that the enterprise’s chosen form of payment must be consistent with the facts and circumstances of the case. These facts and circumstances include the following:

- The written contracts,
- The actual conduct of the parties, and
- The ability of the parties to bear and manage the relevant payment risks.

The drafters take the approach that the amount that the enterprise ascertains should reflect the relevant time value of money and the risk features of the chosen form of payment. Consider the following scenario:

- The enterprise applies a valuation technique.
- The valuation technique results in a calculation of a lump-sum present value for the transferred intangible.
- The transfer might apply a payment form of contingent future sales.
- The taxpayer might apply a payment form discount rate that the enterprise effects the form of its contingent future sales.

The discount rate that the enterprise uses in converting the lump-sum valuation to a stream of future payments over the useful life of the intangible should reflect two variables:

- the increased risk to the transferor that sales will not materialize, and
- the risk that payments might not be forthcoming.

The enterprise will impact the above mentioned amounts by the time value of money, and by the consequences that arise for the enterprise from the deferral of the payments to future years.
Understanding the Intangible Transfer Pricing Examples

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The OECD issued a Discussion Draft on June 6, 2012 that would totally restate Chapter VI of the Transfer Pricing Guidelines. These examples illustrate the guidance that the drafters intend would replace the existing July 2010 Guidelines. After addressing examples that illustrate the identification of parties entitled to intangible related returns, the drafters provide eleven examples that address transactions that involve the use or transfer of intangibles, Section C in the discussion draft, and the determination of arm’s length conditions involving intangibles, Section D in the discussion draft.

The drafters, having eschewed the preexisting intangibles regulations, re-promulgated the final provisions in the July 2010 Guidelines, Annex to Chapter VI – Examples to Illustrate the Guidance on intangible Property and Highly Uncertain Valuation. These three examples specified below are the final three fact patterns within the eleven examples, Examples 20-22.

**Primarni – Example 12a – Paragraph 225**

- The enterprise organizes Primarni in Country A
- Primarni conducts its business in Country A.
- The enterprise organizes Company S in Country B.
- Company S conducts its business in Country B.
- Company S and Primarni are associated enterprises.
- The drafters imply that Primarni is involved in making and in selling Product X.
- Primarni develops a patented invention and know-how that are related to Product X.
- Primarni and Company S enter into a written license agreement, giving Company S limited rights to produce Product X in Country B.
- Under this license agreement, Primarni gives Company S the right to use the Product X patents and know-how for the purpose of Company S’s manufacturing and selling of Product X in Country B.
- Primarni retains the patent and know-how rights to Product X throughout the rest of the world, i.e. all activities in all countries other than in Country B.

**Primarni – Example 12b – Paragraph 226**

- Company S uses the Primarni patents and know-how to manufacture Product X in Country B.
- Company S sells Product X items to its unrelated customers in Country B.
• Company S also sells Product X items to their related distribution entities pursuant to sales agreements.
• Company S’s related distribution entities are apparently located outside Country B, but the drafters are silent on this point.
• Arrangements with these distribution entities call for Company S to pass title to the product X’s products at location of the distribution entities at Company S’s factory.
• This transfer of Product X’s products takes place in Country B.
• The distribution entities resell the Product X units to its customers.
• The customers of the distribution entities are located throughout Asia and Africa.
• The Company S’s reselling operation activities are beyond what the Primarni-Company S agreement contemplates.
• The distribution companies pay an amount to Company S for Product X that enables those distribution entities to earn an arm’s length return for its distribution functions.
• Company S receives no return that would relate to the Product X intangibles.
• Primarni does not exercise its retained patent rights for Asia and Africa to prevent the distribution entities from Company S’s reselling of Product X.
• Primarni does not demand royalties or other compensation for intangibles from the distribution entities operating in Asia or Africa pertaining to the reselling Product X.

Primarni – Example 12c – Paragraph 227

• Under these preceding circumstances, the conduct of the parties suggests that Primarni and Company S should characterize its intercompany transaction as a license of the Product X patent and know-how for Country B, plus Company S’s activities in Asia and Africa.
• The drafters would have Company S ignore the portion of Primarni’s agreement with Company S in situations in which such agreement would limit Company S’s rights to activities taking place in Country B alone.
• This transfer pricing analysis would pertain to ascertaining the amount of compensation due Primarni from Company S for the licensed intangibles.

Primarni – Commentary Example 12

As transfer pricing practitioners, the Primarni example addresses two operating factors:
1. The importance of the parties’ proper drafting and enforcement in structuring a licensing arrangement.
2. The treatment of minor associated enterprises, assuming that Primarni’s sales of Product X to Asia and Africa are in fact minor. The enterprise and the tax administration should monitor the extent of this off-license arrangement. The comparison of off-license sales and on-license sales indicates the value of the license. The more value assigned to the license, the less likely it is that the enterprise would permit off-license sales, measured in terms of sales volume and licensing rate.
Ilcha – Example 13a – Paragraph 228

- The enterprise organizes Ilcha in Country A.
- Ilcha manufactured and sold Product Q in Country B for many years.
- Ilcha operates in Company B through a branch or permanent establishment.
- Ilcha owns patents that are related to the design of Product Q.
- Ilcha has developed a unique trademark and other brand intangibles that relate to Product Q.
- Ilcha registers the Product Q patents and trademarks in Country B.

Ilcha – Example 13b – Paragraph 229

- Ilcha, for sound business reasons, determines that it could enhance its business in Country B if it operated through a separate subsidiary in Country B.
- Ilcha therefore organizes Company S in Country B as a wholly-owned subsidiary.
- Ilcha transfers its tangible marketing activities and marketing assets to Company S.
- Ilcha previously used these activities and assets as a branch in Country B.
- Ilcha enters into a long-term licensing agreement with Company S.
- Ilcha’s agreement with Company S grants to Company S the exclusive right to use the Product Q patents, trademarks, and other intangibles in Country B.
- Company S, therefore, conducts the Product Q business in Country B.

Ilcha – Example 13c – Paragraph 230

- The drafters would have us assume that, over the years of Ilcha’s operation in branch form, Ilcha had developed substantial goodwill and going concern value in Country B.
- The drafters conclude that the transfer of the going business from the Ilcha branch in Company B, together with the transfer of the license of the rights to use the patents, trademarks, and other intangibles in Country B, implicitly conveys the value of that continuing goodwill from Ilcha to Company S.
- The drafters conclude that the transfer pricing analysis should take into account the following facets:
  - Ilcha should take into account the goodwill and going concern value of the tangible assets that Ilcha transfers to Company S and the value of its licensed right to use the intangibles in Country B when it makes these transfer to Company S.

Ilcha – Commentary - Example 13

The example illustrates an example of a transfer of tangible assets and intangible assets where this transfer is fully complete. The example, then, fails to address situations in which the enterprise might prefer to transfer less than all the intangibles rather than all the intangibles to an affiliated entity. This completeness issue raises two issues:
1. The process of ascertaining the value of the transferred intangibles versus the value of the non-transferred intangibles.
2. Ascertaining the legal and economic consequences for transferring the intangibles or not transferring these intangibles.

Forsta – Example 14a – Paragraph 231

- An enterprise organizes Forsta, a consumer company, in Country A.
- Forsta operates in Country A.
- Forsta produces Product Y in Country A prior to year 1.
- Forsta sells Product Y through affiliated distribution companies that are located in many countries around the world.
- Businesses and consumers recognize the importance of Product Y.
- These businesses and consumers view the Product Y trademark as being valuable asset.
- Forsta is entitled to intangible-related returns as to the Product Y trademark.

Forsta – Example 14b – Paragraph 232

- Forsta organizes Company S, a wholly-owned subsidiary, in country B in year 2.
- Company S acts as super-distributor and invoicing center.
- As before, Forsta continues to ship product Y directly to its distribution affiliates.
- However, Forsta passes the title of the product to Company S.
- Company S reinvoices the distribution affiliates for the cost of the products.

Forsta – Example 14c – Paragraph 233

- Beginning in Year 2, Company S reimburses the distribution affiliates for a portion of their advertising costs.
- Because the preceding adjustments have taken place, Company S adjusts upward the prices to the distribution affiliates.
- As a result, the distribution affiliate margins remain constant, notwithstanding the shift of advertising costs from the distributor affiliates to Company S.
- The drafters would have us assume that the margins earned by the distribution affiliates are at arm’s length, both before and after Year 2.
- The drafters would have us assume that Company S performs no functions in regard to advertising.
- Company S does not control any risk related to the marketing of the products.

Forsta – Example 14d – Paragraph 234

- Forsta reduces its prices to Company S in year 3.
• Forsta and Company S justify a reduction in price because Company S is entitled to intangible-related returns that are associated with goodwill as to Product Y that Company S creates through carrying the advertising costs it has borne.

Forsta – Example 14e – Paragraph 235

• In substance, Company S has no claim to a return as to goodwill and Product Y.
• Transfer pricing adjustments made to increase the income of Forsta in year 3 and thereafter would be appropriate.
• Company S has not performed or controlled the functions and risks that are related to the creation, enhancement, maintenance, and protection of goodwill.
• A transfer pricing adjustment would be appropriate to deny any intangible-related return to Company S.

Forsta – Commentary - Example 14

Example 14 illustrates the consequences of a reinvoicing center, the role that Company S had undertaken. The drafters fail to address the Country B structure. The tax administration in Country A should consider Country B might be a tax haven bank secrecy jurisdiction, and Forsta might have syphoned off income from Country A by reinvoicing transactions to Company S. While the drafters would have us assume that the margins earned by the distribution affiliates are at arm’s length, both before and after Year 2, tax administrations should be cautious about that approach if Country B is a tax haven bank secrecy jurisdiction.

Birincil – Example 15a – Paragraph 236

• Birincil acquires all the shares of a formerly unrelated company, Company T, for 100.
• Company T is a company that engages in research and development.
• Company T has partially developed several promising technologies, but Company T has only minimal sales,
• Birincil justifies the purchase price in acquiring Company T primarily based on the following:
  o the value of the promising, but only partially developed, technologies, and by
  o the potential of Company T personnel to develop further new technologies in the future.
• Birincil undertakes a purchase price allocation for accounting purposes as to the acquisition.
• Birincil’s purchase price allocation attributes twenty percent of the purchase price to tangible property and identified intangibles, including patents.
• Birincil’s purchase price allocation attributes eighty percent of the purchase price to goodwill.

Birincil – Example 15b – Paragraph 237
• Birincil undertakes a reinvestment strategy immediately following the acquisition.
• Birincil causes Company T to transfer all of its rights in developed technologies and partially developed technologies to Company S, a subsidiary of Birincil.
• These technologies include patents, trade secrets, and technical know-how.
• Company S simultaneously enters into a contract research agreement with Company T.
• Pursuant to Company S’s contract research agreement with Company T, Company T’s workforce will continue to work exclusively on the development of the transferred technologies, and on the development of new technologies on behalf of Company S.
• The agreement between Company S and Company T provides that Company S will compensate Company T for its research services.
• The Company S – Company T intercompany reimbursement provisions calls for payments that are equal to its cost plus a mark-up.
• All rights to the intangibles developed or enhanced under the research agreement will belong to Company S.
• As a result of this research agreement, Company S will fund all future research.
• Company S will assume the financial risk that some or all of the future risk will not lead to the development of commercially viable products.
• Company S has a large research staff, including management personnel responsible for technologies of the type acquired from Company T.
• Following the transactions in question, the Company S research and management personnel assume full management responsibility for the direction and control of the work of the Company T research staff.
• Company S undertakes the following activities:
  o Company S approves new projects
  o Company S develops and plans budgets
  o Company S in other respects controls the ongoing research work carried on at Company T
• All Company T research personnel will continue to be employees of Company T.
• The Company T will devote its research personnel to providing services under the research agreement with Company S.

Birincil – Example 15c – Paragraph 238

• The drafters conclude that it is important for the enterprise to identify the specific intangibles that Company T transfers to Company S and those intangibles that Company T retains for itself.
• This analysis is important in conducting a transfer pricing analysis of the arm’s length price that Company S would pay for the intangibles that Company T transferred to Company S, and the price that Company T is to pay for the R&D services.
• The drafters make clear that the definitions and valuations of intangibles contained in the purchase price allocation are irrelevant for transfer pricing purposes.
• The 100 amount, the amount that Birincil paid for the shares of Company T, represent the risk-adjusted arm’s length price for Company T’s business.

• Birincil’s full value of Company T’s business should reflect the sum of two amounts:
  o The value of the tangible and intangible assets that Company T transfers to Company S, and
  o The value of the tangible and intangible assets and workforce that Company T retains.

• The reader should note that the business formula fails to reflect workforce intangibles that Company T transfers to Company S.

• The drafters acknowledge that, depending on the facts, Company T might have transferred a substantial portion of the value of the purchased price allocation of goodwill to Company S together with other Company T intangibles.

• The drafters acknowledge that, depending on the facts, Company T might have retained some portion of value described in the purchase allocation as being goodwill.

• Under arm’s length transfer pricing principles, Company T should be entitled to compensation for the following two amounts:
  o The price that Company S paid for the transferred rights to the technology intangibles.
  o The price that Company S paid to compensate Company T in the years following the acquisition transaction for the R&D services of its workforce.

• The drafters provide an important rule of thumb: The enterprise or the tax administration should assume, as a general matter, that the value does not disappear, nor is the value to be destroyed, as part of an internal business restructuring.

Birincil – Commentary - Example 15

The Birincil example causes a disparity as to the treatment for workforce in place, whether the enterprise retains the workforce in place or transfers the workforce in place. On one hand, the business allocation formula fails to reflect Company T’s transfer of assets to Company S. On the other hand, Company T would be entitled to compensation for the R&D services of its workforce.

Zhu – Example 16a – Paragraph 239

• Zhu is a company that is engaged in software development consulting.

• In the past, Zhu has developed software that supports ATM transactions for its client, Bank A.

• In the process of developing such software applications, Zhu created and retained an interest in the proprietary software code.

• That software code might be suitable for use by other similarly-situated banking clients, but with some revision and customization.

Zhu – Example 16b – Paragraph 240
- Company S is Zhu’s associated enterprise.
- Company S enters into a separate agreement to develop software that supports ATM operations for another bank, Bank B.
- Zhu agrees to support Company S by providing its employees, where these employees had worked on the Bank A engagement, to work on Company S’s Bank B engagement.
- Those Company S employees have access to the software designs and know-how that the employees in the Bank A engagement, including proprietary software code.
- Company S utilizes that code and the services of Zhu employees in executing the Bank B engagement.
- Ultimately, Company S provides Bank B with a software system for managing its ATM network.
- This software system includes the necessary license to utilize the software the process develops.
- Zhu and Bank A embed portions of its proprietary code in the software that Company S provides to Bank B.

**Zhu – Example 16c – Paragraph 241**

- The drafters conclude that a transfer pricing analysis of these transactions should recognize that Company S received two benefits from Zhu that require compensation:
  - First, Company S received services from Zhu’s employees, where these employees became available to work on the Bank B engagement.
  - Second, Company S received rights in Zhu’s proprietary software which Company S utilized as a foundation of the software system Company S delivers to Bank B.
- Accordingly, the compensation that Zhu should pay to Company S should include compensation for both the services rendered and the rights in the software.

**Zhu – Commentary – Example 16**

Example does not provide an illustration as to how the enterprise is to quantify results whether the services rendered from Zhu’s employees, or Zhu’s proprietary system.

**Prathamika – Example 17a – Paragraph 242**

- Prathamika is the parent company of an MNE group.
- Over the years, Prathamika has been engaged in several litigation matters.
- As a result, Prathamika has become adept at managing large scale litigation on its own behalf.
- In working on such litigation, Prathamika has developed proprietary document management software that is unique to its industry.

**Prathamika – Example 17b – Paragraph 243**
- Company S is Prathamika’s associated enterprise.
- Company S became involved in a complex litigation situation, similar to the issues with which Prathamika’s legal department has experience.
- Prathamika agrees to select two individuals from its legal team, and make these individuals available to Company S to work on the ensuing litigation.
- Company S, in undertaking this responsibility, makes use of Prathamika’s document management software system.
- Company S’s providing of Prathamika’s document management software system does not provide Company S with access to other litigation matters and make this system available to Company S’s customers.

**Prathamika – Example 17c – Paragraph 244**

- Prathamika did not transfer its rights to Company S as part of its service arrangement.
- The Prathamika employees have experience and software tools that allow them to efficiently perform their services.
- The enterprise or the tax administration should consider Prathamika’s more effectively and efficient performance of their services in undertaking a comparative analysis,
- That comparative analysis should relate to the amount of the service fee that Company S would charge for the services of the Prathamika employees.

**Prathamika – Commentary – Example 17**

The Prathamika fact patent would have the enterprise undertake a comparative analysis in ascertaining the applicable services. The fact remains, though, that drafters fail to provide guidance in assessing the value of legal services, given that the value that lawyer provides might not be comparable to legal services that another lawyer provides.

**Osnovni – Example 18a – Paragraph 245**

- Osnovni is the parent company of an MNE Group.
- The Osnovni MNE Group is engaged in the development and sale of software products.
- Osnovni acquires Company S, a publicly-traded company organized in the same country as the country in which Osnovni is organized.
- Osnovni acquired Company S for price equal to 160.
- At the time that Osnovni acquired Company S, Company S’s shares had an aggregate trading value of 100.
- Competitive bidders for the Company S business offered to pay offered amounts ranging from 120 to 130 for Company S.

**Osnovni – Example 18b – Paragraph 246**
• Company S had only a nominal amount of fixed assets at the time Osnovni acquired the company.
• Company S’s value consisted primarily of the company’s rights in developed intangibles and partially-developed intangibles related to its software products and its skilled workforce.
• Osnovni undertakes a purchase price allocation for accounting purposes.
• Osnovni allocated 10 for tangibles assets, 60 for intangibles, and 90 for goodwill; a total of 160.
• Osnovni justified the 160 purchase price in its presentations to its Board of Directors.
• Osnovni justified the 160 purchase price by reference the complementary nature of the Osnovni group products, and by Company S’s products and potential products.

Osnovni – Example 18c – Paragraph 247

• Osnovni has a wholly-owned subsidiary, Company T.
• Osnovni and Company T are parties to a research and development cost contribution arrangement.
• Company T, by virtue of this cost contribution arrangement, holds the exclusive right to produce and sell all Osnovni group software products in European and Asian markets.
• Company S is not a participant to the Osnovni-Company T cost contribution arrangement.
• The drafters assume that, for the purposes of this example, all arrangements relating to the cost contribution arrangement within the Osnovni group as to products and services prior to Osnovni’s acquisition of Company S are at arm’s length.
• Historically, the cost contribution arrangement allocated 50 percent of the MNE group sales and profits to Company T.
• Then, implicitly, the cost contribution arrangement allocated 50 percent of the MNE group sales and profits to Osnovni.

Osnovni – Example 18d – Paragraph 248

• Osnovni, immediately after acquiring Company S, completes the last step of the transaction by liquidating Company S into Osnovni.
• Osnovni’s country does not tax the liquidation of Company S.
• Thereafter, Osnovni grants an exclusive and perpetual license to Company T.
• Osnovni’s license to Company T pertains to the intangible rights that are related to the Company S products.
• The participants to cost contribution arrangement amend the agreement to include the products and potential products that Osnovni acquired in the Company S acquisition.
• The participants to cost contribution arrangement amend the agreement to include the developed intangibles and partially developed intangibles that relate to Company S’s products.

Osnovni – Example 18e – Paragraph 249
Osnovni makes Company S’s intangibles available to Company T.
Osnovni is to determine an arm’s length price for these intangibles.
In making this determination, Osnovni is to consider the premium it paid, over and above the original trading value of the Company S shares, i.e., the amount that Osnovni included in the acquisition price.
Osnovni’s premium reflects the complementary nature of its own products combined with the acquired products in the European and Asian markets that cost contribution agreement allocates to Company T.
The drafters conclude that Company T should pay an amount for the transferred Company S intangibles and the rights in intangibles where such amount includes an appropriate share of the purchase price premium.
However, there might be situations in which Osnovni should not take into account the purchase price premium.
For example, such a purchase price premium might not be exclusively attributable to product complementarities that are outside of Company T’s geographic market.
The drafters caution that the value that the acquiror attributes to intangibles in the purchase price allocation for accounting purposes is irrelevant for transfer pricing purposes.

Osvovi – Commentary - Example 18

It is our view that drafters failed to consider the ramifications of the differences between tax provisions and the accounting provisions, particularly in jurisdictions that, by statute or regulation, impose conformity obligations.

Pervichnyi – Example 19a – Paragraph 250

- Pervichnyi is the member of an MNE group.
- The MNE group organizes Pervichnyi in Country X, where Pervichnyi does business.
- Pervichnyi is involved in the purchase and sale of Product F.
- Pervichnyi developed patents and trademarks related to Product F prior to year 1.
- Pervichnyi manufactured Product F in Country X.
- Pervichnyi supplied Product F to its distribution affiliates.
- Pervichnyi’s distribution affiliates are located throughout the world.
- The drafters would have us assume that, for the purposes of this example, the prices that Pervichnyi charges to its distribution affiliates are at arm’s length.

Pervichnyi – Example 19b – Paragraph 251

- At the beginning of year 1, Pervichnyi organized a wholly-owned subsidiary, Company S, located in Country Y.
• In order to save costs, Pervichnyi transfers all of its production of Product F to Company S.
• At the time that Pervichnyi organizes Company S, Pervichnyi sells the Product F patents and trademarks to Company S for a lump sum.

**Pervichnyi – Example 19c1 – Paragraph 252a**

• Pervichnyi has distribution affiliates that consistently sell 1000 of Product F annually.
• Pervichnyi expects to sell 1000 of Product F each year through its distribution affiliates for the next five years.
• The distribution affiliates are contemplating reducing its customer prices from 1000 to 950.
• The distribution affiliates believe that it would be in their interest to avoid the long-term erosion of Pervichnyi’s market position.
• The distributors would reduce the customer prices of five percent.
• The quantity would remain the same.
• Revenues, which had been 1000 are now 950.

**Pervichnyi – Example 19c2 – Paragraph 252b**

• Prior to year 1, Pervichnyi’s cost of goods sold for Product F were 600 per year on a consistent basis.
• Pervichnyi expects that its cost of goods sold would remain at that 600 per year level if Pervichnyi continues to produce in country X.
• Pervichnyi is contemplating moving its production of Product F to Company S located in Country Y.
• Company S’s cost of goods sold for the same production volume would be 500 annually if Company S produces Product F in Country Y.

**Pervichnyi – Example 19c3 – Paragraph 252c**

• The selling expenses of the distribution affiliates are constantly 100 per year.

**Pervichnyi – Example 19c4 – Paragraph 252d**

• Country X imposes corporate income tax at a 30 percent rate.
• Country Y imposes corporate tax at a 10 percent rate.

**Pervichnyi – Example 19c5 – Paragraph 252e**

• Countries tax the distribution affiliates at the rate of 10 percent

**Pervichnyi – Example 19c6 – Paragraph 252f**
• The transferred intangibles have a 5-year useful life.

Pervichnyi – Example 19c7 – Paragraph 252g

• An appropriate return for manufacturing entities is 5 percent of cost of goods sold.
• An appropriate return for distribution entities is 2 percent of sales.

Pervichnyi – Example 19c8 – Paragraph 252h

• An appropriate discount rate for a discounted cash flow analysis, taking into account the risks of the Product F business, is 14 percent.

Pervichnyi – Example 19d – Paragraph 253

• Under these circumstances, Pervichnyi and Company S seek to identify an arm’s length price for the transferred intangibles by utilizing a discounted cash value technique.
• As shown on Table 1,
  o Making this determination from Pervichnyi’s point of view.
  o Assuming that Pervichnyi itself continues to manufacture Product F.
• The residual after-tax cash notionally attributable to the transferred intangibles have a present value of 594.

Table 1
From the Seller’s Viewpoint – Pervichnyi owns the intangible
Pervichnyi manufactures and sells to distributors

<table>
<thead>
<tr>
<th>Pervichnyi</th>
<th>Event</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Revenues</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td>673</td>
</tr>
<tr>
<td>2</td>
<td>COGS</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Selling Expen.</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Operating Inc.</td>
<td>280</td>
<td>280</td>
<td>280</td>
<td>280</td>
<td>280</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Tax Rate</td>
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<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Taxes</td>
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<td>84</td>
<td>84</td>
<td>84</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Income after</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>673</td>
</tr>
<tr>
<td>7A</td>
<td>Tax (14% DR)</td>
<td>173</td>
<td>173</td>
<td>173</td>
<td>173</td>
<td>173</td>
<td>594</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Distributors</th>
<th>Event</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Revenues</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>COGS</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td>880</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Selling Expen.</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>
Company S does not exist

Global Consolidated Results

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>Revenues</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
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<td>COGS</td>
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<td>600</td>
<td>600</td>
<td>600</td>
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<tr>
<td>17</td>
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<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>18</td>
<td>Operating Income</td>
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<td>300</td>
<td>300</td>
<td>300</td>
<td>300</td>
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<td>19</td>
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<td>21</td>
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<td>214</td>
<td>214</td>
<td>214</td>
<td>214</td>
<td>214</td>
</tr>
</tbody>
</table>

Pervichnyi – Example 19e – Paragraph 254

- Now we consider the consequences if Pervichnyi transfers the intangibles to Company S.
- The residual after-tax cash flows notionally attributable to intangibles would have a higher present value, that of 941, as reflected in Table 2.
- This difference results from the lower manufacturing costs at Company S, from the lower tax rate for Company S, but partially offset by the lower revenue attributable to a price reduction made possible by the production cost savings.

Table 2
From the Buyer’s Viewpoint – Company S Owns the Intangible
Company S Manufactures and Sells to Distributors

Pervichnyi has no role

<table>
<thead>
<tr>
<th>Distributors</th>
<th>Event</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>29</td>
<td>Revenues</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>COGS</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>Selling Expenses</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>Operating Income</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Tax rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Taxes</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>Income After Tax</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company S</th>
<th>Event</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>36</td>
<td>Revenues</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>COGS</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>38</td>
<td>Selling Expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>
Pervichnyi — Example 19f — Paragraph 255

- The drafters suggest that an enterprise such as Pervichnyi should consider other alternative ownership choices for the intangibles.
- Pervichnyi could retain ownership of the intangibles, without transferring the intangibles to an affiliated or unaffiliated party.
- Then Pervichnyi could have Company S or an alternative supplier manufacture the products in Pervichnyi’s behalf.
- Table 3 reflects the consequences of making such a manufacturing option.
- In that situation, Pervichnyi would be able to capture the benefit of manufacturing Product F in a lower-cost environment.
- Pervichnyi could obtain this manufacturing benefit without transferring the intangibles to Company S.
- As Table 3 indicates, the cash flows attributable to the intangibles would have a present value of 735.

Table 3
From the Seller’s Viewpoint — Pervichnyi Owns the Intangible
Pervichnyi Contract Manufactures through Company S and Sells to Distributors

<table>
<thead>
<tr>
<th>Pervichnyi</th>
<th>Event</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>52</td>
<td>Revenues</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
<td>830</td>
</tr>
<tr>
<td>53</td>
<td>COGS</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
<td>525</td>
</tr>
<tr>
<td>54</td>
<td>Selling expenses</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>55</td>
<td>Operating income</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td>305</td>
<td>305</td>
</tr>
<tr>
<td>56</td>
<td>Tax rate</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>57</td>
<td>Taxes</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td>92</td>
<td>92</td>
</tr>
<tr>
<td>Year 1</td>
<td>Year 2</td>
<td>Year 3</td>
<td>Year 4</td>
<td>Year 5</td>
<td>Total PV</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
<td>----------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Company S**

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

**Global Consolidated Results**

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td>18</td>
<td></td>
</tr>
</tbody>
</table>

**Pervichnyi – Example 19g – Paragraph 256**

- The drafters take the position that the enterprise, in determining the arm’s length compensation for the intangibles, is to take into account the perspectives of both parties, and the options available to each of them.
- The drafters treat this arm’s length compensation approach as being “important.”
- Pervichnyi “would certainly not” sell the intangibles at a price that would yield an after-tax return lower than 594, the present value of the intangible-related cash flows reflected in Table 1 (line 7A).
- Pervichnyi could have generated after-tax income with a present value of that 594 amount by continuing to operate the business as it has in the past.
- There would be no reason to believe that Pervichnyi would sell the intangible for a price that would yield an after-tax return that is lower than the 735 amount reflected in Table 3, line 58.
• Pervichnyi could achieve such a 735 value amount by outsourcing the manufacturing to a lower cost provider on an arm’s length basis.

Pervichnyi – Example 19h – Paragraph 257

• Company S would not pay more than 941 for the intangibles (See Table 2, line 42A).
• If Company S were to pay more than 941 for the intangibles, Company S would derive no return from the risks that are associated with the intangible ownership, as reflected in Table 2, line 42A.
• A higher price would be inconsistent with the reasonably available options to Company S of not entering into the transaction.

Pervichnyi – Example 19i – Paragraph 258

• The drafters take the approach that the enterprise or tax administration in applying a transfer pricing analysis that utilizes a discounted cash flow approach would have to consider how unrelated parties dealing at arm’s length would take into account the cost savings and the cost rate benefits in setting a price for the intangibles.
• That arm’s length price, however should fall between the following range:
  o A price that would yield Pervichnyi an after-tax return equivalent to that reflected in Table 3, and
  o A price that would yield Company S a positive return to its investments and risks, a return that would be a price lower than the present value of the intangible-related cash flow calculated in Table 2.

Commentary – Pervichnyi – Example 19

Consider the following five objections to the Pervichnyi example:
1. As transfer pricing practitioners, it is our view that the drafters failed to provide a basis to ascertain the useful life of the intangibles, 5 years. The transfer pricing results would differ from the formulas in the example if the useful life was less than 5 years or more than 5 years.
2. The drafters presuppose that the appropriate discount rate in the discount cash flow analysis is 14 percent. However, the drafters fail to provide the mechanism under which the enterprise or the tax administration is to ascertain the appropriate discount rate in the discount cash flow analysis.
3. The drafters presuppose the appropriate return for manufacturing activities is 5 percent of costs of goods sold. Nevertheless, the drafters fail to provide the mechanism under which the enterprise or the tax administration is to ascertain the appropriate return for manufacturing activities.
4. The drafters presuppose that the appropriate return for distribution activities is 2 percent of sales. Nevertheless, the drafters fail to provide the mechanism under which the enterprise or the tax administration is to ascertain the appropriate return for distribution activities.
5. The drafters fail to further define the configuration for an enterprise where the discount rate is 14 percent, the return for manufacturing activities is 5 percent, and the return for distribution activities is 2 percent.

**Pharmaceutical Company 1 – Example 20a – Paragraph 259**

- A pharmaceutical company licenses manufacturing and distribution rights to an associated enterprise for an established drug.
- The agreement between the pharmaceutical company and its affiliate fixes the royalty rate for a three-year term.
- The enterprise and the tax administration conclude that
  - the royalty rate is in accordance with industry practice, and that
  - the terms of the agreement are in accordance with equivalent arm’s length agreements for comparable products.
- The enterprise and the tax administration accept the rate as being equivalent to rates agreed upon for uncontrolled transactions, based on the reasonably anticipated benefits that both parties accept at the time that they execute the agreement.

**Pharmaceutical Company 1 – Example 20b – Paragraph 260**

- In the third year of the agreement, the enterprise discovers that the drug has capabilities “in another therapeutic category” in combination with another drug.
- This discovery leads to a considerable increase in sales and profits for the licensee.
- The enterprise did not know in advance as to this knowledge as to capacities of the drug.
- If the enterprise did in fact know these facts in advance, but if they were to negotiate an agreement at arms’ length for year three, the enterprise would have agreed to a higher royalty rate to reflect the increased value of the intangible.

**Pharmaceutical Company 1 – Example 20c – Paragraph 261**

- The enterprise did not anticipate the new capabilities of the drug at the time the parties executed the agreement and the parties established the royalty rate in year one.
- The enterprise established a royalty rate that the enterprise had based on the benefits that both parties reasonably anticipated at that time.
- The enterprise and the tax administration knew the preceding facts.
- The agreement did not contain a price adjustment clause or other protection against the risk of valuation uncertainty.
- The lack of price adjustment clauses or other risks of valuation uncertainty is consistent with the terms of comparable controlled transactions.
- The drafters reach a conclusion based on the analysis of the behavior of independent enterprises in similar circumstances.
The drafters conclude that there is no reason for the enterprise or the tax administration to believe that the development in year three was so fundamental that it would have led at arm’s length to a renegotiation of the pricing of the transaction.

**Pharmaceutical Company 1 – Example 20d – Paragraph 262**

- The drafters, taking all of these circumstances into account, conclude that there is no reason to adjust the royalty in year three.
- The making of such adjustment would be contrary to the principles set out in Chapter VI.
- The making of such adjustment would represent an appropriate use of hindsight in this case.
- See paragraph 173 as to arm’s length pricing for transfers of intangibles when valuation is uncertain at the time of the transaction.
- The drafters conclude that that:
  - There is no reason to consider that the valuation was sufficiently uncertain at the outset.
  - The parties operating at arm’s length would have required a price adjustment clause.
  - The change in value was so fundamental in the development that they would have led to a re-negotiation of the transaction.
- In this regard, see paragraphs 174 and 175 pertaining to arm’s length pricing for transfers of intangibles when valuation is uncertain at the time of the transaction.

**Pharmaceutical Company 1 – Commentary – Example 20**

The drafters fail to define the term “therapeutic category.”

**Pharmaceutical Company 2 – Example 21a – Paragraph 263**

- The facts in Example 21 are the same as in Example 20 except as noted.
- The drafters would have us assume that the parties renegotiated the agreement at the end of a three-year period.
- At this stage of the company’s development, the parties know that the rights to the drug are considerably more valuable than these rights had been at the initiation of this relationship.
- Nevertheless, the unexpected development concerning the product is still recent.
- As a result, the parties to the agreement cannot reasonably assess the following potential inputs to the process:
  - Whether the company’s sales will continue to rise.
  - Whether the enterprise will discover further beneficial effects from the drug.
  - What developments in the market will affect sales, as competitors piggyback on the discovery.
• These considerations make the evaluation of the intangible rights a highly-uncertain process.
• Nevertheless, despite these facts, the associated enterprises enter into a new licensing agreement for a term of ten years.
• That licensing agreement significantly increases the fixed royalty rate.
• The parties set a higher rate based on their speculative expectations as to continuing and increasing demand.

Pharmaceutical Company 2 – Example 21b – Paragraph 264

• The drafters specify that it is not industry practice for an enterprise to enter into long-term arrangements having fixed royalty rates in a situation in which:
  o the intangible involved potentially had a high value, but
  o a track record did not establish the high value of the intangible
• Here there is no evidence that, given the valuation uncertainty, the associated enterprises might not make projections that an independent enterprise might consider adequate to justify having an agreement a fixed royalty rate.
• The drafters would have us assume that there is evidence that independent enterprises would have insisted on financial protection.
• This financial protection takes place in the form of prospective price adjustment clauses.
• The parties review prospective adjustment clauses annually.

Pharmaceutical Company 2 – Example 21c – Paragraph 265

• Assume that the enterprise increased its sales in year 4.
• The parties had set up a ten-year agreement to establish a royalty rate.
• The enterprise and the tax administration regard this royalty rate a being appropriate under the arm’s length principle.
• A competitor introduces a drug at the beginning of year 5 where this new drug provides a greater benefit than does the first drug in that therapeutic category.
• The first drug, in combination, had provided the company with unexpected benefits.
• Sales of the first drug for this use rapidly decline.
• The drafters conclude that the royalty rate that the parties fixed at the outset of the ten-year agreement are not at arm’s length beyond year 5.
• Accordingly, the drafters conclude that it is justifiable for the tax administration to make a transfer pricing adjustment from the beginning of year 6.
• The drafters conclude that the tax administration’s tax adjustment is appropriate because the evidence indicates that, in comparable circumstances, independent enterprises would have provided in the agreement for a price adjustment based on an annual review.
• See, arm’s length pricing for transfers of intangibles when valuation is highly uncertain at the time of the transaction, p 177.
Pharmaceutical Company 2 – Commentary - Example 21c

The example looks to “a greater benefit” and “unexpected benefits.” The drafters fail to provide guidance in ascertaining when, and in what situations, an enterprise or a tax administration can “jump the cue.”

Microchip Company – Example 22a – Paragraph 266

- Company X licenses the rights to Company Y to produce and market a microchip for a period of five years.
- Company Y is a newly-established subsidiary.
- Company X and Company Y fix the royalty rate at 2 percent.
- Company X and Company Y fix the royalty rate based on a projection of benefits that Company Y is to derive from the exploitation of the intangible.
- This projection shows expected product sales of 50 million to 100 million in each of the first five years.

Microchip Company – Example 22b – Paragraph 267

- Company X and Company Y establish that contracts between independent enterprises dealing with comparable intangibles in comparable circumstances would not consider the projections sufficiently reliable to justify a fixed royalty rate.
- Accordingly, Company X and Company Y would normally agree upon a price adjustment clause to account for the differences between actual benefits and projected benefits.
- Company X has an in-house comparable.
- Company X sets up an arrangement with an independent manufacturer for a comparable intangible operating under comparable circumstances for the following adjustments to the royalty rate:

<table>
<thead>
<tr>
<th>Sales</th>
<th>Royalty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 100 million</td>
<td>2.00 %</td>
</tr>
<tr>
<td>Next 50 million</td>
<td>2.25 %</td>
</tr>
<tr>
<td>Next 50 million</td>
<td>2.50 %</td>
</tr>
<tr>
<td>In excess of 200 million</td>
<td>2.75 %</td>
</tr>
</tbody>
</table>

Microchip Company – Example 22c – Paragraph 268

- In fact, sales by Company Y are 50 million.
- In subsequent years, Company Y’s sales are three times the projected figures.
- The parties had expected product sales of 50 million to 100 million.
- The actual product sales were in fact product sales of 150 million to 300 million.
• In accordance with the principles of this Section VI, the tax administration would be justified in these subsequent years in determining the royalty rate on the basis of the adjustment clause.
• A comparable adjustment clause, such as between Company X and the independent manufacturer, would apply in this context.
• The tax administration would be justified in using such an adjustment clause even though the agreement between X and Y does not provide for such a clause.
• See arm’s length pricing for transfers of intangibles when valuation is highly uncertain at the time of the transaction, paragraphs 174, 176, and 177.

**Microchip Company – Commentary - Example 22**

The drafters fail to provide guidance as to which circumstances the enterprise or the tax administration should view as being “highly uncertain.”
Examples Illustrating Parties Entitled to Intangible-Related Returns

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The OECD issued a Discussion Draft on June 6, 2012 that would totally restate Chapter VI of the Transfer Pricing Guidelines. These examples illustrate the guidance that the drafters intend would replace the existing July 2010 Guidelines. This draft includes an Annex that provides 22 examples. Eleven of these examples specifically provide illustrations of the parties that would be, or would not be, entitled to intangible-related returns. The purpose of this analysis is to review and to comment upon these eleven entitlement fact patterns. The drafters divide these eleven examples into four categories:

**Analysis of Parties Entitled to Intangible-Related Returns**
- Premiere - Example 1
- Primero - Example 2
- Primair - Examples 3 through 8
- Shuyona - Examples 9 through 11

The six Primair examples have an initial common fact pattern. Similarly, there is a common fact pattern for the three Shuyona examples. The material below reflect three facets: The transfer pricing category (Premier, Primero, Primair, or Shuyona) and the letter designation dividing up the examples, the OECD’s Examples within the Annex, and the OECD’s paragraph number. Our analysis follows each example.

**Premiere – Example 1a – Paragraph 182**

- The parties are part of MNE group.
- Premiere is the parent company of this MNE group.
- Company S is a member of the MNE group and is a wholly-owned subsidiary of Premiere.
- Premiere preforms R&D functions in support of its business operations.
- The MNE group seeks to obtain patents for its patentable inventions.
- The MNE group has R&D functions, and these functions result in these patentable inventions.
- It is the practice of the Premiere group that they assign all the rights in such inventions to Company S.
- Premiere’s rationale in making the assignment of these rights to Company S is to centralize and simplify global patent administration.
- Company S employs three lawyers to perform its patent administration work.
- Company S does not, however, conduct or control any of the R&D activities of the Premiere Group.
- Company S has no technical R&D personnel.
- The drafters, then, do not treat lawyers as being R&D personnel.
• Company S does not incur any of the Premiere group’s R&D expense.
• Company S, at the time that Premiere assigns rights to Company S, makes a 100 Euro payment to Premiere.
• Company S makes this 100 Euro payment to Premiere in consideration of the rights that Premiere provided to Company S.
• Company S made that consideration as to the rights to a patentable invention.
• Company S simultaneously grants to Premiere an exclusive, royalty free patent license for the full life of the registered patent.
• The drafters view the 100 Euro payment as being nominal.
• The drafters conclude that the Company S made the nominal payments to Premiere merely to satisfy technical contract law requirements.
• Payments as to rights are related to Premiere’s assignments.
• The 100 Euro payment is generally much lower than the arm’s length price of the assigned rights to the patentable inventions.

Premiere - Example 1b – Paragraph 183

• Company S holds the patent registrations and other contractual rights to the intangibles.
• Nevertheless, despite these facts, Company S is not entitled to intangible-related returns for transfer pricing purposes.
• The drafter’s rationale for this conclusion is that Company S neither bears risks or controls risks that are related to intangible development or enhancement.
• Company S does not perform or control any functions that are related to intangible development or enhancement.
• Company S does not bear any expense where that expense is related to the development of the intangibles or the enhancement of the intangibles.
• Accordingly, Premiere, not Company S, is entitled to any intangible-rated returns where these returns are attributable to patents that developed by Premier’s research and development efforts.
• The drafters conclude that Company S should receive arm’s length compensation from Premiere for its patent administration services.
• Such patent administration services that Premiere provides on behalf of Company S include amounts to cover its nominal payments to Premiere for patent rights, for its other patent administrative costs, and an appropriate profit element.
• Such patent administration services that Premiere provides on behalf of Company S should not provide Company S with intangible-related returns related to the patents for which Company S holds registrations.

Premiere - Commentary – Example 1

We are in general agreement with the drafters’ result in Example 1. Nevertheless, the drafters implicitly treat the MNE as being a large multinational enterprise rather than stating this characterization as a fact. Consider that the MNE was a small enterprise, having ten employees –
including Company S’s three lawyers – and Premiere’s R&D personnel. The lawyers’ work is significant in that situation. Compare this situation with Permiere having thousands of employees. A claim should be made that both Company S and Premiere should share the intangible-related returns when both entities are small. Accordingly, we suggest Example 1 add the term “large” in describing the Premiere group.

Primero - Example 2a - Paragraph 184

- Primero, the parent company of an MNE group, is engaged in the pharmaceutical business.
- Primero does business in Country M.
- Primero develops patents and other intangibles related to product X.
- Primero registers product X’s patents and other intangibles in countries around the world.

Primero – Example 2b- Paragraph 185

- Primero has a wholly-owned subsidiary in Country N, Company S.
- Company S distributes Product X through Europe and the Middle East on a limited-risk basis.
- Company S purchases Product X from Primero.
- Company S resells Product X to unrelated customers in countries throughout its geographic area of operation.
- In the first three years of its operations, Company S earns arm’s length returns from its distribution functions.
- Company S, having a limited-risk characterization, has arms length returns.
- Primero, not Company S, is entitled to intangible-related returns as to Product X.
- After three years of operations, it is apparent that Product X causes serious side effects in a significant percentage of those patients that use Product X.
- It becomes necessary for Company S to recall Product X and remove Product X from the market.
- Company S incurs substantial costs in connection with the recall of Product X.
- Primero does not reimburse Company S for these recall-related costs or for the resulting product liability claims.

Primero – Example 2c – Paragraph 186

- The drafters conclude that, under these circumstances, there is a mismatch.
- The mismatch takes place between Primero’s asserted entitlement to intangible-related returns as to Product X, on one hand, with the costs associated with the risks supporting that assertion, on the other hand.
- The drafters suggest that a transfer pricing adjustment would be appropriate to remedy this mismatch.
The drafters take the approach that, in all likelihood, the most appropriate adjustment would be allocate the recall and product liability-related costs from Company S to Primero.

The drafters suggest an alternative approach, that, “in some circumstances,” an appropriate alternative might be to adjust the product pricing for all years between Primero and Company S to reflect the fact that the relationship was not actually a limited-risk relationship.

**Primero - Commentary – Example 2**

The drafters provide two solutions the Primero – Company S relationship structure: a cost reallocation taking place after the event, or a retroactive allocation taking place before the event. It is our view, as transfer pricing practitioners, that because Primero and Company S are based in two separate jurisdictions, Country M and Country N, and these two countries might have different filing requirements and statutes of limitation, Example 2 should favor the enterprise or the tax administration making after-the-fact adjustments rather than relying on retroactive adjustments.

**Primair A – Example 3a – Paragraph 187**

- Primair, a resident of country X, manufactures watches.
- Primair markets its watches in many countries around the world under the R trademark and trade name.
- Primair is the registered owner of the R trademark and trade name.
- The R name is widely-known in countries where Primair sells its watches,
- The R name has obtained considerable economic value in those markets through Primair’s efforts.
- Primair has never marketed R watches in Country Y.
- The R name is not known in the Country Y market.

**Primair A – Example 3b- Paragraph 188**

- Primair decides to enter the country Y market in year 1.
- Primair incorporates a wholly-owned subsidiary in Country Y, Company S.
- Company S would be Primair’s distributor in Country Y.
- Primair enters into a long-term royalty-free market and distribution agreement with Company S at the same time in year 1.
- Under the long-term royalty-free market and distribution agreement, Primair grants to Company S the exclusive right to market and distribute watches bearing the R trademark and using the R trade name in Country Y.
- The agreement has five-year duration, with an option for a further five years.
- Primair provides Company S with no other rights relating to the R trademark and trade name.
In particular, Primair prohibits Company S from re-exporting watches bearing its trademark and trade name.

Company S’s sole activity is the marketing and distributing watches bearing the R trademark and trade name.

The drafters would assume the watches are not part of a portfolio of products Company S distributes in Country Y.

Company S imports packaged watches into Country Y, ready for sale to the final consumer.

Company S undertakes no secondary processing.

**Primair A - Example 3c – Example 189**

The contract between Primair and Company S provides for the following:
- Company S purchases the watches from Primair in Country Y’s currency.
- Company S incurs the associated carrying costs associated with the purchase – inventory financing and receivables financing.
- Company S assumes the corresponding selling risks – the inventory risk, the credit risk, and the financing risk.

The contract between Primair and Company S requires Company S to act as marketing agent for Preimair, to assist in the developing the market for R watches in Country Y.

Company S consults with Primair in developing the Country Y marketing strategy for R watches.

Primair undertakes the following functions as to Company S:
- Primair develops the overall marketing plan for Company S based largely on its experience in other countries.
- Primair develops and approves Company S’s marketing budgets.
- Primair makes final decisions regarding Company S’s advertising designs, product positioning, and preparing its core advertising messages.

Primair primarily bears the costs and risks of developing Company S’s market.

Primair reimburses Company S for the cost of advertising and for other marketing efforts that Company S incurs in assisting the market development for R watches in Country Y.

Company S provides the following functions as to Primair:
- Company S consults on local market issues related to advertising.
- Company S assists in executing the marketing strategy under Primair’s direction,
- Company provides evaluations of the effectiveness of various elements of the marketing strategy.

Primair provides a fee as compensation to Company S for providing these marketing support activities.

Primair’s fee to Company S is based on the level of marketing expenditures the Company S incurs, including a profit element.

**Primair A – Example 3d – Paragraph 190**
• The example postulates that Primair and Company S would analyze the marketing efforts and its selling efforts separately.
• The analysis presupposes that the parties would undertake a thorough comparability analysis, including a detailed functional analysis.
• Based on the above-mentioned analysis, the drafters conclude that it is possible for the enterprise to conclude that the price that Company S pays to Primair for the watches is separate from the compensation that Company S receives for the marketing efforts it undertakes on behalf of Primair.
• The drafters would have us assume the following facts:
  o Based on identifiable comparable transactions, the Company S’s price paid for watches from Primair is at arm’s length.
  o The price enables Company S to earn a price at an arm’s length compensation level for selling the watches.
  o The price enables Primair to compensate Company S for its distribution function, e.g., selling the watches, and for the associated risks Company S assumes.

**Primair A - Example 3e – Paragraph 191**

• Company S, in years 1 through 3, embarks upon a strategy to develop the Country Y market for R watches.
• Company’s strategy is consistent with its agreement with Primair to develop the Country Y market for R watches.
• Company S incurs marketing expenses in the process of implanting its marketing strategy.
• Primair reimburses Company S for the marketing expenses it incurs, together with a mark-up on these expenses.
• This reimbursement process is consistent with the contract.
• By the end of year 2, Primair has established the R trademark and trade name, making the R trademark and trade name well-established in Country Y.
• Company S derives compensation for the marketing activities it performs on behalf of Primair.
• The drafters hold that this compensation is at arm’s length.
• Company S would make this comparison to the amounts that others would have paid to independent advertising and marketing agents.
• Company S would make this comparison to the independent advertising and marketing agents where Company S would treat these amounts as comparables, as part of the comparability analysis.

**Primair A – Example 3f – Paragraph 192**

• The drafters conclude that, under the above-mentioned circumstances, Primair would entitled to the intangible-related returns at are attributable to the R trademark and trade name.
• The drafters acknowledge that Company S performs certain marketing functions, and that Company S’s marketing functions contribute to the value of the trademark in Country Y.
• Nevertheless, the drafters conclude that the “best measure” of Company S’s arm’s length return is by reference to the returns that independent advertising and marketing agents would earn.
• This “best measure” analysis would apply where the independent advertising and marketing agents’ functions, risks, and assets are comparable with those of Company S, as the parties reach this conclusion through this comparability analysis.

Primair A – Commentary - Example 3

Based on the facts at hand, both Primair and Company S contribute to the overall functions performed. As transfer pricing practitioners, it our view that Primair and Company S should divide the ensuing intangibles based on the comparison of effort expended by both Primair and Company S.

Primair B – Example 4a1- Paragraph 193

• Company S is more involved in marketing in this Example 4 than was the case in Example 3.
• There is different contract between Primair and Company S.
• Under the new contract between Primair and Company S, Company S is now obligated to develop and execute its marketing plan for Country Y.
• The new contract between Primair and Company S does not provide detailed controls concerning Primair’s marketing plan.
• Company S bears the costs and assumes certain risks associated with its marketing activities.
• The agreement between Primair and Company S does not specify the amount of marketing expenditures Company S is expected to incur.
• Instead, the agreement requires Company S to use its best efforts to market the watches.
• Primair does not reimburse Company S for its expenditures.
• Company S does not receive any other direct or indirect compensation from Primair.
• Company S expects to earn its reward solely from the sale of R brand watches to third-party customers in the Country Y market.

Primair B – Example 4a2- Paragraph 193

• Primair and Company S undertake a thorough functional analysis.
• This functional analysis reveals that Primair exercises a lower level of control over the marketing activities of Company S.
• This “lower level of control” means that Primair does not review and approve Company S’s marketing budget or detailed designs of the marketing plan.
• Company S bears different risks in Example 4 than in Example 3.
• Primair compensates Company S in a different manner in Example 4 than in Example 3.
• The contractual arrangements between Primair and Company S are very different,
• The risks that Company S assumed are greater in Example 4 than Example 3.
• Company S does not receive cost reimbursements or a separate fee for marketing activities from Primair.
• The only controlled transaction between Primair and Company S in Example 4 is the transfer of the branded watches.
• As a result, Company S can obtain its reward only through selling R brand watches to third-party customers.

Primair B – Example 4a3- Paragraph 193

• As a result of these differences, Primair and Company S adopt a lower price for watches in Example 4 than the prices for watches determined for purposes of Example 3.
• As a result of differences that the functional analysis determines, Primair and Company S use different criteria for identifying comparables, and for making comparability adjustments, than in the case in Example 3.

Primair B – Example 4b- Paragraph 194

• Assume that in years 1 through 3, Company S embarks on a strategy that is consistent with its agreement with Primair.
• Company S incurs marketing expenses that pertain to its marketing strategy.
• Company S has high operating expenditures as a result of applying this marketing strategy.
• Company S has slim margins in years 1 through 3 because of having high operating expenditures.
• Company S’s efforts have established the R trademark and trade name in Country Y by the end of year 2.
• Here the marketer/distributor actually bears the costs and associated risks of the marketing activities.
• When the marketer / distributor in fact does bear these costs and risks, the issue is the extent to which the marketer / distributor can share in the potential benefits from these activities.
• The drafters would have assume that the Country Y tax authorities conclude that Company S would have expected to incur its actual level of marketing expense if Country S were unrelated to Primair.

Primair B – Example 4c- Paragraph 195

• Company S bears the cost and associated risks of its marketing activities under a long-term contract, exclusive of Company’s S exclusive distribution rights for the R watches.
As a result of implementing this agreement, Company S has the opportunity to benefit from the marketing and distribution activities it undertakes, or to suffer a loss from these activities.

Primair and Company S look to ascertain an analysis of reasonably reliable comparable data.

The parties conclude that, for purposes of this example, the benefits that Company S obtains result in profits similar to those made by independent marketers and distributors, bearing the same types of risks and costs as Company S.

The drafters do not look to all independent marketers and distributors, bearing the same types of risks and costs as Company S.

Instead, the drafters would narrow the scope of this analysis to newer companies. The drafters would look to enterprises having the first few years’ activities as to similar comparable long-term marketing and distribution agreements.

In addition, the drafters would seek to compare the marketing and distribution of the similarly unknown products.

Primair B – Example 4d- Paragraph 196

Based on the foregoing assumptions, the drafters conclude Company S’s return is at arm’s length.

Further, Company S’s marketing activities, as illustrated by its marketing expenses, are not significantly different than those activities performed by independent marketers and distributors in comparable uncontrolled transactions.

The following results apply:

- Primair and Company S are entitled to a portion of the intangible-related returns that are associated with the R trademark and related intangibles.
- The information the parties obtain concerning comparable uncontrolled transactions suggests that Company S earns the return earns an arm’s length return.
- Company S’s arm’s length return reflects its functions, risks, and its resulting entitlement to intangible-related returns.
- Company S requires that Primair would receive no additional compensation.

Primair B – Commentary – Example 4

We suggest that both Primair and Company S are entitled to portions of the intangible-related returns. We suggest that the enterprise or the tax administration reach this analysis based on the enterprises’ risks and functions.

Primair C – Example 5a - Paragraph 197

- As a general matter, the facts in Example 5 are the same as in Example 4 except as noted.
- Company S incurs market development functions in Example 5 that are more extensive than the market development functions that Company S incurs in Example 4.
Primair C – Example 5b - Paragraph 198

- Company S, as marketer/distributor, bears the costs and risks of the marketing activities in Country Y.
- The drafters suggest that the issue becomes the extent to which the marketer/distributor can share the potential benefits from these activities.
- The drafter would have Company S undertake a thorough comparability analysis.
- The comparability analysis identifies several uncontrolled companies engaging in similar marketing and distribution functions under similar long-term marketing and distribution arrangements.
- The drafters would have us assume that the level of marketing expense that Company S incurs in years 1 through 5 far exceeds the level of marketing expense by the identified marketers and distributors.
- The parties analyze Company S’s market development activities.
- The drafters conclude that, given Company S’s market development activities, Company S has assumed significantly greater costs and risks than do comparable independent enterprises.
- Company S has substantially higher costs and risks than it did in Example 4.
- Evidence supports the conclusion that Company S’s profits are significantly lower than the profits made by the identified comparable marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

Primair C – Example 5c - Paragraph 199

- As in Example 4, Company S bears the cost and the associated risks of its marketing activities under a long-term contract.
- This analysis excludes Company S’s marketing and distribution rights for the R watches.
- Company S has an opportunity to benefit from the marketing and distribution activities it undertakes, and has the opportunity to suffer a loss from those marketing and distribution activities.
- However, the drafters determine that Company S has borne marketing expenditures that are beyond what independent enterprises in comparable transactions and similar rights would have done for their own benefit.
- The result is that Company S has significantly lower profits than does other enterprises.

Primair C – Example 5d1 - Paragraph 200

- The drafters determine that the enterprise or that tax administrations could conclude that:
  - Company S has incurring marketing expenditures that a substantially in excess of the levels of such expenditures that independent marketer/distributors incur in comparable transactions.
• By incurring these expenditures, Company S has acted to increase Primair’s intangibles.
• Primair has not adequately compensated Company S for the margin it earns on the resale of R watches.

- The drafters take an approach that, under such circumstances, it would be appropriate for the Country Y tax authority to propose a transfer pricing adjustment.
- The Country Y tax administration could base such an adjustment on compensating Company S for its marketing activities performed, and for the expenditures that Company S incurs for the benefit of Primair.
- The Country Y tax administration would make this adjustment consistent with what independent enterprises dealing at arm’s length in comparable transactions might have expected to agree.
- Depending of the facts and circumstances. Country Y tax administration can make such an adjustments based of the following:

**Primair C – Example 5d2 - Paragraph 200**

- Country Y’s tax administration could reduce the price that Company S paid for the R brand watches that Primair sold to Company S.
- Country Y’s tax administration could make this adjustment by applying the resale price method or by applying the transactional net margin method.
- Country Y’s tax administration can use available data about the profits that comparable marketers and distributors might make where these marketers and distributors have a comparable level of marketing and distribution expenditure.

**Primair C – Example 5d3 - Paragraph 200**

- The drafters discuss the residual profit split method as an alternative transfer pricing method.
- Under this residual profit split method, Country Y would split the combined profits from sales of R branded watches in country Y.
- Under the residual profit split method, Company S and Primair would have basic returns for the functions the performed.
- Then, Company S and Primair would split the residual profit on a basis that takes into account the relative entitlements to intangible-related returns of Company S and Primair, and the relative contributions of both Company S and Primair to the value of the trademark and trade name.
- The drafters fail to specifically define the term “basic returns.”

**Primair C – Example 5d4 - Paragraph 200**
• Country Y’s tax administration can provide in the adjustment that Primair is to reimburse Company S for the excess marketing expenditures it has incurred, over and above the marketing expenditures incurred by comparable independent enterprises.
• These expenditures include a profit element that pertains to functions and risks these expenditures reflect.

Primair C – Example 5e - Paragraph 201

• The drafters conclude that Country Y’s proposed adjustments as to Primair are based on Company S’s having performed functions, incurred risks, and incurred costs.
• The process would provide entitlements to Company S for compensate for its unincorporated intangible related returns.
• These adjustments would provide Country Y’s tax administration with a means of compensating Company S for expenditures for which Premair failed to compensate Company S.
• The drafters comment that a different outcome could be appropriate if the arrangements between Company S and Primair were such that Company S could expect to obtain an arm’s length return on the additional investment during the remaining term of the distribution agreement.

Commentary - Primair - Example 5

It is our opinion, as transfer pricing practitioners, that the drafters unfairly limited the options that should be available to an enterprise or to tax administrations. We suggest that the drafters take into account the following:

1. The drafters seek to use residual profit split measure as an alternative transfer pricing method, ignoring the contribution analysis specified in section 2.119.
2. The drafters ignore the fact Company C’s overloaded expenses can be result of a multiplicity of factors, such as:
   a. Company S’s selecting ineffective decision makers, or making undesirable decisions, such as, for example, by making ineffective media buys.
   b. Primair might be making thoughtless decisions, such as, for example, attempting to sell watches with the wrong wristband size for individuals in Country Y.
   c. Company S might be facing adverse issues than does its competitors because of the present international economic malaise.
3. Company S might suffer from being “last in line” from an economic standpoint, the obverse of “first mover” advantage.
4. As transfer pricing practitioners, it is our view that the fact pattern in Example 5 would create an unfair burden on Primair – How would Primair ascertain such comparable data, the amounts that others would have paid?

Primair D – Example 6a - Paragraph 202

• The facts in Example 6 are the same as Example 4 except as noted:
Company S now enters into a three-year royalty agreement with Primair.
- The agreement provides that Company S will market and distribute the watches in country Y market.
- Neither party has the option to renew the agreement.
- At the end of the three-year period, Company S does not have a new contract with Primair.

Primair D – Example 6b - Paragraph 203

- The example stipulates that in fact independent enterprises enter into short-term distribution agreements.
- These independent enterprises incur marketing and distribution expenses.
- These independent enterprises stand to earn a reward commensurate with the functions they perform, with the assets they use, and the risks they assume.
- Primair and Company S obtain evidence from comparable independent enterprises which shows that these enterprises do not invest large sums of money in developing their marketing and distribution infrastructure.
- The independent enterprises would obtain only a short-term marketing and distribution agreement.
- The independent enterprises do not face the risk of non-renewal with compensation.
- The potential short-term nature of the marketing and distribution agreement means that Company S does not benefit from the marketing and distribution it incurs at its own risk.
- Company S might not benefit from the marketing and distribution efforts.
- The preceding factors mean that Company S’s efforts might well benefit Primair in the future.

Primair D – Example 6c - Paragraph 204

- Company S assumes risks in Example 6 that are substantially more than the risks that Company S assumes in Example 4.
- Primair has not compensated Company S on an arm’s length basis for bearing these additional risks.
- In this particular case, Company S has undertaken an overkill approach.
- Company S has undertaken development activities and has borne marketing expenditures that are beyond what comparable independent enterprises with similar rights would incur for their benefit.
- Company S’s overkill strategy results in incurring significantly lower profits than what comparable enterprises would have earned.
- The drafters view the contract between Company S and Primair as being short term.
- The short term nature of this contract makes it unreasonable to expect that Company S has the opportunity of obtaining benefits under the contract.
- Under these circumstances, the drafters conclude that Company S is entitled to receive intangible-related returns.
• Company S could receive intangible-related returns in the form of higher compensation for having acted to increase the value of the R trademark and trade name during the terms of its arrangement with Primair.

**Primair D – Example 6d - Paragraph 205**

• Primair could compensate Company S in the form of direct compensation, i.e., compensating Company S for the marketing expenditures and marketing development functions that Company S has undertaken.
• Alternatively, Primair could reduce the amount it charges to Company S for watches during Years 1 through 3.

**Commentary - Primair – Example 6**

• As transfer pricing practitioners, we should consider the causes and effects of Company S’s overkill strategy. Company S might over-emphasize its marketing efforts with a view toward increasing its market share, now and in the immediate future.
• We should consider whether Company S engaged in predatory pricing. It is possible that Company S used a predatory pricing market share strategy with the objective of removing its competitors. Company S might be selling watches at lower price does its competitors, or, in this particular case, Company S might attempt to overwhelm the marketplace and the media, perhaps to create “buzz” concerning the watches.

**Primair E – Example 7a – Paragraph 206a**

• The facts in Example 7 are the same as in Example 4, but with the following additions.
• Company S successfully establishes the R brand in Country Y by the end of year 3.
• Primair and Company S renegotiate their earlier agreement at the end of year 3.
• Primair and Company S enter into a new long-term licensing agreement.
• This new agreement commences at the beginning of year 4.
• The new agreement has a five-year duration.
• Company S, but not Primair, has the option to renew the contract for a further five years.
• Under this new agreement, Company S agrees to pay a royalty to Primair based on Company S’s gross sales of all watches bearing the R trademark.
• In all other respects, the new agreement has the same terms and conditions as in the previous arrangement between the parties.
• Company S and Primair do not adjust the price that Company S pays for the branded watches as a result of the introduction of the royalty.

**Primair E – Example 7b – Paragraph 206b**

• Company S’s sells of R brand watches in year 4 and in year 5, but these sales are consistent with the earlier budgets that Company S and Primair had forecasted.
• Company S’s profitability declines substantially as of the beginning of year 4 because of the royalty.

**Primair E – Example 7c – Paragraph 207**

• The drafters indicate that Company S and Primair are unable to find evidence that independent marketers / distributors of similar branded products have agreed to pay royalties.
• Company S’s level of marketing expenditures and their activity, from year 4 going forward, is consistent with the marketing expenditures and activities of independent enterprises.
• Despite the preceding facts, Company S’s profits are consistently lower than are the profits made by independent entities during the corresponding years as to similar long-term marketing and distribution agreements because of the royalty.

**Primair E – Example 7d – Paragraph 208**

• The drafters take the position that, for transfer pricing purposes, the enterprise would not expect to pay a royalty on an arm’s length basis where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles.
• The enterprise might retain the right to use such intangibles in distributing a branded product that the entity supplies to the intangible-related returns that are attributable to such intangibles.
• In such circumstances, the royalty that Company S pays to Primair causes Company S’s income to be lower than that of independent enterprises having comparable functions, risks, and assets.
• The drafters conclude that the Country Y’s tax administration can disallow the royalties as a transfer pricing adjustment based on the facts of this case.

**Primair E - Commentary – Example 7**

It might be the case that Company S and Primair might have arranged for the royalty as a means of stripping-out Company S’s income from Country Y. The tax administrations could view these set of facts are creating indicia of a tax avoidance purpose.

**Primair F – Example 8a – Paragraph 209a**

• The facts in Example 8 are the same as those set out in Example 5, with the following additions.
• Primair stops manufacturing watches at the end of year 3.
• Primair contracts with a third-party to manufacture these watches on Primair’s behalf.
• As a result of this change, Company S imports unbranded watches from the manufacturer.
• Company S undertakes secondary processing to apply the R name and logo.
• Company S packages the watches before Company S sells the watches to the final customer.
• Company S then sells and distributes the watches in the manner described in Example 5.

Primair E – Example 8b – Paragraph 209b

• As a consequence, Primair and Company S renegotiate their earlier agreement at the beginning of year 4.
• Primair and Company S enter into a new long-term licensing agreement.
• The new agreement starts at the beginning of year 4.
• The new agreement is for five years.
• Company S, but not Primair, has the option to renew the agreement for a further five years.

Primair E – Example 8c – Paragraph 209c

• The new agreement grants Company S the exclusive right, within country Y, to process market, and distribute watches bearing the watches bearing the R trademark.
• The consideration is Company S’s agreement to pay a royalty to Premair based on the gross sales of all such watches.
• Company S receives no compensation from Premair as to the renegotiation of the original marketing and distribution agreement.
• The drafters assume, for purpose of this Example 8, that the purchase price that Company S pays for the watches from the beginning of year 4 is arm’s length.
• Company S pays no consideration for branding the watches and determining the price by embedding the R name in the watches.

Primair E – Example 8d – Paragraph 210

• Country Y’s tax administration audits Company S in year 6.
• During this audit, Country Y’s tax administration determines, based on a proper functional analysis, that the level of Company S’s marketing expenses during year 1, year 2, and year 3 far exceed those marketing expenses incurred by independent marketers and distributors with similar long-term marketing and distribution agreements.
• Country Y’s tax administration determines that the level of Company S’s marketing activity exceeds the marketing expense of independent marketers and distributors.
• Country Y’s tax administration undertakes a comparability analysis and functional analysis as to Company S’s activities.
Given the extent of Company S’s market development activities, and the comparability analysis and functional analysis, that Company S has assumed significantly greater costs and risks than comparable independent enterprises.

Evidence suggests Company S’s profits are significantly lower than the profits made by comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

**Primair E – Example 8e – Paragraph 211**

- Country Y’s tax administration undertakes an audit for years 4 and 5.
- Country Y’s tax administration ascertains that Company S bears the costs and associated risks of its marketing activities under the new long-term licensing arrangements with Primair.
- Country Y’s tax administration ascertains that the agreement with Primair is for a long term.
- The Company S – Primair arrangement provides Company S with an opportunity to benefit from these activities, or to suffer a loss from these activities.
- However, Company S has undertaken market development activities and has incurred marketing expenditures that are far beyond what comparable independent licensees with similar long-term licensing arrangements would undertake and incur for their own benefits.
- Company C’s activities result in Company S having significantly lower profits that would comparable enterprises.

**Primair E – Example 8f – Paragraph 212**

- Based on the preceding facts, Company S is entitled to intangible-related returns by virtue of the functions, risks, and costs that Company S assumed.
- Primair should compensate Company S by an additional return for the market development activities it has undertaken.
- For year 1, year 2, and year 3, the facts in Example 5 describe the possible bases for such an adjustment for Company S.
- For years 4 and 5, the bases for an adjustment for Company S would be similar.
- However, for years 4 and 5, Primair could reduce the adjustment for royalty payments from Company S to Primair rather than adjust Company S’s purchase price of the watches.
- The drafters comment that, depending on the facts and circumstances, Primair should consider whether Company S should be compensated for its entitlement to intangible-related returns in some manner in connection with the renegotiation of the arrangement at the end of year 3.

**Primair F – Commentary - Example 8**
The drafters note that Company S undertakes secondary processing, but the drafters fail to explain further the ramifications of this secondary processing. As transfer pricing practitioners, it our view that Company S should be entitled to intangible-related returns, notwithstanding the secondary processing. The presence of secondary process should impact the cost analysis.

**Shuyona A – Example 9a – Paragraph 213**

- Shuyona is the parent company of a MNE group.
- Shuyona is organized in country X and operates in country X.
- The Shuyona group is involved in the production and sale of consumer goods.
- The Shuyona group carries out ongoing research for two purposes:
  - In order to maintain, and, if possible, improve its market position.
  - To improve existing products and develop new products.
- The Shuyona group maintains two R&D centers:
  - Shuyona operates one center in country X, the Shuyona R&D center.
  - Company S, Shuyona’s subsidiary, operates a center in country Y.
- The Shuyona R&D center undertakes the following activities:
  - The Shuyona R&D center is responsible for the Shuyona’s overall research program.
  - The Shuyona R&D center designs research programs.
  - The Shuyona R&D center develops budgets.
  - The Shuyona R&D center makes decisions as to where the MNE group will conduct its research.
  - The Shuyona R&D center monitors the progress as to all R&D budgets.
  - The Shuyona R&D center controls the R&D functions for the MNE group.
- The Shuyona group senior management controls the R&D functions.

**Shuyona A – Example 9b – Paragraph 214**

- The Company S’s R&D center operates on a separate project-by-project basis.
- In that manner, the Shuyona R&D center assigns the projects and the Company S R&D center carries them out.
- Company S R&D personnel can suggest modifications for the research program.
- The Shuyona R&D center must formally approve any such research program modification.
- The Company S R&D center reports its progress on at least a monthly basis to supervisory personnel at the Shuyona R&D center.
- The Company S management must seek approval of the Shuyona management for further expenditures if Company S exceeds its budget.
- Contracts exist between the Shuyona R&D center and the Company S R&D center.
- These contracts specify that Shuyona will bear all the risks and costs as to the R&D that Company S undertakes.
• Pursuant to the contracts between these two companies, Shuyona registers all patents, designs, and other intangibles that Company S research personnel develop.
• Shuyona pays Company S a service fee for its research and development activities.

Shuyona A – Example 9c – Paragraph 215

• Under these circumstances, Shuyona is entitled to intangible-related returns.
• Shuyona can derive these intangible-related returns through Company S’s R&D.
• The issue becomes the determining of Shuyona’s service fee paid to Company S.
• The enterprise or the tax administration should consider the relative skill and efficiency of the Company S R&D personnel as a comparability factor.
• The parties might require transfer pricing adjustments to reflect the amount that a comparable R&D service provider would be paid for its services.
• In general, such adjustments should generally relate to the years in which Company S provides the services.
• These adjustments would not affect Shuyona’s entitlement to future intangible related returns from Company S R&D activities.

Shuyona A – Commentary – Example 9

As transfer pricing practitioners, it our view that while Shuyona is entitled to earn intangible-rated returns, perhaps the “lion’s share,” Company S might be a second contributor to the intangible-rated returns. Company S is at risk, even if partially, and for an interim basis, but nevertheless should be entitled to its perhaps minor share of the intangible-rated returns.

Shuyona B – Example 10a – Paragraph 216

• Shuyona is the parent company of a MNE group.
• Shuyona is organized in country X and operates in country X.
• In Example 10, as in Example 11, but in contrast with Example 9, Shuyona's operations are exclusively in country X.
• The Shuyona group is involved in the production and sale of consumer goods.
• The Shuyona group carries out ongoing research for two purposes:
  o In order to maintain, and, if possible, improve its market position.
  o To improve existing products and develop new products.
• The Shuyona group maintains two R&D centers:
  o Shuyona operates one center in country X, the Shuyona R&D center.
  o Company S, Shuyona’s subsidiary, operates a center in country Y.

Shuyona B – Example 10b – Paragraph 217

  o The Shuyona group sells two product lines:
    o Shuyona conducts all R&D concerning product line A.
Company S’s R&D center conducts all R&D concerning product line B.
Company S functions as the regional headquarters of the Shuyona group in America.
Company S has the global responsibility for the operation of the business relating to product line B.
Shuyona registered all patents that Company S developed by its research efforts.

Shuyona B – Example 10c – Paragraph 218

- The two R&D centers, Shuyona and Company S, operate autonomously.
- Each center bears its own operating costs.
- Company S R&D center undertakes the following under the general policy direction of Shuyona’s senior management:
  - The Company S R&D center develops its own research programs.
  - The Company S R&D center establishes its own budgets,
  - The Company S R&D center makes determinations as to when the company should terminate or modify its R&D projects.
  - The Company S R&D center hires its own R&D staff
- The Company S R&D center reports to the product line B management team for Company S.
- The Company S R&D center does not report to the Shuyona R&D center.
- The Shuyona and Company S R&D teams sometimes work together in joint meetings to discuss research methods and common issues.

Shuyona B – Example 10d – Paragraph 219

- Under the preceding circumstances, Company S is entitled to intangible-related returns derived from the research outputs of its own R&D center as related to product line B.
- Shuyona’s registration of Company S’s developed patents does not determine the entitlement of the intangible-related returns.

Shuyona B - Commentary - Example 10

Company S incurs functions, risks, and assets where these activities indicate that Company S should be entitled to intangible-related returns. The reader should contemplate that the MNE began with its Shuyona operations, and then set up Company S. It then would be possible that Shuyona set up Company S as being a workforce-in-place transfer situation. In such an event, Shuyona should receive a portion of the intangible-related returns.

Shuyona C – Example 11a – Paragraph 220

- Shuyona is the parent company of a MNE group.
- Shuyona is organized in country X and operates in country X.
- In Example 11 as Example 10, but in contrast with Example 9, Shuyona’s operations are exclusively in country X.
Nevertheless, despite the following statement as to exclusivity, the drafters take the approach that the relationships between the Shuyona R&D center and the Company S R&D center are the same as in Example 9.

The Shuyona group is involved in the production and sale of consumer goods.

The Shuyona group carries out ongoing research for two purposes:
- In order to maintain, and, if possible, improve its market position.
- To improve existing products and develop new products.

The Shuyona group maintains two R&D centers:
- Shuyona operates one center in country X, the Shuyona R&D center.
- Company S, Shuyona’s subsidiary, operates a center in country Y.

Shuyona C – Example 11b – Paragraph 221

- Shuyona transfers patents and other technology-related intangibles to a new subsidiary, Company T, which Shuyona organized in country Z in year 1.
- Company T establishes a manufacturing facility in country Z.
- Company T begins to supply products to the Shuyona group around the world.
- This example assumes that Company T’s compensation that Company T makes in exchange for the transferred patents and related intangibles with Shuyona reflects the arm’s length value of the transferred intangibles.

Shuyona C – Example 11c – Paragraph 222

- At the same time as Shuyona transfers patents and other technology-related intangibles to Company T, Company T enters into a contract research agreement with Shuyona.
- At the same time as Shuyona transfers patents and other technology-related intangibles to Company T, Company T enters into a separate contract research agreement with Company S.
- Company T agrees to the following pursuant to these two agreements:
  - Company T agrees to bear the risk of future R&D.
  - Company T agrees to assume the cost of all future activity.
  - Company T agrees to pay a service fee to Shuyona and to Company S.
- Company T determines the service fee to be the sum of the following amounts:
  - The cost of the R&D activities that Company T undertakes on behalf of Shuyona or Company S.
  - A markup that is equivalent to the profit markup over cost that is earned by “allegedly comparable companies” engaged in providing research services.

Shuyona C – Example 11d – Paragraph 223

- Company T has no technical personnel that are capable of conducting or supervising the research activities.
- Shuyona continues the preceding activities:
  - Shuyona continues to develop and design its own R&D program.
Shuyona continues to establish its own R&D budgets.

Shuyona continues to determine its own levels of R&D staffing.

Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the same manner described in Example 9.

**Shuyona C – Example 11e – Paragraph 224**

- The drafters conclude that, under these circumstances, that the parties should treat Shuyona as the party entitled to intangible-related returns as to the R&D that Shuyona conducts after the date that Shuyona transfers the patents and related technology intangibles to Company T.

- Shuyona should be entitled to intangible-related returns as to its own activities and to the R&D activities that Company S conducts.

- Company T should not be entitled to intangible-related returns relating to the ongoing R&D.

- The basis for this conclusion denying entitlements to Company T is that Company T does not control risks, or perform and control the key R&D functions.

**Shuyona C – Commentary – Example 11**

As transfer pricing practitioners, it is our view that the tax administrations in country X, where Shuyona is located, or in country Y, where Company Y is located, should, in addition to denying the entitlement to Company T because of its lack of key R&D functions, challenge the MNE group’s rationale in setting up Company T in country Z. It is possible that the MNE group lost interest or funds to make the Company T activities a reality. In contrast, the facts might otherwise indicate that the MNE is seeking to create a tax evasion scheme by initiating the Company T diversion.

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1 6/6/2012 draft, 1
2 6/6/2012 draft, 2
3 6/6/2012 draft, 3
4 6/6/2012 draft, 4
5 6/6/2012 draft, 5
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7 6/6/2012 draft, 7
8 6/6/2012 draft, 8
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13 6/6/2012 draft, 13
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15 6/6/2012 draft, 15
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September 13, 2012

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development

Re: June 2012 Intangibles Discussion Draft

Dear Mr. Andrus:

I. Introduction

This letter is in response to the request of the Centre for Tax Policy and Administration of the Organisation for Economic Co-Operation and Development ("OECD") for comments on the June 6, 2012 discussion draft entitled Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions ("Discussion Draft").

This letter sets forth the comments of the Transfer Pricing Discussion Group ("TPDG") on the Discussion Draft. The TPDG consists of U.S. and foreign-based multinationals in numerous industries. The industries include automotive, chemicals, consumer durable goods, food and beverage, industrial equipment of various types,
information gathering and dissemination, news, pharmaceuticals and technical information. Participants in the TPDG have a wide range of business activities potentially relevant to intangible assets, including research and development, licensing, manufacturing, marketing, distribution and services of various types.

The TPDG meets regularly to discuss matters directly and indirectly related to transfer pricing. The TPDG also submits comments on government proposals as well as those of the OECD.

In a letter dated September 14, 2010, the TPDG offered comments to the OECD in response to its request for suggestions for the scope of a then new project involving the transfer pricing aspects of intangible assets. The TPDG is gratified that the Discussion Draft encompasses many of the topics that the TPDG and other commentators suggested be within scope. The TPDG also appreciates the effort that has been made by all the participating countries and OECD staff in addressing the topics in the Discussion Draft.

As intangible asset topics can be challenging for transfer pricing and as different countries can and do have different perspectives, it is not surprising that portions of the Discussion Draft do not yet reflect a consensus of the participating countries. The lack of consensus at this point, however, does not diminish the value of the Discussion Draft nor make it any less opportune to, as the OECD has done, provide the public with an opportunity to submit comments. The Discussion Draft is a constructive document that addresses widely recognized topics and presents innovative thoughts intended to address both old and new issues.
The TPDG offers the following comments in a constructive spirit intended to assist the OECD and the participating countries in advancing this work to the next level. It is important for both taxpayers and tax administrators to have clear guidance with respect to transfer pricing for intangible assets and for this guidance to reflect consensus views that tax administrations will follow. If tax administrations follow, consistently, a single set of guidelines that adheres to basic arm’s length principles, then this should reduce the level of uncertainty in planning, of controversy in tax audits and of the incidence of international double taxation of income arising from intangible assets. These objectives, along with ease in administration, should remain major goals of this OECD project.

The comments in this letter are divided into sections. The sections follow the order of the topics set forth in the Discussion Draft for a new Chapter VI for the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration of July 2010 (“OECD Guidelines”):

- Section II: Summary of TPDG Recommendations and Comments
- Section III: Identifying Intangibles
- Section IV: Identification of Parties Entitled to Intangible Related Returns
- Section V: Transactions Involving the Use or Transfer of Intangibles
- Section VI: Determining Arm’s Length Conditions in Cases Involving Intangibles
- Section VII: Annex, Examples to Illustrate the Guidance on Special Considerations for Intangible Property
- Section VIII: Conclusion
II. Summary of TPDG Recommendations and Comments

Among the recommendations and comments made by the TPDG in this letter with respect to the Discussion Draft's proposals for a new Chapter VI for the OECD Guidelines are the following:

- Chapter VI should continue to use the phrase intangible property, or in the alternate use the phrase “intangible asset,” rather than referring merely to “intangibles.”

- The Chapter VI definition of “intangible assets” (or “intangible property”) should, as the Discussion Draft provides, focus on an item that is capable of being owned or controlled for use in commercial activities and that is not a physical or financial asset; the definition should add that services are not intangible assets but that a transfer of a contract to provide services is a transfer of an intangible asset (entering into the contract does not, however, transfer an intangible asset).

- Chapter VI should state that countries should not, for transfer pricing purposes, characterize as an intangible asset an item that would not be so treated for other income tax purposes. Using the tax definition does not interfere with determining arm's length prices.

- Chapter VI should adopt the Discussion Draft's position that there is a class of items (e.g., market characteristics, group synergies) that is not properly characterized as an intangible asset but that can affect the determination of arm’s length prices for a transaction.

- Chapter VI should explicitly state that an assembled workforce is in the above class and is not an intangible asset.

- Chapter VI should state, as the Discussion Draft does, that “separate transferability” is not a pre-condition for an item to be an intangible asset but also add that a lack of transferability can adversely affect the item’s value.

- Chapter VI should not adopt the Discussion Draft’s statement that an item can still be an intangible asset in the absence of any form of protection unless this can be illustrated with a commercially realistic example and the statement can be narrowly drawn.

- Chapter VI should avoid the Discussion Draft’s occasional reliance on speculation or theories about how unrelated parties “should” or “would”
structure their transactions in determining the related parties to which the returns attributable to intangible assets should be assigned; instead, Chapter VI should consistently rely on factual information about the comparables and their commercial realities.

- Chapter VI should not adopt the *Discussion Draft’s* statement that if a service provider is not compensated at arm’s length, then this is relevant to whether it is entitled to intangible asset related returns.

- Chapter VI should consistently respect the contractual arrangements of related parties that are aligned with the conduct of the parties in determining which entity is entitled to intangible asset related returns.

- Chapter VI should not incorporate statements in the *Discussion Draft* that would require a related party that claims intangible asset related returns to:
  1. use its own employees for intangible asset related functions, rather than allowing it to outsource functions to others, as well as (2) “control,” as opposed to “bear,” risks.

- Instead, Chapter VI should provide that entitlement to intangible asset related returns depends (1) on the parties’ contracts and behavior consistent with their terms; (2) the affiliate claiming the intangible asset related returns being able to benefit from the relevant opportunities and bearing the relevant risks; and (3) that, when an affiliate outsources intangible asset related functions, it has the financial capacity and expertise to agree to a budget and other contractual terms as well as to determine whether the contracts’ terms are followed (i.e., the affiliate should be an “informed hiring party”). This suggestion parallels principles already in the *OECD Guidelines*.

- Chapter VI should not, contrary to the suggestion in the *Discussion Draft*, recharacterize the existing *OECD Guidelines* nine-step process for identifying reliable comparables as a process for determining arm’s length “conditions” when used with respect to intangible assets.

- Chapter VI should consistently support the position that the taxpayer is free to structure its related party transactions and that tax administrations must respect this structure when consistent with its implementation.

- Likewise, Chapter VI should contain language that will discourage tax administrations from using theories about which alternative arm’s length structures, terms, or other conditions are relevant in analyzing the arm’s length transfer pricing of the parties’ actual, contracted, related party transactions that are implemented consistent with the contracts.

- The guidance provided by Chapter VI would not be improved by incorporating the *Discussion Draft’s* recommended phrase, “section D.1.(vi)
intangibles,” and its proposed definition. It could be helpful, however, if a revised Chapter VI emphasized the message that seems to be associated with that phrase (i.e., that potential TNMM/CPM comparables should not be rejected merely because they have intangible assets of value) and provided that message with a clear context.

- Chapter VI should remind readers that determining what is an acceptable level of reliability for comparables and methods can become an exercise in relativity, and that imperfect or “reasonable” marketplace comparables may be more reliable than alternatives, such as profit splits that do not use any marketplace comparables in splitting the residual profit.

- Chapter VI should incorporate the Discussion Draft’s warning against adopting a method that too readily assumes that all residual profit should necessarily be allocated to the party entitled to intangible asset related returns.

- Chapter VI should omit judgmental comments in the Discussion Draft that are generalizations, such as that profit split methods are not likely to be reliable in certain situations; instead, Chapter VI should focus on providing more guidance that explains what factors are useful in developing or evaluating reliable methods, such as careful analyses of the facts, or in considering the relative reliability of alternative methods.

- Chapter VI should adopt many of the Discussion Draft’s comments about discounted cash flow methods (“DCFs”) while adding others, such as considerations relevant to using “hurdle rates” and that DCFs can capture both functional and intangible asset returns.

- Chapter VI should incorporate all but two or three of the 22 examples recommended in the Discussion Draft for an Annex to Chapter VI. The TPDG believes that including examples is a very useful means of explaining statements of principle that will be in Chapter VI. The guidance provided in various Discussion Draft examples can be easily improved by adopting clarifying suggestions contained in Section VI of this letter. Among the types of clarifying suggestions are avoiding factual assumptions, providing a bit more relevant factual detail about the taxpayers and comparables, and having the analyses and conclusions in the examples more consistently rely on facts rather than on theories or speculation.
III. Comments on Identifying Intangibles

The first part of the Discussion Draft focuses on the beginning of Chapter VI, Special Consideration for Intangibles Property, of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of July 2010 (“OECD Guidelines”).

Proposed Chapter VI refers to “intangibles” rather than the phrase “intangible property” used currently in the OECD Guidelines. The TPDG recommends that a new Chapter VI and other relevant parts of the OECD Guidelines either continue to use “intangible property,” or adopt the phrase “intangible asset,” rather than merely referencing “intangibles.” This recommendation is based on more than following tradition.

Both the “intangible property” and “intangible asset” phrases reinforce a basic objective of the proposed Chapter VI, which is to focus on something “which is capable of being owned or controlled for use in commercial activities.” The words “property” and “asset” each imply something that is “capable of being owned or controlled for use in commercial activities.” In contrast, the term “intangibles” is amorphous and is capable of being stretched inappropriately to encompass far more than the drafters intended or that the business community and tax advisers would agree is appropriate.

Even if amended to use “intangible property” or “intangibles asset,” a revised version of proposed Chapter VI can continue to make clear that accounting definitions of “intangible assets” are not controlling as to whether something is an intangible asset

1 Paragraph 5.
for transfer pricing purposes. Likewise, a new Chapter VI can still effectively communicate that whether or not an intangible asset is expensed or amortized for tax purposes does not determine whether it is an intangible asset for transfer pricing purposes.

The use of “intangible asset” or “intangible property” will serve as a reminder to tax administrations and taxpayers that not everything of value that is not a service or property is an “intangible.” This would reinforce the Discussion Draft position that such a characterization is not necessary to establish, nor does it avoid establishing, using the taxpayer’s facts and marketplace evidence to determine whether or not any item, of whatever nature, has any particular value.

Indeed, one of the major contributions of the Discussion Draft is recognizing that there is a class of items that is not properly characterized as an intangible asset and that can affect the determination of arm’s length prices. The Discussion Draft correctly views market specific characteristics and group synergies in this way, stating that neither is an intangible. Such features may, as the Discussion Draft states, instead have to be addressed as comparability factors. This approach of the Discussion Draft helps preserve the clarity of the definition of intangibles assets, as it should. The TPDG recommends that future OECD work maintain this approach.

The Discussion Draft would be improved by likewise stating that an assembled workforce is not an intangible asset. Fortunately, the Discussion Draft recognizes that there is a potential benefit to the transferee of an assembled workforce in saving “the

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2 Paragraphs 23 and 24.
expense and difficulty of hiring and training a new workforce...,” and that this may “affect the compensation required in connection with the transaction...”³ This implies that an assembled workforce is not an intangible asset, but it would be better to say so directly.

A related matter concerns the statement that “a long term contractual commitment to make available the services of a particular group of uniquely qualified employees may constitute an intangible in a particular circumstance.”⁴ The TPDG recommends that this statement be omitted from future guidance. The Discussion Draft does not explain what these “particular circumstances” might be, thereby creating uncertainty. Moreover, and in all events, a service provider, whether an individual or a workforce, that has contracted to provide its services on a long term basis has done no more than agree to a condition (the length of the term) that as the Discussion Draft already recognizes, “may affect the arm’s length price for services,” and “should be taken into account...in a transfer pricing comparability analysis.”⁵

At the same time, the TPDG believes that a transfer of an executed contract, such as a contract to make available the services of a person or group, is a transfer of an intangible asset. Further, such an intangible asset may or may not have value, positive or negative. The value will depend in large part on whether the executed contract that is transferred contains set prices for the services, tangible property, or other items and, if so, for how long. Thus, a transfer of a long term executed contract

³ Paragraph 26.
⁴ Paragraph 26. (Emphasis supplied.)
⁵ Paragraph 25.
for the right to buy products or to acquire services at set prices may constitute a transfer of an intangible asset with value. The initial execution, is not however, a transfer of an intangible asset. The TPDG recommends that Chapter VI incorporate these clarifications and distinctions.

The TPDG agrees with the statement in the Discussion Draft that “separate transferability is not a necessary condition for an item to be characterized as an intangible…for transfer pricing purposes.” However, the TPDG recommends that this paragraph add that lack of transferability should be taken into account as a comparability factor and can adversely affect the value of the intangible asset.

The TPDG concurs that the “availability and extent of legal, contractual, or other forms of protection may affect the value…[of an intangible asset]…and the returns that should be attributed to it.” The TPDG questions, however, the Discussion Draft statement that, notwithstanding the absence of protections, an item can still be “characterised as an intangible for transfer pricing purposes.” Perhaps the next guidance can either illustrate such a circumstance with commercially realistic examples and constrain the scope of the statement, or remove the statement. The TPDG endorses the Discussion Draft’s explicit acceptance that “not all intangibles deserve separate compensation in all circumstances, and not all intangibles give rise to premium returns in all circumstances.”

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6 Paragraph 7.  
7 Paragraph 7.  
8 Paragraph 7.  
9 Paragraph 9.
The TPDG understands that the guidance proposed for Chapter VI of the OECD Guidelines is intended only to address transfer pricing matters, not other tax matters.\(^\text{10}\) Likewise and conversely, the TPDG concurs with the Discussion Draft’s comment that the OECD Model Tax Convention definition of “royalties” in Article 12 is not intended to provide guidance on whether and how much compensation should be provided for the use or transfer of intangible assets. However the Discussion Draft goes too far, in the TPDG’s judgment, by stating that the Article 12 definition is “not relevant for transfer pricing purposes.”\(^\text{11}\) It would be more accurate to state that the definition is not relevant in determining how much consideration there should be for an item for transfer pricing purposes. It could be relevant, even though not dispositive, for other transfer pricing purposes.

The Discussion Draft also goes too far in suggesting, in its commentary in a subsequent section on transactions involving the use or transfer of intangibles, that tax “labels” such as “intangibles” and “services” can be arbitrary. As is explained in Section IV of this letter, the TPDG believes that Chapter VI should discourage tax authorities from treating as a service or intangible a transaction that would not be so treated for other income tax purposes. This suggestion does not in any way constrain the ability of tax administrations to determine arm’s length prices for items.

\(^{10}\) Paragraph 12.

\(^{11}\) Paragraph 12.
IV. Comments on Parties Entitled to Intangible Asset-Related Returns

The *Discussion Draft* specifically requests business to comment on whether the proposed formulation of the principles in this part of the *Discussion Draft* clearly and successfully communicates that certain factors should determine the parties to which the returns attributable to intangibles should be assigned and to what extent. The TPDG believes that this aspect of the *Discussion Draft* relies too frequently on theory rather than on commercial facts. Further, some of the key factors the *Discussion Draft* advocates are inherently subjective and unclear and, therefore, will not be successful. The TPDG addresses which factors in the *Discussion Draft* are appropriate given commercial realities and the principles of the arm’s length standard and would assist compliance by taxpayers as well as administration by tax authorities.

Although the *Discussion Draft* helpfully lists certain relevant factors that have been mentioned in past discussions about this topic, other factors are arguably new, questionable, or given an inappropriately significant role. For instance, one of the factors proposed for determining which members of a multinational group are entitled to intangible asset related returns may surprise many in the private sector. It provides, in essence, that if a member of the group that is not entitled to a return on intangible assets under the relevant registrations and contracts provides services in connection with the development, enhancement, maintenance, or protection of the intangibles, then whether it is compensated on an arm’s length basis for the services is relevant to
whether it is entitled to intangible related returns. This factor, which is fortunately omitted from a subsequent summary in the Discussion Draft, should not be retained. If a service provider’s compensation is not at arm’s length, then the appropriate remedy is to adjust the compensation, not to try to recharacterize the service provider as an owner of intangible assets.

The TPDG agrees with the thrust of the following introductory statement in the Discussion Draft:

Where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity entitled to use the intangible and to exclude others from using the intangible, under applicable law and under relevant contracts, is the entity entitled to intangible returns with respect to that intangible for transfer pricing purposes.

Initially, the Discussion Draft appears to recognize that a contractual and legal owner of intangible assets is entitled to claim returns on said assets even though it outsources certain functions related to “the development, enhancement, maintenance, and protection of the intangibles…” If the Discussion Draft only said that much about outsourcing, then its guidance would reflect the actual, commercial practices of unrelated parties and would be administrable. However, and unfortunately, the Discussion Draft goes well beyond this, as discussed next.

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12 Paragraph 29.
13 Paragraph 54.
14 Paragraph 35.
15 Paragraph 40.
The Discussion Draft articulates “certain expectations.” One expectation is that “the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles.” In other words, the Discussion Draft provides that outsourcing activities related to intangible assets, whether to third parties or affiliates, may jeopardize the hiring party’s entitlement to intangible asset returns even if, among other things, it has all the relevant registration and contractual rights and bears all the relevant risks.

With all due respect, the OECD Guidelines have no basis for challenging, under any circumstances, the assignment of intangible asset returns made between two independent parties. By reason of their independence from each other their transactions, including their assignments of intangible asset returns, are at arm’s length. Thus, a new Chapter VI should reject proposed requirements in the Discussion Draft as to how a hiring party should control, manage or otherwise conduct itself when hiring an unrelated party to carry out functions relevant to any aspect of research, development, enhancement, etc. related to intangible assets. The comments that follow on this outsourcing and “return assignment” subject focuses on related party outsourcing transactions, which in principle are within the purview of a new Chapter VI.

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16 Paragraphs 39, 40.
17 Paragraph 40. (Emphasis supplied.)
18 Presumably determinations of which party is entitled to intangible asset returns made in outsourcing transactions with third parties accepted by a new Chapter VI as agreed to by the hiring party and its unrelated service provider. By definition, these are arm’s length transactions.
19 Paragraph 40, for example.
The *Discussion Draft* provides, in brief, that for any member of a group to be entitled to intangible returns it must at a minimum:

- perform and control important functions;
- bear and control the risks and costs related to developing and enhancing the intangible assets; and
- bear and control risks and costs associated with maintaining and protecting its entitlement to the return on the intangible assets.\(^{20}\)

The TPDG would like the OECD member countries to know that the business community views the above “expectations” or rules, as amplified by other statements and examples in the *Discussion Draft*, as constituting extreme positions that do not reflect business reality, and therefore do not respect the arm’s length principle, and that need to be reconsidered and modified.

The TPDG is sympathetic to a concern that tax administrations may have about a taxpayer with no full-time employees that would claim the returns on an intangible asset merely because it is the registrant or hiring party with respect to the asset. The TPDG believes, however, that the appropriate way for OECD member countries to address such a concern is to reflect upon what third parties actually do in the marketplace when hiring external service providers, rather than to rely on theories about how parties should behave commercially amongst themselves.

TPDG members have among them persons who hire third parties to engage in intangible asset related functions such as research, development, marketing and so forth. Based on the experience of these business, not tax, people, the proposed

\(^{20}\) Paragraph 54.
standards for entitlement to intangible asset returns are not reflective of what commonly occurs in the marketplace and in fact go well beyond what third parties can do in many marketplace transactions.

An example of outsourcing a function to third parties involves toxicology for a pharmaceutical company. There are independent companies that are expert at providing such a function, and in some cases are hired to run the trials (design, choose the trial location, provide personnel, and deliver study results). In such an instance, the hiring company bears the risk and pays for the services. However, and even as an “informed hiring party,” it does not control the personnel conducting the trial or provide daily oversight. In general, while a company may have the expertise it needs to hire a third party to engage in research and development (“R&D”) or marketing, that does not mean that it controls, or commercially could control, the activities or decisions of the personnel at the contract service provider. Nor does or can the hiring party necessarily perform important functions in connection with the third party’s activities.

As another illustration, it is increasingly common that an owner or licensor of a patent seeks an unrelated entity with the technical expertise to develop products under the patent. The party hired to conduct additional research or development often works in a very independent manner. In some arrangements there may be joint committees on development or research that consult on the project. However, these committees function in a merely advisory manner, allowing the hired service provider a great deal of, or nearly complete, autonomy as to the conduct of the research or development. In addition, the holder of the patent often grants a research or development service
provider the right to subcontract work, which further removes any opportunity for the patent holder to even attempt to influence the performance of important functions.

In such arrangements, both the patent holder and the service provider are responsible for some or all of the costs and expenses each incurs with respect to its activities. The service providers in many such cases control their research, are responsible for certain costs and bear risks in their compensation, which is often provided according to milestones of achievement in the project. At the same time, the patent holder maintains its rights in the intangible assets. In the event of improvements by the service provider, it is common for the agreement with the patent holder to stipulate that any intellectual property rights in the improvement will be transferred and assigned to the patent holder.

Thus, while the hiring party may have all of the opportunities and risks of intangible asset related successes and failures coming out of the third party’s R&D or other services, the service provider will typically have its own risks and opportunities as a service provider. These can include following its contractual terms and objectives, such as meeting deadlines for delivering results, and working efficiently and within the timeline and budget it agreed to in the contract. The hiring party cannot manage, let alone control, the service provider’s risks. These distinctions between the hiring party’s risk and service provider’s risks are important but are not articulated in the Discussion Draft. A new Chapter VI should clearly recognize these distinctions. Also, Chapter VI should focus more on risk bearing, as the TPDG recommends next.
The Discussion Draft would require that the members of the group that are entitled to intangible asset related returns “control the risks associated with the development, enhancement, maintenance and protection of the intangibles.” This requirement is unrealistic (risks are, by definition, not completely controllable), inconsistent with third party commercial behavior and not administrable.

Outsourcing personnel observe that the Discussion Draft’s proposed role of risk bearing in determining which affiliated entities are entitled to intangible asset returns for tax purposes vastly understates how significant risk bearing is commercially when third parties define their entitlements to returns from intangible assets. In the commercial marketplace, the party that, at risk, commits the funds necessary for a project involving intangible assets reaps the benefits in the event that returns from the assets exceed the costs and shoulders the loss if they do not. Thus, the new Chapter VI should emphasize the significance of risk bearing in determining entitlement to intangible asset returns much more than the Discussion Draft does now.

Members of the TPDG involved in third party outsourcing transactions believe that many intangible asset related transactions between third parties with which they are familiar would not meet the “control” and related requirements proposed in the Discussion Draft for related parties. In other words, the proposals would frequently reject as the correct recipient of the financial returns from intangible assets even third parties that are the legal and commercial owners of intangible assets and that actually earn those returns in marketplace transactions.

\[21\] Paragraph 42.
The TPDG is concerned that the Discussion Draft’s failure to align its proposed standards for entitlement to intangible asset related returns with real commercial practices will increase rather than decrease controversy and confusion. Again, the Discussion Draft’s reliance on theory rather than commercial reality is objectionable.

Aside from the lack of commercial reality of the Discussion Draft’s proposals, the TPDG is concerned about their subjective and unclear nature. What does it mean generally speaking to “control” functions, particularly in the context of outsourcing functions related to intangible assets. More specifically what is required to demonstrate the “design and control of research and marketing programs, management and control of budgets, control over strategic decisions regarding intangible development programs…and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.”22 Does “management” or “control” mean making day-to-day operational decisions, or something else? What happens if each of two or more affiliated parties has elements of “control”? If “control” is fragmented amongst affiliates, are none of them eligible to earn returns on the intangible assets? Alternatively, are they all entitled to intangible asset returns and, if so, how does one determine the relative proportions based on “control”?

At one point, the Discussion Draft states that “principles analogous to those of paragraphs 9.23 through 9.28 [of the OECD Guidelines] should be applied.”23 The

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22 Paragraph 40. (Emphasis supplied.)
23 Paragraph 41.
referenced paragraphs address risk allocation and control in the context of business restructurings. These paragraphs begin by accepting the use of an “external provider” (i.e., outsourcing activities) to administer or manage risks. They also state that the hiring party should have “the capacity to make decisions to take on the risk…[and to thereby]…to put the capital at risk.” The hiring party should, according to this part of the *OECD Guidelines*, be able to assess the outcome of the service provider’s activities.

The *OECD Guidelines* illustrate these statements by way of a description of an outsourcing arrangement for research. The example accepts that the hiring party is considered by contract to be “the owner of the outcome of the research” even though it outsources the research and neither manages nor performs the relevant functions. The hiring party retains ownership of the outcome for tax purposes if it can make the decision to hire the party (or can terminate the contract) and can decide on the type of research and its objectives as well as the benefit for the project. In other words, the principles of these paragraphs in the *OECD Guidelines* accept ownership of intangible asset returns generated by way of outsourcing by what this letter refers to as an “informed hiring party.”

Unfortunately, the *Discussion Draft* does not follow the principles of paragraphs 9.23 through 9.28 when it objects to outsourcing functions and requires being in “control” of functions.

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The *Discussion Draft*’s elevation of the importance of “control” in determining entitlement to intangible asset related returns also represents an abrupt departure from statements regarding the role of control elsewhere in the *OECD Guidelines*. For example, a single paragraph of Chapter I makes the following appropriately qualified observation about the role of control in third party arrangements: “In arm’s length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control.”\textsuperscript{26} This general observation does not, moreover, purport to dictate how either unrelated parties or related parties “should” structure their transactions. Similarly, although Chapter IX expands on the potential usefulness of control as “[o]ne relevant, although not determinative factor” in assessing the allocation of risk among related parties, it does so only in the context of providing guidance in situations where no comparable uncontrolled transactions can be found to demonstrate examples of arm’s length behavior.\textsuperscript{27}

In contrast, the *Discussion Draft*’s identification of control as a required element in any claim for entitlement to intangible asset returns would represent a new and very troubling approach. Unfortunately, the boldness with which the *Discussion Draft* forges ahead in this extremely critical area of transfer pricing guidance is not supported by any reference to the actual behavior of third parties.

The impractical aspects of these *Discussion Draft* proposals come into focus when recognizing that management structures within multinational groups change frequently for business reasons. Today, persons in one affiliate may make certain

\textsuperscript{26} Paragraph 1.49. *OECD Guidelines*.
\textsuperscript{27} Paragraph 9.20. *OECD Guidelines*. 
decisions on R&D or marketing, but tomorrow other persons in other entities might have that responsibility. In these circumstances and under the Discussion Draft’s proposals, does entitlement to intangible asset related returns shift among affiliates as management personnel or responsibility changes within the group even though contractual, funding, and risk taking capacity and other rights and obligations of the hiring party remain constant?

The TPDG is concerned with how these proposals would affect multinational groups that centralize certain decision making aspects for the group on design, research and development, or other activities related to intangible assets. It is not unusual for U.S. and foreign-based multinationals to centralize the ultimate decisions over group R&D, group manufacturing, group marketing, etc., as well as for the group’s budgets for these activities. Frequently, this is centralized at the parent company level while many relevant functions and other responsibilities are carried out by other affiliates having their own funding, opportunities, risks and day-to-day management. The TPDG is concerned that the current “control” proposals could mean that affiliates (other than the parent or another affiliate that is a centralized ultimate decision maker for the group) cannot earn returns from intangible assets for transfer pricing purposes even if the other affiliates are “informed hiring parties”; only the centralized entity will. Is that the intended result?

If so, then it is, with all due respect, an inappropriate result. If a multinational group arranges its activities so that certain affiliates by contract and commercial law are the owners of the resulting or enhanced intangible assets, then they are by commercial law entitled to the income therefrom. They operate under their own day-to-day
management and do so with their own risk and with their own opportunity. It would be unreasonable and contrary to longstanding views of the arm’s length standard to adopt proposals that in essence would view a multinational group, with multiple entrepreneurial affiliates engaged in developing and enhancing intangibles with the overall leadership of the centre, as having only one entity entitled to the intangible asset related returns: the parent/centre.

The proposals could also cause groups with multiple affiliates carrying out intangible related functions as service providers to have the intangible asset related returns fragmented among them even though they traditionally have not been, and should not be, entitled to returns on the intangibles assets. This could occur if there is no one entity within the group that is perceived to have all the requisite levels of functions, activities, and controls called for in this draft of Chapter VI. Does this mean that each of the service providers would be entitled to intangible asset returns and, if so, how does one determine the relative proportions?

The TPDG strongly encourages the OECD and participating countries to reconsider and change these aspects of proposed Chapter VI. The OECD Guidelines should not propose requirements for transfer pricing between affiliates that third parties frequently do not and cannot meet and that multinationals cannot administer within their own groups.

In lieu of the multiple, subjective and commercially unrealistic requirements proposed in the Discussion Draft now, the TPDG suggests an alternative approach. The first part of the TPDG proposal is that a legal or contractual owner of an intangible asset
that bears the risks of, and has the opportunities associated with, its discovery, development, enhancement, maintenance, or other factor, as the case may be, should be entitled to claim the intangible asset related returns therefrom for tax purposes. Secondly, if such an entity outsources discovery, development, enhancement, maintenance or other functions, then it can still claim the intangible asset related returns if it has the financial capacity and expertise to agree to a budget and other contractual terms for such functions as well as to determine whether the contract’s terms are followed. Such an entity is referred to here as an “informed hiring party.” In brief, in addition to having the right contract and following it, and providing the funding at its risk and for its opportunity, an informed hiring party should be capable of making decisions about entering into and administering compliance with the outsourcing contract, although even administering compliance could be outsourced under the principles of the OECD Guidelines.28

Third, the revised OECD Guidelines could state that a hiring party’s ability to claim intangible asset returns as an “informed hiring party” may be called into question to the extent that it outsources to related parties substantially all of the important functions relevant to the discovery, development, enhancement and maintenance of the intangible assets. However, the taxpayer must have the opportunity to establish that, as a factual matter, it has the capacity to make informed decisions about its outsourcing with the affiliates. If it meets this factual burden, then, as an “informed hiring party,” it should retain the intangible asset related returns rather than have them be reallocated to the affiliates conducting the outsourced functions.

28 Paragraph 9.23 of the OECD Guidelines.
In summary, there are opportunities for the OECD Guidelines to use much clearer, more administrable and more commercially realistic factors in deciding which affiliate is entitled to intangible asset related returns for transfer pricing purposes. The parties can and should clearly document their intangible asset ownership through intra-group contracts that, as appropriate, reinforce or differ from mere registration. Moreover, contractual ownership and responsibility for success or failure within the group should be coupled with the ability to make informed decisions about outsourcing with related parties and the financial capacity to provide the requisite funding. Associated with contractual ownership and funding is the understandable corollary of in fact having the opportunity and bearing the risk that the R&D, marketing or other services or activities being conducted may or may not result in a commercially successful intangible asset. These are all relatively objective and auditable factors.
V. Comments on Transactions Involving the Use or Transfer of Intangibles

The Discussion Draft helpfully distinguishes between transactions in which intangibles assets are used in connection with controlled transactions but not transferred and other situations in which the intangibles assets themselves may be transferred.\(^\text{29}\) It also appropriately warns against either taxpayers or tax authorities trying to “artificially separate intangibles that, as a matter of substance, cannot be separated.”\(^\text{30}\)

In illustrating combinations of intangible assets, the Discussion Draft examines pharmaceuticals. The Discussion Draft views government regulatory approval to market the product as an intangible asset and that, in combination with the patent protecting the active pharmaceutical ingredient and the product’s trademark, together are potentially “extremely valuable.”\(^\text{31}\) The paragraph goes on to recommend that understanding the interactions between these three classes of intangible assets is essential to effective transfer pricing analyses.

One unfortunate aspect of this industry-specific illustration of intangible asset combinations is the suggestion that there may be only three classes of relevant items for pharmaceuticals. There are in fact others, however, such as patents that relate to the formulation, use, dosing regime, or combination products, that may exist. Trade secrets, such as for manufacturing processes, may also be present.

\(^{29}\) Paragraphs 59-64.  
\(^{30}\) Paragraph 70.  
\(^{31}\) Paragraph 68.
A further issue is that pharmaceutical companies do not generally view government regulatory approval as an intangible asset that can be valued. Rather, the molecule creation, research and development, testing process and the creation of the data set are generally viewed by the companies as the appropriate intangible assets to value.

The TPDG recommends that the illustration be revised to avoid giving the impression that contributing aspects of the pharmaceuticals business are always in three classes and are always valuable, let alone “extremely valuable.” By referring to the combination of the three as potentially “extremely valuable,” the Discussion Draft may be creating unrealistic expectations or prejudices as to value for intangible assets in one industry and, in all events, is not reinforcing one of the main points of the example. The TPDG also recommends that the Discussion Draft be revised to state that the value of the relevant intangible assets, as a group may, or may not, be greater than the sum of the values of each of them when viewed in isolation from the others. This is a factual question.

In conclusion on this topic, the illustration should be revised to avoid prejudging how to value one industry’s intangible assets or to determine an exclusive list of what those assets “should” be. The OECD Guidelines are not an appropriate vehicle to debate or attempt to resolve such intensely factual matters, let alone for an entire industry. Instead, a new illustration could merely acknowledge the potential complexities of relationships of various intangible assets of pharmaceuticals and that business facts must be carefully examined before reaching any transfer pricing analyses or conclusions.
In addressing transfers of intangibles in combination with other business transactions, the Discussion Draft states that “not all” intangible asset transactions require complex evaluations or the application of profit-split methods. Unfortunately, this cautionary statement can be read to suggest that profit splits should be commonly used, although not always. In fact, there are many intangible asset transactions that can reliably avoid complex valuations or profit splits. It would be preferable if the text said something more process oriented, such as “intangibles transactions may be resolved under various transfer pricing methods, including profit splits, depending upon the related parties’ facts and the availability and the reliability of any marketplace comparables.”

The TPDG concurs with the important observation that “intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or rights in the intangible.”\(^\text{32}\) This part of the Discussion Draft illustrates this well.\(^\text{33}\) The TPDG also generally concurs with the observation that “restrictions imposed in license and similar agreements on the use of an intangible…are often of significant importance”\(^\text{34}\) but suggests that the next draft omit the modifiers “often” and “significant.” It would be helpful to state that it is uniformly important to understand such restrictions, although they may or may not turn out to be dispositive or have a significant effect on the resulting transfer pricing analysis.

Parts of the Discussion Draft emphasize, as they should, carefully examining the

\(^{\text{32}}\) Paragraph 59.

\(^{\text{33}}\) Paragraphs 59-61.

\(^{\text{34}}\) Paragraph 64.
facts of the related party transactions as well as of the transactions between unrelated parties. The TPDG concurs that the facts of each specific situation, including the terms of relevant contracts and whether the parties follow the terms, should determine whether a particular transaction is a provision of products or services or the transfer of intangibles or a combination. The TPDG also agrees, with one edit, with the statement of the ultimate objective which is “to identify the prices and other conditions that would be are established between unrelated persons in the comparable transactions.”

35 Paragraphs 62-64.
36 Paragraph 75.
VI. Determining Arm’s Length Conditions

This part of the Discussion Draft starts out recommending the use of the nine-step process in paragraph 3.4 of Chapter III of the OECD Guidelines to identify “arm’s length conditions” for transactions involving the use or transfer of intangibles. The use of the word “conditions” is puzzling, particularly given that the nine-step process referred to is by its terms designed to lead to the identification of reliable comparables. Paragraph 3.4 of Chapter III does not refer to “conditions.” As used in the heading and the following text of the Discussion Draft, “conditions” can, and appears to, mean something different from what the nine-step process actually involves.

The Discussion Draft’s use of “conditions” seems to be related to the Discussion Draft’s observation that “for wholly legitimate reasons, due to the relationship between them, associated enterprises might structure a transaction involving intangibles in a manner that independent enterprises would not contemplate.” “Conditions” seems to encompass using theories of what the arm’s length structure, terms, or other “conditions” should be for related party transactions notwithstanding “wholly legitimate reasons,” the agreements and actions of the related parties, or marketplace evidence and commercial realities. Hopefully, this is not the intention behind the Discussion Draft.

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37 Paragraph 77. (Emphasis supplied.)
38 See Paragraph 3.4 of Chapter III.
39 Other provisions in Chapter III, such as Paragraphs 3.11 and 3.15, use the word “conditions” in contexts that, when taking into account the French version of the OECD Guidelines, suggest references to contractual terms. At other places, such as in Paragraph 3.60, the French version of the OECD Guidelines suggests that a relevant “condition” may equate to a price or a margin. Based on these and other examples, there is confusion in the OECD Guidelines about what “condition(s)” means. A new Chapter VI should avoid this confusion.
40 Paragraph 78.
Draft and will not be the design of what will become a consensus OECD document and a new Chapter VI for the OECD Guidelines. In any event, a more accurate title for this part of the Discussion Draft might be along the lines of “Determining Arm’s Length Compensation.”

It would be constructive for the Discussion Draft to add that tax administrations, and for that matter taxpayers, need not engage in speculation or rely on theories about what would or would not be “contemplated” by third parties. The taxpayer is free, as the OECD Guidelines and other parts of the Discussion Draft make clear, to structure its related party transactions. Under the arm’s length standard, this structure is supposed to be respected for tax purposes when the taxpayer implements it consistent with its form and contractual terms.

Of course, respect for the related party transaction as structured does not mean automatic or required acceptance that the price or value used by the taxpayer is at arm’s length. Tax authorities can evaluate the arm’s length nature of the compensation based on the marketplace evidence of compensation in the most reasonably comparable third party transactions, making adjustments for factual differences where necessary. If there are no such transactions or other marketplace evidence, then tax authorities can judiciously use a reliable alternative. However, whether using marketplace evidence or alternatives to determine the amount of compensation it is neither necessary nor appropriate for tax authorities to, in form or in substance, determine which terms or conditions the related party transaction “should have had” even if the authorities speculate that independent enterprises would not “contemplate” the transaction structure used by the taxpayer. The TPDG respectfully requests that the
Discussion Draft clearly and consistently distinguish between not accepting a transaction’s structure (precluded) and challenging the levels of compensation the structure provides to the related parties (accepted).

The Discussion Draft reveals serious problems with the proposed “realistically available options” concept by way of a puzzling example of why “the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party.”

Certain structural or other options might be reasonable in the eyes of an unrelated party but not commercially realistic for an affiliate when business is run on a group level. For example, in the case of a multinational group with small system profits, intangible assets may have a negative value (e.g., routine functional returns are higher than system profits). In theory, the intangible asset owner has the option to discontinue this business. A rational commercial group, however, might not discontinue the business if it generates system profits.

Is the Discussion Draft suggesting (inappropriately) that the intangible asset owner should in these or other circumstances have particular commercial terms or conditions, in a structural sense, with its affiliates? Alternatively, is the Discussion Draft recommending (appropriately) that, given the commercial terms and conditions of the affiliates, such as the low system profits in the above example, tax authorities should gather marketplace evidence about compensation such as royalty rates to evaluate.

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41 Paragraph 83.
whether or not the owner is entitled at arm’s length to receive intangible asset related returns in certain amounts or should, instead be paying a “subsidy” to the transforee?

In discussing ownership and use of intangible assets as a comparability factor, the *Discussion Draft* introduces the concept of “section D.1.(vi) intangibles.” While the full definition has three clauses it appears to boil down to whether a related party intangible asset is “not similar” to intangible assets with incremental “future economic benefits” used by or available to parties in “potentially comparable transactions.” The *Discussion Draft* warns against the rejection of potential comparables merely because they have or use “section D.1.(vi) intangibles;” i.e., intangibles not similar to those of value in otherwise potentially comparable transactions.

The TPDG agrees that potential comparables, such as CPM/TNMM companies, should not be rejected merely because they have or use intangible assets of value. Any rejection of the potential comparables should be based on marketplace evidence – not speculation or theories – that their intangible assets actually affect their financial results (upward or downward) in such a manner or to such an extent that the potential comparables do not provide a reliable means to determine the arm’s length compensation of the relevant related party, and that the potential comparables’ results cannot be made reliable by way of adjustments.

Unfortunately, as written, the proposed definition of “section D.1.(vi) intangibles” is of questionable utility. Moreover, the definition invites speculation and theories by

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42 Paragraphs 84-89.
43 Paragraph 105.
using phrases such as that the intangible asset is “expected to yield greater future economic benefits than would be expected in the absence of the intangible” and that its use or transfer “would be remunerated.” Due to the difficulties inherent in the proposed definition and because a phrase is not needed to achieve the Discussion Draft’s objective, the participating countries should consider dropping the phrase and its definition from future guidance. The TPDG supports guidance that reinforces that the acceptance or rejection of comparables (e.g., CPM/TNMM comparables) should be based on marketplace evidence from actual transactions rather than on speculation or hypothesis.

On a related matter, in a case where the focus is on a related party transaction that uses intangible assets, as opposed to one that transfers intangible assets, the marketplace evidence should include a discussion of the actual effects of the intangible asset on the results of potential comparables such as TNMM/CPM companies, not expectations of future benefits.

The TPDG supports the statement that “potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill.” As written, this statement may be referring to the use of comparable publicly traded companies (i.e., in TNMM or CPM analyses) rather than true transactional (i.e., contractual) comparables such as third party licenses. However, the discussion refers to pricing methods that fall into both the

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44 Paragraph 105. (Emphasis supplied.)
45 Paragraphs 84-89, 120.
46 Paragraph 89.
CPM/TNMM and true transactional categories and thus may be intended to apply to all these circumstances. This should be clarified.

The *Discussion Draft* helpfully provides a non-exhaustive list of factors to be considered in a comparability analysis relevant to intangibles:

1. exclusivity
2. extent and duration of legal protection
3. geographic scope
4. useful life
5. stage of development
6. rights to enhancements, revisions and updates
7. expectations of future benefits
8. existence of risks related to the likelihood of obtaining future economic benefits, including risks related to future development, product obsolescence and depreciation in value, infringement, product liability and other matters related to the future use of the intangibles.\(^{47}\)

The TPDG observes that in a true transactional comparability analysis where provisions of related and unrelated party contracts can be compared with each other, one may be able to ascertain what important risks third parties believe exist in their transactions and who should bear them. Although such third party contracts are unlikely to quantify the expected value of the risk, other information can be used to incorporate quantum adjustments for differences in risks in the pricing analysis.

\(^{47}\) Paragraphs 90-102.
The Discussion Draft usefully observes the challenges inherent in comparability adjustments due to differences between the related and unrelated party transactions. It also notes that the possibility of making comparability adjustments is especially important when dealing with royalty rate data drawn from commercial databases or proprietary compilations of publicly available license or similar agreements. The latter observation, while accurate, may diminish the role of such databases too much, especially if the fall-back method is routinely profit split without any transactional or other marketplace evidence on how to split the residual profit. Is that the intended result?

The TPDG believes that the Discussion Draft should remind the reader that determining an acceptable level of reliability can, both in the database situation and as a general matter, become an exercise in relativity. In other words, imperfect marketplace comparables may well be more reliable than using an alternative that does not have marketplace comparables (e.g., using theory or hypothesis without supporting marketplace evidence to divide the residual in a profit-split approach).

The Discussion Draft opposes selecting the most appropriate transfer pricing method on the basis of an “arbitrary” label (e.g., services versus intangibles). Instead, the choice of method should be based on the “economic consequences of the transactions.” In this connection, the Discussion Draft asserts as an example that “the performance of a service using intangibles may have very similar economic consequences to a transaction involving the transfer of an intangible (or the transfer of

48 Paragraphs 103, 104.
49 Paragraph 107.
The basis for this assertion, which appears to be a theory, is not provided. The assertion does not take into account that different rights are provided to a customer when it has both a license to use intangible assets and a contract to receive services compared with when it only receives services made more valuable by the service provider’s intangible assets and has no rights to use those assets. In fact, other parts of the Discussion Draft acknowledge these factors. Thus, this assertion should be withdrawn or explained.

Along the same lines, this part of the Discussion Draft unfortunately appears to be prepared to treat as a service or as an intangible asset a transaction that would not be so treated for other tax purposes. This is legally and otherwise objectionable, particularly in any transfer pricing regime that imposes on intangible assets, not services or other transactions, special rules or standards for transfer pricing. For example, a U.S. statutory provision using the language “commensurate with the income” applies only to transfer pricing for intangible property, not for services, tangible property, or other items. Thus, it is important that the OECD Guidelines avoid encouraging the creation of definitions of intangible assets or property that conflict with commonly accepted tax rules or principles. Maintaining such definitional consistency for tax purposes does not in any way constrain the tax authorities, or taxpayers, from determining the arm’s length prices for the items, whatever their tax characterization may be.

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50 Paragraph 107.
As an illustration of the preferred way of addressing this issue, the Discussion Draft appropriately recognizes in other sections\(^{51}\) that an intercompany service may be more valuable if it utilizes intangible assets even though there is no transfer of an intangible asset. No part of the Discussion Draft should support recharacterizing a service as an intangible asset under a strained definition of intangible asset.

The Discussion Draft helpfully warns against adopting a method that “too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns.”\(^{52}\) It would be useful to follow up this useful statement with illustrations, such as one in which the party without the intangible assets bears materially greater risks.

While the Discussion Draft discourages attempts to estimate the value of intangible assets based on the cost of intangible asset development plus a return it is, appropriately, not doctrinaire about this.\(^{53}\) However, in explaining the limited circumstances in which estimated costs of reproducing or replacing the intangible asset may be appropriate the Discussion Draft appears to be unduly restrictive. It would be helpful if the Discussion Draft again reminded readers that relative reliability is relevant in choosing or rejecting a cost-oriented valuation approach. Is the alternative to the cost-oriented approach one based on marketplace evidence or is it theoretical and based on assumptions? All other things being equal, the cost-oriented approach could be more reliable than the theoretical alternative. In other words, there may be

\(^{51}\) Paragraph 59.
\(^{52}\) Paragraph 108.
\(^{53}\) Paragraph 112.
substantial reliability questions in using a theoretical approach rather than even a cost-oriented one.

The Discussion Draft discourages the use or application of general “rules of thumb” to divide intangible returns between, for example, a licensor and a licensee. Does this mean that the OECD member countries do not endorse the old “25/75” split? It would be useful for this part of the commentary to distinguish between what it calls a “general rule of thumb” and other types of broad guidance based on empirical analyses, even though they might be based on numerous third party transactions.

In discussing other approaches to be used when reliable comparable uncontrolled transactions cannot be identified, the Discussion Draft says it is important to consider, among other things, “the business reasons for engaging in the transactions” and “the perspectives of and options realistically available to each of the parties to the transaction.” Unfortunately, the Discussion Draft seems, once more, to be too interested in challenging the motive behind or the structure chosen for the related party transactions. At the same time, the Discussion Draft helpfully states that “there is no requirement that associated enterprises structure their transactions in precisely the same manner as unrelated parties might have done.” The Discussion Draft should, as is suggested above, consistently break the tension between statements about investigations of or challenges to the structure as chosen by the taxpayer versus the

54 Paragraph 116.
55 Paragraph 126.
56 Paragraph 127.
respect required for it in favor of both the latter and adjusting the levels of compensation resulting from the chosen structure.

The Discussion Draft occasionally constrains the application of profit-split methods, such as where it states that “in some circumstances” where reliable uncontrolled transactions cannot be identified transactional profit-split methods may be utilized.\(^{57}\) This particular statement applies to sales of goods and services involving the use of intangibles. The scope of “some circumstances” is significantly broadened by a subsequent statement that the use of transactional profit-split methods may be appropriate when both parties to the transaction make “unique and valuable contributions” to the transaction.\(^{58}\) This is too subjective a phrase to provide certainty and clear guidance. Moreover, does this phrase have the same meaning as both parties having “section D.1.(vi) intangibles?” Why does the Discussion Draft use either, let alone both, of these concepts? One suggestion from the TPDG is to omit references to “unique and valuable contributions” or to define this phrase in a way that gives it clear, objective meaning.

The Discussion Draft is rather Delphic when it refers to “transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions”\(^{59}\) as being usable in transactions. Query, what does this paragraph mean and what guidance would it add to the OECD Guidelines?

\(^{57}\) Paragraph 128.
\(^{58}\) Paragraph 128.
\(^{59}\) Paragraph 131.
The Discussion Draft states that, based on experience, the “methods most likely to prove useful are the CUP method and the transactional profit-split method. Valuation techniques can be useful tools in some circumstances.”\textsuperscript{60} The Discussion Draft seems to de-emphasize unduly the use of CPM/TNMM to one tested party, such as a licensee, perhaps because of a fear that it will cause the intangible asset residual to go entirely to the licensor/owner of the intangible asset.\textsuperscript{61} If, as is frequently the case, the CPM/TNMM comparables have their own intangible assets (e.g., customer lists, marketing expertise or manufacturing know how and processes), or are licensees themselves, then their returns will reflect both functions and intangible assets, as well as other factors such as risks. Thus, the Discussion Draft should clarify that using such comparables does not necessarily result in an inappropriate allocation of intangible asset returns.

The Discussion Draft next comments on the application of profit-split methods in connection with license transactions and in connection with transfers of full rights to intangibles.\textsuperscript{62} The Discussion Draft warns that profit-split methods are “unlikely” to “readily yield a reliable estimate” of arm’s length results in connection with transfers of partially developed intangibles.\textsuperscript{63} The Discussion Draft perceives profit-split approaches as unlikely to “readily yield a reliable estimate of the contributions of the parties to the creation of income in years following the transfer.”\textsuperscript{64} The TPDG believes that this guidance on profit-splits would be improved if it were less theoretical and judgmental, \textsuperscript{60} Paragraph 136.  
\textsuperscript{61} Paragraph 136.  
\textsuperscript{62} Paragraphs 141-144.  
\textsuperscript{63} Paragraph 144.  
\textsuperscript{64} Paragraph 144.
suggested other potential methods for such circumstances, explained why they are likely to be more reliable, and reminded the reader about the importance of developing the facts and considering the relative reliability of potentially alternative methods.

The TPDG supports the *Discussion Draft’s* endorsement of valuation approaches that estimate the discounted value of projected future cash flows as potentially “particularly useful analytical tools.” However, there are problems with the *Discussion Draft’s* position that the arm’s length price for the transfer of the intangibles should fall somewhere within the range formed by the discounted present values of the streams of cash flow attributable to the intangible from the perspectives of both parties to the transaction. As financial projections from both parties are rarely available it is questionable whether this standard is practical, even assuming it is consistent with the arm’s length principle. The TPDG offers comments below, in connection with its analysis of Example 19, on other serious difficulties with using different perspectives to try to create a range of arm’s length prices or values.

The *Discussion Draft* covers at some length the use of the discounted value of projected cash flow, without endorsing a particular rate and without covering what is known as “hurdle rates.” It would be useful to expand the text to cover hurdle and perhaps other rates. Moreover, the a new Chapter VI should explicitly acknowledge that DCF computations can capture both expected functional and intangible asset returns.

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65 Paragraph 148.
The *Discussion Draft* states that estimates of value based on discounted value projected cash flows can be highly volatile due to changes in the various assumptions underlining a particular valuation model. The TPDG agrees with this observation, particularly as to the choice of discount rates. The *Discussion Draft* recommends that taxpayers and tax administrations using these techniques should explicitly set out each of the relevant assumptions, describe the basis for selecting the valuation parameters and be prepared to defend their reasonableness. This type of balanced, non-judgmental advice is helpful and provides a model for OECD guidance on pricing for intangible assets. It is preferable to some other, more judgmental, commentary, such as that used in describing profit split discussed above.

The *Discussion Draft* encourages taxpayers to put in their documentation some sensitivity analyses reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted. The TPDG’s reaction is that it may be more appropriate to provide a sensitivity analysis upon request in an audit, rather than uniformly preparing such analyses in documentation.

The *Discussion Draft* lists the following areas of particular concern relevant to the reliability of the discounted cash flow valuation technique:

1. accuracy of financial projections
2. assumptions regarding growth rates
3. discount rates
4. useful life of intangibles and terminal values
5. assumptions regarding tax rates.\textsuperscript{66}

The \textit{Discussion Draft} explains that there is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. The \textit{Discussion Draft} warns against assuming that weighted average costs of capital ("WACC") can always be used. The TPDG agrees with both of these observations.

The \textit{Discussion Draft} addresses the useful life of a "base intangible" as follows:

In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for development for future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that non-routine returns are attributable to such intangibles in perpetuity.

Fortunately, the \textit{Discussion Draft} states that the "facts and circumstances" should be used to determine the projected useful life.\textsuperscript{67} A cross-reference to preceding paragraphs seems to be intended to remind the reader about other principles for estimating the useful life of an intangible asset.\textsuperscript{68} However, one of the paragraphs referred to contains essentially the same guidance and the other addresses somewhat different subjects. Query, does the \textit{Discussion Draft} have the correct cross-reference?

\textsuperscript{66} Paragraphs 153-170.
\textsuperscript{67} Paragraph 165.
\textsuperscript{68} Paragraph 165 refers the reader to Paragraphs 95 and 96.
In any event, it would be helpful if the Discussion Draft had more guidance about using facts to estimate useful life, including how to value the intangible asset if the useful life either increases or decreases based on the risks faced in the market.

On assumptions regarding taxes, the Discussion Draft states that "prices for transfer pricing purposes under a discounted cash flow analysis must typically be determined on a pre-tax basis." This may be unintentionally contradicted by a subsequent statement that acquisition prices are usually supported on an after-tax basis. A new Chapter VI should address the relationship between the two statements. Also, a new Chapter VI should say more about market cap than appears in this text and in Example 19.

The Discussion Draft discusses valuation issues in circumstances where there is great uncertainty about the intangibles at the time of a transaction that transfers rights to them. The Discussion Draft raises the possibility that independent enterprises might adopt shorter term agreements, include price adjustment clauses, have understandings that major unforeseen developments would lead to a renegotiation of the pricing arrangements and so forth. The Discussion Draft also acknowledges that "in some cases independent enterprises might find that the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections, without reserving the right to make future adjustments." These statements tend to balance each other. However, the instruction to tax

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69 Paragraph 169.
70 Paragraph 170.
71 Paragraphs 171-175.
72 Paragraph 172.
administrations to evaluate third party arrangements that “would have been made” in comparable circumstances by independent enterprises goes too far by encouraging tax administrations to ignore or change, in form or in substance, how the taxpayer actually structured its transaction, as well as to speculate. Instead, the Discussion Draft should advise tax administrations to look for marketplace measures of the value or price for the structure and arrangements actually used by the taxpayer. As mentioned above, it is important that tax administrations not speculate about which of various alternative third party arrangements “should have” or “might have” been used. Instead, they should determine the arm’s length compensation given the particular arrangements chosen by the taxpayer.

The Discussion Draft explains the different forms of payment (e.g., lump sum versus periodic) the taxpayers can choose.\textsuperscript{73} It states further that taxpayer agreements with regards to the form of payment should be respected, except as may be provided in certain paragraphs of the OECD Guidelines. While tax administrations are urged to evaluate what independent enterprises would have done under comparable circumstances, it should be stressed again that this not be a hypothetical or theoretical exercise, but rather based on the facts of the actual transactions or independent enterprises that serve as the comparables.

\textsuperscript{73} Paragraph 175.
VII. Comments on Annex Examples

Sections II – V of this letter provide the TPDG’s comments on the Discussion Draft’s proposed text for a new Chapter VI of the OECD Guidelines. The following paragraphs focus on the examples in the Annex of the Discussion Draft that are intended to illustrate the text the Discussion Draft proposes for the new Chapter VI. The TPDG congratulates the drafters of the Discussion Draft for including so many examples and encourages this means of giving guidance to continue. The examples are useful in explaining the proposed statements of principle.

The TPDG comments below are intended to clarify the examples and to make them more useful. The following comments also explain how the examples could be changed to illustrate the TPDG’s recommendations in Sections II – V of this letter for clarifications and modifications of the principles and other statements in the Discussion Draft’s text proposed for the OECD Guidelines.

Example 1 concludes that Company S, a patent administrator, is not entitled to intangible asset related returns. Company S administers patents created within its group; an inventing affiliate assigns its rights to S in exchange for 100 Euro. This payment satisfies “technical contract law requirements.”74 In addition, S simultaneously grants to the assigning affiliate an exclusive, royalty-free patent license for the full life of the patent.

74 Paragraph 182.
This example is confusing because, given the exclusive, royalty-free license back from S to the assignor, what intangible asset related returns could S possibly claim as a contractual or legal matter? There is no flow of income from the intangible asset to S in the example. In brief, S's inability to claim intangible asset related returns exists independent of any of the other factors identified and relied upon in Example 1: lack of risk bearing and control, lack of performance and control of functions, lack of cost bearing. Example 1 would be more realistic if it stated that as a contractual and legal matter S appropriately did not claim intangible returns and the TPDG recommends that Example 1 be so revised.

The TPDG agrees that as Example 1 now states, the assigning affiliate should provide S with arm's length compensation for its patent administration services and costs. In that connection, requiring the assigning affiliate to reimburse S for its nominal payment for the patent rights is counter productive and unnecessary. The assignor and S have agreed that commercially S is the owner of the patents. To the extent that S has to make a nominal payment to help achieve its owner status commercially, the tax authorities should respect that legitimate commercial goal rather than explicitly undermine it. In any event, S will have a “profit,” part of which may be used by it to absorb these nominal costs. Thus, the TPDG recommends that Example 1 not state that the assignor reimburse S for the 100 Euro nominal purchase price that S paid to the assignor.

Example 2 describes a situation in which a “limited risk” distributor purchases patented pharmaceutical products from the affiliate ("Primero") holding the patents for the products. After three years of operations the distributor incurs substantial costs in
connection with a recall of one of the products, “X,” because X causes serious side effects in a significant percentage of patients that use X. Example 2 takes issue with the fact that Primero does not reimburse the distributor for the recall related costs or the resulting product liability claims.

While the TPDG concurs that there should be a reimbursement, it does so based on factual assumptions that a revised Example 2 should make explicit. First, Example 2 should state that the distributor that sold the products in its market followed all regulatory and other requirements. This should make clear that the distributor was not in any way responsible for the ensuing sicknesses (for example, the distributor did not market the drug beyond the approved indications). Secondly, Example 2 should state whether the contract between Primero and the distributor provides that Primero, not the distributor, bears product recall and product liability costs. It should also explain whether the comparables used to determine the distributor’s otherwise arm’s length profits do not bear product recall and product liability costs in their dealings with third parties. Establishing the factual similarities and differences between the comparables and the affiliated distributor provides a key basis for making the reimbursement adjustment. Merely characterizing the distributor as “limited risk” does not provide such a factual basis; the characterization can mean different things to different readers and assumes factors, such as what the intragroup contract provides specifically as to product recall and liability as well as whether the parties’ behavior was consistent with the contracts terms.

The TPDG questions the concluding statement in Example 2 that “in some circumstances an appropriate alternative…[to reallocating the product liability and recall
costs]…may be to adjust the product pricing for all years…to reflect the fact that the relationship was not actually a limited risk relationship.”75 This alternative conclusion leaves much to the imagination of the reader and can suggest the possible acceptance by Chapter VI of unprincipled choices of remedies upon audit by tax administrators. There is no discussion of which “some circumstances” might justify an attempt to recast the relationship, even back to years in which the distributor in fact operated on a “limited risk” basis. Indeed, Example 2 does not contain any facts that might justify reaching this alternate conclusion for Primero and its affiliated distributor for prior years. Thus, the TPDG recommends that the alternate conclusion be omitted. Alternatively, it could be based on facts describing extreme circumstances such as a consistent multi-year disregard of the relevant aspects of the intra-group contract, that the comparables do not bear such risks in their third party dealings, and that no comparability adjustment was made by the taxpayer in its pricing analysis for that difference between the comparables and the related distributor.

Example 3 focuses on whether a distributor (“S”) of a trademarked, branded product in a new market where the brand is unknown is entitled to the intangible asset return attributed to the brand and the trademark. Example 3 correctly concludes that such return does not belong to the distributor; instead it belongs to the company (“Primair”) that manufactures the product, owns the trademark and trade name and sells the product to the distributor under a multi-year exclusive contract. Example 3 states that there are three separate compensation streams between Primair and S:

75 Paragraph 186.
1. the price S pays Primair for the product;

2. a fee paid by Primair to S for its marketing for Primair, which includes an “appropriate profit element”; and

3. reimbursements by Primair to S for the cost of its advertising and other marketing efforts.

The example concludes that the marketing fee is at arm’s length by reference to “returns earned by identified advertising and marketing agents identified and whose functions, risks and assets have been determined to be comparable…” 76

The TPDG applauds the example’s reliance on explicit marketplace facts rather than on assumptions or theories to justify its (correct) conclusion. The parties in Example 3 have a highly unusual three-part compensation scheme. However, these facts appear, appropriately, not to be the basis for the conclusion that the trademark owner and manufacturer, not the distributor, is entitled to the intangible asset return. Example 3 should include such a clarifying statement, although that may not be necessary if the new Chapter VI has a revised version of proposed Example 4, which is discussed next.

Example 4 builds on Example 3 by changing some of the related-party facts, including that the distributor now has more risks and different forms of compensation. Instead of being compensated by Primair with a separate marketing fee as well as cost reimbursements, the distributor purchases the products from Primair at a lower price. The example is not explicit on why the distributor has more risks.

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76 Paragraph 192.
Example 4 should be revised to say (a) whether the purchase price is reduced with the objectives of covering an arm’s length marketing fee and to reimburse the expected marketing costs and (b) whether by contract and in practice the parties adjust the purchase price periodically to assure that in a year the objectives of (a) are met. If the answers to these questions are “yes,” then the returns S receives should be similar if not identical to the returns S receives in Example 3 and they should satisfy the arm’s length standard using the comparables identified in Example 3. If, however, the answers to the above questions are “no,” which may be what the drafters intended for Example 4, then this should be made explicit as it would help explain why the distributor has more risk and therefore may be entitled to more compensation at arm’s length than in Example 3. In that event, Example 4 should make clear how the companies used as comparables in Example 4 differ from those used in Example 3; presumably the former have, over time, higher profit and greater loss opportunities because of their additional risks. A revised Example 4 should mention these factual differences from Example 3.

Example 4 concludes that S’s returns are at arm’s length based on the comparables used in Example 4 (“independent marketers and distributors in comparable uncontrolled transactions”). Subject to the clarifications suggested above, this conclusion seems reasonable and complete. Example 4 should not go further and speculate or equivocate, as it does now, that “Primair and Company S may each be entitled to a portion of the intangible related returns associated with the…trademark and related intangibles.” The TPDG recommends that this statement be removed from

\footnotesize{77 Paragraph 195. 
78 Paragraph 196. (Emphasis added.)}
Example 4. The facts presented in the example do not indicate that the comparable marketers and distributors have any rights to trademarks or related intangibles. Example 4 states that the comparables have long-term, exclusive marketing and distribution rights and the facts presented do not indicate that S has any rights from Primair other than the exclusive distribution and marketing rights for five years. These exclusive rights appear, like those of the comparables, sufficient to add value over time to S’s otherwise functional marketing and distribution returns.

The TPDG endorses Example 5’s efforts to rely on marketplace facts, in particular comparable third party arrangements with comparable marketing activities and expenses, to establish the affiliated marketer-distributor’s arm’s length return. That return is obtained through the prices it pays.

However, Example 5 makes two types of assumptions that should be addressed with facts. First, it assumes S’s level of marketing expense, which “far exceeds that incurred by the identified comparable independent marketers and distributors,”79 is required by and benefits the affiliate holding the trademarks (“Primair”). Secondly, why, to paraphrase the example, is it “evident”80 that incurring relatively excessive marketing expenses increases the value of the trademarks? Excessive marketing expenses do not necessarily increase sales or profits. They can have the effect of maintaining sales and the value of the trademark in the face of competition. Excessive marketing expenses can also adversely affect profits if they are the consequence of poor management decisions, inefficient implementation, poor advice from marketing

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79 Paragraph 198.
80 Paragraph 198.
advisors, the peculiarities of marketing in the particular geographic marketplace, and so forth.

Example 5 should explain factually why it is evident that Company S’s extra marketing has produced more profits and why this increases the value of Primair’s intangibles rather than being assigned to something else, such as the long-term value of S’s customer list.

If Example 5 is revised to explain the factual basis for the current example’s assumptions and how these facts support the perceived pricing problem, then Example 5 can be more effective in addressing the transfer pricing remedy to the problem. Although the TPDG agrees that in different facts and circumstances there might be different remedial pricing approaches, Example 5 presents only one set of facts and circumstances and it should present only one remedy rather than the three it currently presents:

1. adjusting the transfer price paid by the distributor for the product (“approach one”);
2. using a residual profit split (“approach two’’); or
3. directly compensating the distributor for the excess marketing expenditures, plus an “appropriate profit element for the functions and risks reflected by the expenditures” (“approach three”).

Example 5 indicates that each of these three will achieve the goal of “compensating Company S for the marketing activities performed and expenditures incurred for the

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81 Paragraph 200.
benefit of Primair.”82 With all due respect, these three approaches are highly unlikely to produce the same results in the circumstances presented in Example 5. On their face, approaches one and three are conceptually similar to each other in that both view the distributor as performing a service that needs to be rewarded. In contrast, approach two goes beyond that to say that the distributor has acquired an interest in some unidentified (presumably marketing) intangible assets.

The second approach is not justified by the facts presented in Example 5.83 Moreover, Example 5 does not take into account the potential complexity of a profit split because Primair, as the manufacturer, may own manufacturing intangibles that need to be rewarded beyond its functional manufacturing return (i.e., through the profit split). In brief, approach two should be omitted from Example 5. Omitting the profit-split alternative from Example 5 is consistent with the conclusion in Example 6, which does not encompass a profit-split remedy. Example 6 is based on Example 5 but with even more risk for the distributor.

As between the two approaches mentioned in Example 5, the remedy calling for marketing services compensation appears to be more appropriate and reliable than the one reducing prices given the facts in Example 5. However, Example 5 could discuss whether both approaches produce similar results and that the choice of one or the other should be made based on objective factors such as the availability and reliability of

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82 Paragraph 200.
83 There is also no factual support for the conclusion in paragraph 201 that states the distributor is entitled to “intangible related returns” as opposed to, for example, marketing service returns.
factual information about the comparables. The choice should not, however, be based on unidentified, and therefore potentially unprincipled, factors.

A final point on Example 5 is that it currently and unfortunately instructs tax authorities to base proposed transfer pricing adjustments on what “independent enterprises dealing at arm’s length in comparable transactions might be expected to have agreed.” This amounts to an invitation to tax authorities to hypothesize and speculate. Instead, the instructions to tax authorities should be to base any proposed adjustments on the facts of the third party transactions or companies actually used as the comparables.

Example 6 modifies Example 5 by providing that the distributor enters into a three year royalty-free agreement to market and distribute the products with no option to renew. Primair does not enter into a new contract with the distributor at the end of the three year period. Based on stipulated facts, Example 6 asserts that the distributor “could not, or may not be able to, benefit from the marketing and distribution expenditures it incurs at its own risk.” This sort of speculation about future profitability is, with all due respect, unreliable and inappropriate and is likely to lead to additional and unnecessary controversy. However, Example 6 also states that sales volumes, purchase prices, marketing costs, etc. projected at the time of the deal demonstrate that the distributor “could not” benefit from the arrangement, and that there is evidence from third parties that they do not enter into such contracts. The latter facts are sufficient to provide an objective factual basis for Example 6 to challenge the arm’s length nature of

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84 Paragraph 200.
85 Paragraph 203. (Emphasis supplied.)
the compensation between Primair and its distributor and to propose an adjustment. Example 6 should not, however, attempt to justify an adjustment to the related party pricing on the basis that the arrangement “may not” be financially beneficial for the distributor. Thus, Example 6 should delete the “may not” reference and retain the “could not” language and fact-based explanation.

In addition, Example 6 should not justify a proposed adjustment based on actual but unforeseen business results in circumstances where the business projections made by the parties at the time of their deal demonstrate that the deal was reasonable at the time. Further, Example 6 should caution against a tax administration proposing an adjustment merely because the distributor in fact had “significantly lower profits…than are made by comparable enterprises.” 86 If the distributor was inefficient or made poor management decisions, then it had business, not transfer pricing, problems. On the other hand, if it was directed by Primair to incur these expenditures and they in fact resulted in higher sales and higher profits for Primair, then that is a problem that transfer pricing adjustments can remedy.

Example 7 has the same terms and conditions as Example 4 (i.e., Company S develops and executes a marketing plan without detailed control by Primair). Company S receives no separate cost reimbursements or marketing fee. The only transaction is the transfer of branded watches.

It is unclear why, at the end of the third year in their five-year marketing agreement, Primair would insist on a new license arrangement with a royalty payment,

86 Paragraph 204. (Emphasis supplied.)
and why Company S would enter into such an agreement with no downward adjustment to the price payable to Primair. The TPDG agrees that a transfer pricing adjustment to disallow the new royalties or a reduction in the transfer prices is appropriate. As revealed by comparable searches, evidently it is not the practice between a trademark owner and independent distributor/marketer to require the payment of royalties where the latter only receives rights to utilize the intangibles in distribution. However, this general practice is not, in the view of the TPDG, critical to the analysis.

What is critical is that Company S’s profits are “consistently lower” than the profits made by independent enterprises that have been determined to be comparable. What Example 7 does not say, but should, is whether the comparables’ higher profits are attributable to the absence of a license and royalty, which may be what the drafters intended, or due to lower purchase prices along with an offsetting royalty. In any event, the focus should be on the particular facts of the specific comparables, not general industry practices.

Example 8 builds on Example 5 by changing the relationship between the distributor and Primair in year four. Beginning in that year the distributor pays a royalty to Primair in exchange for the right to purchase the products in an unbranded form, to process and brand them, and to distribute them on an exclusive basis for five years. Example 8 reaches two sets of pricing conclusions; one for years one to three (under the old arrangement) and another for years four through eight (under the new arrangement).
As Example 5 already addresses the issues and remedies for years one through three, that part of Example 8 should be omitted. This revision would leave the focus of Example 8 on the changes affecting years four through eight. Also, the omission of the discussion of remedies for the earlier years would eliminate any implication that the changes in year four, involving the move to a license, should have any consequences for the characterization, definition of issues, or remedies for years one through three. Those years had a different contractual arrangement and other different facts.

Example 8 mentions that when making the contractual change in year four, which in effect voided the last two years of the initial distribution arrangement, the distributor did not receive compensation from Primair in respect of the renegotiation of the original marketing and distribution contract. This one-sided statement should be made more balanced. A new sentence should provide that neither party received compensation from the other for the renegotiation. As Primair gave up intangible rights it had in the original contract, it might also have been entitled to compensation for the renegotiation.

More basically, Example 8 should emphasize, in concluding that the distributor “has become entitled to intangible related returns” in years four through eight, that the parties structured their relationship in those years as a license, with the distributor having legal rights to intangibles that it did not have previously. In fact, the distributor’s “functions, risks and costs” in years five through eight are basically the same as they were in years one through three except that, as a licensee, it is obligated in the later

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87 Paragraph 212.
years to pay a royalty for the new intangibles rights it obtains. Also, Example 8 should be revised to state that the royalty is only partially offset by the lower purchase price for the goods.

Example 9 involves a multinational group with two R&D centres, one in the parent and the other in a subsidiary. The example correctly concludes, based on the facts presented, that the parent, which bears all the risks and cost related to the subsidiary’s R&D, is entitled to the “intangible related returns that may be derived from intangibles developed through the R&D efforts” of the subsidiary. This statement should, however, be revised to state unambiguously that the parent is entitled to “all of the intangible asset related returns…” This may have been the intention of the drafters as Example 9 does not contain facts that would support providing any of the intangible asset returns to a person other than the parent.

Example 9 goes on to explain, correctly, that the subsidiary should be compensated through a service fee. It also provides that if transfer pricing adjustments are necessary to make the service fee arm’s length, then they should “generally relate to the year the service is provided…” The TPDG recommends removal of the word “generally.” It is difficult to understand why the fee would ever relate to another year.

Example 10 also portrays a parent and subsidiary with its own R&D centre. The two centres operate autonomously. Example 10 focuses on the fact that the parent

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88 The added functions of “future processing” and affixing the brand name are not characterized in Example 8 as significant.
89 Paragraph 215.
90 Similar references to “all” should be inserted in the other examples in which there is no factual basis for “sharing” or “dividing” the intangible asset returns between affiliates.
91 Paragraph 215. (Emphasis supplied.)
registers all patents developed by the subsidiary. The TPDG concurs with the example’s conclusion that the subsidiary is entitled to “intangible returns” related to its R&D efforts but would recommend again that the reference be to “all intangible asset returns related to…”

Example 11 involves in relevant part a manufacturing subsidiary that supplies its output to other members of its group. The manufacturing subsidiary buys from its parent, for an arm’s length price, existing intangibles for its products and is entitled to the return on these intangibles. In addition, the subsidiary, through a contract research agreement, hires the parent to conduct, at the subsidiary’s risk and cost, all future R&D activities for the subsidiary. Example 11 states the subsidiary pays the parent for its costs plus a markup equivalent to that earned by “allegedly comparable companies engaged in providing research services.” Example 11 concludes by denying the manufacturing subsidiary intangible related returns with respect to the R&D conducted under the contract research agreement.

The TPDG’s first recommendation for Example 11 is that the word “allegedly” be deleted or that Example 11 explain why the third party R&D service providers are not comparable and how that is relevant to the analysis.

The TPDG’s second recommendation is that the facts of Example 11 be modified to be more realistic. A company, such as the manufacturer in question, that has the financial capacity and expertise to purchase and use intangibles in its own...

92 Paragraph 219.
93 Paragraph 222. (Emphasis supplied.)
94 Curiously, Example 11 should, but does not, reallocate to the manufacturing subsidiary the amounts it paid under the R&D service contract to the R&D service provider, plus a time value of money charge.
manufacturing operations surely can also have the financial capacity and expertise needed to hire another party to provide R&D services. Example 11 should be revised to address such a situation. The revised version of Example 11 should include as facts that the manufacturing subsidiary has the financial capacity and expertise to agree to a budget and other terms for the R&D services contract and has the expertise to use and benefit from the intangibles intended to result from the R&D services. In brief, the manufacturer is capable of making an informed decision about entering into both the intangible asset purchase and R&D service contracts. It can be considered an “informed hiring party.”

Example 12 involves an intercompany license of a patent purporting to limit the licensee’s rights to the patent to country “B.” In fact, however, the licensee sells the patented product, which it manufactures, in other countries. The affiliated licensor does not exercise its patent rights either to stop the sales outside of country B or to demand that the licensee pay it royalties on such sales. The example concludes that a transfer pricing analysis should not respect the purported geographic limitation in determining the compensation due to the licensor. While the TPDG concurs with this conclusion, Example 12 should clarify that the disregard applies only to the licensee’s improper sales outside of country B.

Example 13 involves a company (“Ilcha”) that incorporates its foreign branch, and transfers to the new corporation (“S”) the tangible assets (e.g., manufacturing facilities) and “marketing assets” of the branch. Ilcha owns the relevant design patents, has developed a unique trademark which it has registered and “other brand intangibles.” Ilcha licenses all of these intangibles to the newly incorporated S. Example 13
concludes that in conducting the pricing analysis of how much S should pay Ilcha for the tangible and intangible assets transferred and licensed to S, the “substantial” goodwill and ongoing concern value that Ilcha’s branch developed, which were implicitly transferred to S, should be taken into account. Example 13 should be revised to explain how the goodwill “should be taken into account.” Is it an aspect of the trademark or something else?

The facts of Example 14 are that a company (“Första”) organized in country A manufactures a product that is trademarked and that the mark is “well recognized and valuable.” Första organizes a “super distributor” and invoicing centre (Company “S”) in country B to purchase the product form Första and resell it to Första’s distribution affiliates. S begins to reimburse its distribution affiliates for part of their advertising costs while increasing S’s prices to the distribution affiliates by an equal amount; i.e., the distribution affiliates receive the same margins before and after the reimbursement change. Then, Första reduces its prices to S because the latter is allegedly “entitled to intangible related returns associated with goodwill in respect of...[the product]...created through the advertising costs it has borne.”

The purpose of Example 14 is unclear. Is it to distinguish between trademark returns versus returns attributable to goodwill? If so, then Example 14 should explain what the distinction is and why it has meaning given the facts of Example 14. Example 14 is, however, probably not the right vehicle to explain or illustrate such a distinction as there is no transfer of a going business to which goodwill might be attributed. The main

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95 Paragraph 231.
96 Paragraph 234. (Emphasis supplied.)
text of the Discussion Draft correctly states that it is “generally recognized that goodwill...cannot be segregated or transformed separately from other business assets.”

In all events, a revised Example 14 should omit its penultimate sentence which points out that S did not perform or control various functions and risks, etc., relevant to the “maintenance and protection of that goodwill.” Even if S had engaged in such activities, the intangible asset related return belongs to Första as it owns the trademark, which is “well recognized and valuable,” and “is entitled to...all...intangible related returns with respect to the...trademark.”

Example 15 concludes by stating that “It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.” The drafters should add “nor should it be assumed that an internal restructuring increases value. Facts about a restructuring and value, not assumptions or theories, should be controlling in a transfer pricing analysis of a restructuring.”

With all due respect, the TPDG believes the following statement in Example 15 goes too far: “definitions and valuations of intangibles contained in the purchase price allocation are irrelevant for transfer pricing purposes.” Even a related party purchase price allocation – which presumably is to what this sentence refers – can be relevant. Depending upon the facts and analysis supporting the purchase price allocation, it may

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97 Paragraph 21.
98 Paragraph 235. Is “that” goodwill the "goodwill in respect of...[the product]...created by the advertising costs it has borne.” Paragraph 234. This should be clarified.
99 Paragraph 231.
100 Paragraph 238.
101 Paragraph 238. (Emphasis supplied.)
even provide the most reliable analysis for transfer pricing purposes. Perhaps the drafters of Example 15 meant to say that the related party purchase price allocation is not controlling; the allocation will stand or fall based on the strengths or weaknesses of its underlying facts and analysis. It would be beneficial to revise Example 15 along those lines.

Example 16 describes one affiliate ("Zhu") helping another ("S") develop software for the latter’s unrelated customer. Zhu assists S by “providing” employees who have access to Zhu’s software designs and know-how, including proprietary code. Ultimately S provides its customer with a software system including a license to use the software developed in the project. Example 16 holds that there are two compensable transactions: 1) services provided by Zhu’s employees to S; and 2) rights conveyed to S to use Zhu’s software.

Example 16 should clarify that Zhu’s personnel remained its employees during their work on the project, rather than being assigned to S in a secondment (generally not subject to mark-up). It would also be helpful if Example 16 stated whether Zhu and S entered into an agreement in which Zhu licensed the relevant intangible assets to S, and whether Company S compensates Zhu either through separate royalty payments or as part of the overall amount of compensation.

Example 17 recognizes the distinction between using intangibles in delivering a service, and that the service is more valuable due to the use of the intangibles, versus transferring intangibles to the service recipient. In its facts, Example 17 correctly concludes that the former analysis applies, not the latter.
Example 18 addresses allocating a price premium paid in acquiring an unrelated company between two of its geographic markets (Europe/Asia versus the rest of the world) in a subsequent intra-group structuring transaction. Example 18 should explain whether the purchase price paid for the third party was based on an after-tax DCF analysis, which is frequently used in third party corporate acquisitions. If so, then Example 18 should explain how that relates to the instructions in the Discussion Draft to use pre-tax DCFs for transfer pricing purposes.102

Example 19 analyzes the arm’s length nature of a lump sum received by a parent corporation in return for transferring to its subsidiary the patents and trademarks associated with a product that the parent used to produce and sell, and that the subsidiary will now begin to produce and sell. Example 19 stipulates that the related parties “seek to identify the arm’s length price for the transferred intangibles by utilizing a discounted cash flow valuation technique.”103 Example 19 explores three different “DCF” analyses in addressing whether the lump sum payment is at arm’s length. Example 19 does not state, but should, why in its facts a DCF is reliable or justifiable under the arm’s length standard, particularly as compared with data from the marketplace about comparable transactions.

Beyond that, Example 19 is problematic as it breaks the long-standing and basic tenet of the OECD Guidelines that tax authorities should respect the transaction chosen by the taxpayer. Example 19 does not suggest that the related party transaction described in Example 19 lacks substance or has any other shortcoming that would

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102 Paragraph 169.
103 Paragraph 253.
arguably allow the transaction to be valued for transfer pricing purposes other than as structured and implemented by the parties. However, that is what Example 19 does in effect.

In analyzing the arm's length nature of the lump sum, Example 19 compares the net present value of the intangible assets in question as if:

1. they were retained by the seller which continued to manufacture and sell the products;
2. they were transferred to the subsidiary which then manufactured the products and sells them; and
3. they were retained by the seller which then hired the subsidiary (or a third party) to manufacture the products on its behalf.

The TPDG realizes that the proponents of the approach taken in Example 19 might claim that the example actually accepts the transaction as the parties structured and implemented it (i.e., number two above), but that in valuing the transaction it is appropriate to consider alternative arrangements (i.e., one and three above). With all due respect to the proponents, such a claim relies on semantics.

A further problem with Example 19 is that it states that the parent “would certainly not sell the intangibles at a price that would yield an after tax return…” lower than what the parent could make “by continuing to operate the business as it has in the past.”\(^{104}\)

This statement unfortunately presents a theory rather than facts. There could be business reasons why the parent would sell at a lower price. For instance, could the parent have used the amounts received in the sale, along with the personnel it freed up, 

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\(^{104}\) Paragraph 256.
in another more attractive business? The same objectionable theoretical approach appears in a subsequent statement that the parent would not sell for less than what it could achieve through outsourcing.\textsuperscript{105} Again, there may be sound business reasons why the outsourcing alternative is unattractive or not viable.

In brief, this part of Example 19 takes simplistic, theoretical views of why businesses should make decisions. Instead, the focus of the analysis should be on the totality of the actual business facts, not on whether a transaction makes financial sense at a theoretical level.

The TPDG recommends for all of the above reasons that the OECD omit Example 19 from the next draft of its work on intangible assets.

Example 20 wrestles with the question whether an unanticipated discovery of a use for a licensed product, that generates a “considerable increase in sales and profits for the licensee”\textsuperscript{106} provides a basis for an upward adjustment to the royalty rate paid by the licensee in the year in question. In the facts of Example 20, the year in question is also the last year of the license. The TPDG concurs with the conclusion of Example 20 that there is no foundation for adjusting the royalty rate in year three. The TPDG also concurs with the basis provided for this conclusion; i.e., that in fact the terms and rate of the related party license, including the absence of a royalty adjustment clause or other protection against the risk of uncertainty, are “equivalent to...[the terms and

\textsuperscript{105} Paragraph 256.
\textsuperscript{106} Paragraph 260.
rate]...agreed in uncontrolled transactions…” The TPDG believes it is unnecessary and confusing for the same sentence to state that the terms are also “found to be in accordance with industry practice” and recommends that this phrase be deleted. The strongest possible evidence is already present in Example 20’s use of actual arm’s length agreements as comparables.

Example 21 builds upon and modifies the facts of Example 20 by stating that in the third year the parties agree to a new license to begin in year four for a period of ten years. The new license “significantly increases the fixed royalty rate…” Example 21 concludes, based on the facts presented, that the new royalty rate cannot be regarded as arm’s length after year five and that the tax administration can make a pricing adjustment beginning in year six. Assuming that an adjustment in year six is justified, Example 21 should make clear that the adjustment can be made by either the taxpayer or the tax administration. For example, the affiliates involved could in year six renegotiate the fixed rate.

The other clarification the TPDG recommends for Example 21 concerns the evidence favoring or opposing a year six change to the royalty rate. Rather than refer to the relatively vague notion of industry practice, Example 21 should limit what it relies upon to the evidence that specific long-term third party agreements involving intangibles of potential but unproven high value and other comparable circumstances, including a fixed royalty rate, uniformly contain provisions for annual price (royalty) adjustments.

107 Paragraph 259.
108 Paragraph 263.
Another suggestion for Example 21 is to modify the second sentence of Paragraph 265. The reference to “in combination” is unclear. Also, should the “unpredictable” reductions in sales of the licensed product be attributed, as it is currently, to the entry of a new, “better” competing product? In general, products have the unpredictability of lost sales due to new competition. It might be better if the unanticipated decreases in sales of the licensed product were attributed to an unforeseeable characteristic of the licensed product (e.g., it had unforeseeable negative adverse effects).

Example 22 describes another set of circumstances in which related parties agree to a fixed royalty rate for multiple (five) years. Example 22 states that in the years following the first years of the agreement sales are three times greater than the projected figures used by the parties to set the fixed rate. The conclusion of Example 22 is that the royalty rate should be adjusted in the subsequent years. The basis for the conclusion would be substantially improved by referring clearly to the similar level of uncertainty in the internal third party comparable deal that has terms that make adjustments to the rate. Thus, Example 21 should omit the statements that any third party transactions other than the actual comparable “normally” would have price adjustment clauses and that third parties “would not consider the projections sufficiently reliable…”  

109 Paragraph 267.
VIII. Conclusion

The Discussion Draft is a remarkable document, particularly given how quickly the OECD was able to prepare and release it. The Discussion Draft makes important contributions to what can become a new, more informative, Chapter VI of the OECD Guidelines. The TPDG applauds all involved for producing the Discussion Draft. At the same time, and as explained in this letter, the TPDG believes that a new Chapter VI should modify some important aspects of what the Discussion Draft proposes as well as make various clarifications.

The TPDG appreciates very much the opportunity to comment on the Discussion Draft. It also welcomes an opportunity to participate in the November meetings on this subject with the OECD and participating countries. Please contact the undersigned with any questions or comments about this matter.

Sincerely yours,

Steven Hannes
September 13, 2012

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
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France

Dear Mr. Andrus:


As you know, the Treaty Policy Working Group is an informal association of large global companies based throughout the world, which represent a broad spectrum of sectors. The Treaty Policy Working Group has been working since 2005 to analyze and address tax policy and administration concerns regarding transfer pricing, profit attribution, permanent establishment, and related issues that are critical to the avoidance of double taxation and the conduct of cross-border trade and investment. We appreciate the OECD’s continued leadership in developing guidance on these important issues and its inclusion of representatives from key non-OECD economies in this process.

We applaud the release of the Discussion Draft for comment prior to conclusion of a full consensus among Delegates in the WP6 deliberations. This new procedure, coupled with the clarity of the drafting and the extensive public discussion by yourself, WP6 Chair Michelle Levac, and others of issues raised by the Discussion Draft, provides a valuable opportunity for stakeholder input at a more useful stage in the process. We encourage the continued use of this procedure and its adoption throughout the Centre for Tax Policy and Administration.

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Given the considerable reach of the Discussion Draft, we have focused these comments on the key issues of concern to TPWG members. We look forward to the opportunity to comment further on the complete draft currently slated for release in 2013.
Executive Summary

The Discussion Draft is a substantial product in which WP6 has, in unusually short order, addressed a series of difficult and potentially divisive issues. It helpfully confirms a series of important points. First and perhaps foremost, it adopts a relatively narrow definition of compensable “intangible” that is similar to the owned or controlled aspects of the analysis advocated by the TPWG. It specifically confirms that group synergies and market-specific characteristics (including low labor costs), in contrast, do not constitute intangibles, a position that the TPWG had also endorsed. The Discussion Draft also acknowledges that goodwill and ongoing concern value are not separately transferable. And it further acknowledges that not all R&D expenditures and marketing activities create or enhance an intangible, that not all intangibles give rise to premium returns in all circumstances, and that intangible related returns (“IRR”) on an intangible may be zero or negative. All of these points are critical to the effort to bring clarity to the transfer pricing treatment of intangibles.

However, the Discussion Draft also raises some new concerns and leaves some open questions that merit further consideration and reflection, including the following:

- The Discussion Draft provides no meaningful affirmative guidance for determining taxing jurisdiction in cases in which the requirements for IRR entitlement are not performed by a single entity. Many of its requirements appear to be aimed at specific cases and do not provide the general guidance that is needed for the majority of cases. At the same time, the Discussion Draft could easily be read as generally rejecting the one-sided methods frequently used by taxpayers, calls the viability of CUP and TNMM methods into question, and points to an increased use of profit split methods. This sets the stage for increased, rather than reduced, controversy and double taxation.

- The Discussion Draft also provides no affirmative guidance that would enable taxpayers to select an appropriate (or the most appropriate) transfer pricing method, to prepare contemporaneous documentation based on that method, and to avoid transfer pricing-related penalties. Taxpayers need such guidance to prepare their intercompany agreements, where relevant, their transfer pricing policy and documentation, and their tax return, and financial statement positions.

- As currently phrased, the Discussion Draft could be read to depart from the arm’s length principle in important respects, in an apparent attempt to address concerns such as base erosion and profit shifting and demands from some countries for increased taxation at source. For example, the Discussion Draft adopts prescriptive requirements that, taken together with its different approach to defining control, seem inconsistent with new Chapter IX, recently revised Chapters I-III, and other provisions of the Guidelines in the
degree to which they disregard the taxpayer’s contractual terms and actual transactions and the legal ownership of assets, specify the entity that must perform and control certain functions and bear and control risks and costs, and appear to preclude the use of certain transfer pricing methods. Such provisions are also at odds with the globally or regionally coordinated manner in which many multinational enterprises conduct their group operations and centralize or outsource functions, and set an unreasonably high functional threshold for allocating any IRR to an entity that amounts to an inappropriate factual mandate. They thus appear designed to change the conduct or taxation of the taxpayer rather than to price its actual transactions by reference to the arm’s length principle. While it could be appropriate for the Discussion Draft to note that the comparability analysis must pay close attention to the actual functions performed, assets used, and risks assumed by the entity or entities in question, the proposal to use the Guidelines to establish prescriptive, entity-specific functional requirements raises serious issues for the application of the arm’s length principle in the majority of cases, which are among high-tax countries and do not raise such concerns. The principal focus in determining whether a resident entity should be allocated IRR should be a close analysis of the functions, assets and risks of that entity.

- For example, where a method that does not depend on the functions, assets, and risks of the nonresident entity is the most appropriate method under Chapter II of the Guidelines and one side of the transaction can be reliably benchmarked, the Discussion Draft should confirm that one-sided methods such as the transactional net margin method may continue to be applied. If profit split methods are to become the most appropriate method in many circumstances, they will prove difficult for both taxpayers and tax administrations to apply, and much additional guidance regarding their application will be needed, as they have little experience and the Guidelines lack such guidance, given the OECD’s historical antipathy towards profit split methods. Current differences among countries regarding year-end adjustments will also have to be addressed, as profit split methods either require such adjustments or the quality and motive of forecast-based mechanics are questioned. Clear, principled, and practical affirmative guidance on all of these issues would be essential if the new IRR framework is to be applied.

- The Discussion Draft also adopts a concept of control that goes beyond that adopted recently in Chapter IX, in an attempt to limit IRR entitlement where the performance and management of functions are undertaken by different companies within a multinational group. This heightened concept of control seems particularly at odds with arm’s length behavior when applied in the context of functions performed by associated enterprises. Even multinational group companies that perform substantial functions are unlikely to meet this higher threshold.
• As the Discussion Draft acknowledges at one point, IRR does not equal all nonroutine return. The Discussion Draft also acknowledges that not all residual profit necessarily goes to the intellectual property owner. However, its application of these principles is inconsistent and its discussion of discounted cash flow methods and other points does not adequately acknowledge the value of other contributions to profit or loss. It would be helpful for the Discussion Draft to further emphasize that other categories of nonroutine return not generated by intangible assets must be taken into account. Entrepreneurial profit is one such category; whether it arises from good strategic thinking, business planning, or just luck, it is an element of profit that is not attributable to any particular asset, and it can be associated with a particular legal entity and not spread across all assets equally. The Discussion Draft should also confirm that profits arising from taking risks that are not associated with a particular intangible asset are likewise not IRR.

• The Discussion Draft is silent as to whether and in what circumstances funding creates an entitlement to IRR. It requires that certain costs be borne by an entity claiming entitlement to IRR but cautions, without offering further guidance, that the bearing of costs, with or without legal ownership, will not create an entitlement to IRR. Funding of intangible development may not be the only relevant factor, but it is an inherently risky entrepreneurial function that directly contributes to the earning of income and thus should be rewarded as more than a “passive investment.” We understand that various alternative mechanisms for rewarding funding are still under discussion by WP6. We believe that this issue merits serious consideration and that when an entity bears costs with associated entrepreneurial risk, it should receive the IRR return attributable to its investment in the intangible.

• The Discussion Draft identifies a series of factors as comparability factors that cannot be treated as intangibles, including market conditions, location-based advantages, and corporate synergies. It indicates that the transfer pricing treatment of such comparability factors remains under discussion by WP6 and will be addressed in a forthcoming draft. Meanwhile, a number of statements in the Discussion Draft appear potentially to undercut this distinction, such as the treatment in Example 19 of location savings and tax rate differentials and the ambiguous discussion of assembled workforce. While the Discussion Draft appropriately acknowledges that comparability factors may affect the valuation of transferred assets, we are concerned that it could be read to signal that such valuations may be performed not in a manner consistent with comparability analyses, but in a manner that effectively negates the distinction between comparability factors and intangibles. If the distinction between intangibles and comparability factors is to be meaningful and administrable, it must be maintained clearly for both definitional and valuation purposes.
• The Discussion Draft sets out a useful framework for identifying intangibles by requiring that they be “capable of being owned or controlled for use in commercial activities.” However, in treating goodwill as an intangible, the Discussion Draft undermines this framework by creating significant ambiguity about what goodwill means and how it should be addressed for transfer pricing purposes. If goodwill is not clearly addressed in a manner appropriate for transfer pricing, the financial valuation understanding of goodwill as a residual concept will make it difficult in practice to distinguish goodwill from comparability factors such as synergies.

• The Discussion Draft also raises issues regarding the valuation of goodwill. Despite its position that the taxpayer’s purchase price allocation is not relevant to valuing particular assets, there appears to be room left for tax administrations to use an acquisition price analysis to determine the value of “goodwill” for transfer pricing purposes. However, the values assigned for that purpose are not necessarily arm’s length values of intangibles subject to transfer pricing, and the notion and value of goodwill in such allocations is not indicative of intangible assets subject to transfer pricing and current taxation. In addition, amounts identified as goodwill in an acquisition price context typically also include control premia as well as synergies and other expected benefits of the acquisition, which may or may not materialize.

• We note that WP6 is deliberating on the extent to which information regarding subsequent events may be considered relevant to an evaluation of the arm’s length nature of the compensation for a past transaction. The TPWG agrees that it may be appropriate in some circumstances to permit such information to be considered by both tax administrations and taxpayers, provided that its use is limited in a manner that prevents an inappropriate or one-sided use of hindsight and provides an effective mechanism for relief from economic double taxation.

• We applaud the inclusion of numerous examples to illustrate the application of the positions reflected in the Discussion Draft. However, some of the examples need to be conformed more closely to the text of the Discussion Draft and of the Guidelines.

• The Discussion Draft fails to confirm that this new guidance will not be applied with retrospective effect. Retrospective application would create additional controversy and likely prompt questions regarding the legal status of the Guidelines in many countries.

The TPWG respectfully requests that these issues be further considered and addressed by WP6 in its ongoing deliberations.
Key Issues

While the Discussion Draft makes many positive contributions on difficult points, it also raises a number of issues that are of particular concern to TPWG members. The most important of these are discussed in more detail below, together with our recommendations for the consideration of delegates.

1. Insufficient Affirmative Guidance

The Discussion Draft requires that IRR “follow the contributions to the value of the intangibles.”1 It contemplates that one or more group companies within a multinational enterprise may be entitled to “part or all” of the IRR from an intangible or intangibles. However, it frames IRR entitlement largely in the negative, by prescribing a long list of circumstances in which claims to IRR will not be respected. Perhaps as a result of this negative framework, the Discussion Draft fails to provide sufficient guidance on the minimum thresholds that a company must meet to support a claim of IRR. Nor does it provide affirmative guidance on how to determine respective “entitlements” where there are either multiple conflicting claimants or no claimants that satisfy all of its requirements. There is also no practical guidance to assist taxpayers and tax administrators in applying this proposed new framework. Finally, the definition of “intangible” leaves room for confusion on certain points that should be affirmatively clarified.

For example, the Discussion Draft contemplates that a profit split method “often” will be applied in connection with license transactions “to evaluate the respective contributions of the parties to earning combined income.”2 It first sets forth negative propositions, suggesting that the “profit contribution of the rights in intangibles made available by the licensor” would be only one of the factors contributing to the earning of income, and cautioning that “[i]t should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor.”3 The Discussion Draft then lists the other factors that would be considered: functions performed and risks assumed by the licensee, limitations on the licensee’s current and future use of the licensed intangibles, and other intangibles used by the licensor and the licensee. There is no consideration of the compensation paid by the licensee, of the respective costs borne by the licensee and the licensor, of the functions performed and risks assumed by the licensor, of other assets used by the parties, or of other factors normally considered in applying the arm’s length principle in such circumstances according to paragraph 34 of the Discussion Draft, such as the time period, exclusivity, geographical scope, and other provisions of the license.

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1 Discussion Draft, text box on page 12.
2 Discussion Draft, paragraph 141.
3 Id.
Nor is there any indication of how the factors identified as relevant to IRR entitlement would be weighted in determining the respective contributions by the parties to the earning of income and the resulting profit split. For example, the Discussion Draft states, at paragraphs 108 and 141, that not all residual profit goes to the intellectual property owner, but that is the result under Example 19. Elsewhere, the Discussion Draft appears to signal that the IRR entitlement belongs in the first instance to the licensee, stating:

In the case of a licence or similar arrangement, the licensee will be the entity entitled to intangible related returns attributable to its licenced rights, subject to its obligation to provide arm’s length compensation for the grant of the licence.4

This similarly fails to provide guidance on the respective claims of the parties or the valuation of their contributions, although it does appear to create a presumption in favor of the licensee.

We believe that the premise of paragraph 108 is correct and should be applied consistently throughout the Discussion Draft. Clearly, there is profit within a group that arises from the bearing of entrepreneurial risk and other economic circumstances and not only from the use of IP assets. The use of discounted cash flow methods for long periods into the future, with a focus on concepts such as platform intangibles and contracts for future research and development services, creates a risk that such contributions to profit or loss will be ignored.

Without affirmative guidance, the creation of multiple potential entitlements such as these would lead to increased controversy between taxpayers and tax administrations, as well as among tax administrations themselves. The predictable results would be a rise in global profit splits (or other unpredictable negotiated settlements) that are unlikely to produce arm’s length results together with an increase in the incidence of unresolved double taxation.

If the IRR concept is to be introduced, taxpayers will need clear, principled, and practical guidance on which to base their intercompany agreements, where relevant, and their transfer pricing policy and documentation, tax return, and financial statement positions. Taxpayers will be expected to select an appropriate (or, where required, the most appropriate) transfer pricing method and to prepare appropriate contemporaneous documentation based on that method where required, and will face penalties in many countries if their positions are challenged. Particularly if profit split methods are to be used and CUT and TNMM methods generally rejected, additional guidance will be needed regarding their application, a subject on which the Guidelines are largely silent due to their historical antipathy towards such methods.

4 Discussion Draft, paragraph 35.
Tax authorities also need more guidance on how to apply the new IRR framework in practice, and competent authorities and arbitrators will need clear and principled guidance to resolve the cases that come before them on a principled basis. Tax administrations are not equipped to resolve controversies regarding IRR entitlements on a case-by-case basis, given their already overburdened resources, increasing differences in treaty interpretation, and incomplete treaty networks. Nor would this be desirable from the perspective of predictability and consistency.

It is, therefore, critical that the Discussion Draft provide clear, principled, and practical affirmative guidance on these issues if the IRR concept is retained as proposed.

The Discussion Draft’s definition of “intangible” should also be clarified to state affirmatively, for the avoidance of doubt, that the welcome decision not to apply the royalty withholding tax provisions of Article 12 for transfer pricing purposes is not also intended to suggest that the classification provisions under Article 12 may be disregarded to treat computer programs, digital goods, and similar non-material goods as intangibles. This is consistent with the exclusion from the definition of intangible already provided for financial assets in paragraph 1 of the Discussion Draft and could be accomplished by adding a similar exclusion.


The Discussion Draft contains anti-base erosion and anti-profit shifting provisions, which it presents as provisions to achieve “alignment” of conduct with the terms of legal registrations and contracts and to identify “the prices and conditions that would be established between unrelated persons in comparable transactions.” We have no issue with requirements that the actual conduct of the parties be consistent with their intercompany agreements or with the economic substance notions reflected in the current Guidelines. We also agree that the Guidelines should, consistent with Article 9, require adjustments to the compensation of intercompany transactions when and only when necessary to reflect the compensation that would have been paid by an independent party dealing at arm’s length in a comparable transaction under comparable circumstances.

However, the provisions of the Discussion Draft reflect factual presumptions regarding the conduct of unrelated persons which are assumed to be generally valid but for which no empirical data are provided. They would permit transfer pricing adjustments in many cases without regard to contrary evidence or analysis of what unrelated persons would have done, or even to reliable internal comparables or other facts and circumstances established by the taxpayer. This

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5 See, e.g., Discussion Draft, paragraphs 35, 40, 54. This has been identified as an issue even by a commentator otherwise generally supportive of the approach of the Discussion Draft. See Durst, “The OECD’s Discussion Draft on Transfer Pricing for Intangibles,” Tax Notes, 315-319, at 318 (July 16, 2012).
seems fundamentally incompatible with the arm’s length principle as interpreted in the Guidelines.

**Entitlement to IRR**

The Discussion Draft reflects these presumptions in a series of prescriptive requirements for entitlement to IRR, which apparently are intended to ensure that neither contractual obligations, legal ownership, nor the bearing of costs, alone or together, will create an entitlement to IRR. The Discussion Draft\(^6\) provides that a group company claiming entitlement to IRR generally must satisfy the following requirements “in substance”—

- “Physically” and “through its own employees” “perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles,” including but not specifically limited to:
  - the design and control of research programs, management and control of budgets, and control over strategic decisions regarding intangible development programs;
  - the design and control of marketing programs, management and control of budgets, and control over strategic decisions regarding intangible development programs; and
  - (In many cases) important decisions related to preserving the legal protections accorded to intangibles and the defense of intangibles against infringement, generally including important decisions regarding such defense and protection;

- “Control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm’s length basis,” generally including ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible;

- “Bear and control the risks and costs related to developing and enhancing the intangible”; and

- “Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns”; and

\(^6\) See, e.g., Discussion Draft, paragraphs 40, 41.
Mr. Joseph L. Andrus  
September 13, 2012

- Have its legal registrations\(^7\) and the terms of relevant contracts “in alignment with” relevant functions, risks, and costs.

These provisions appear to be intended to permit a tax administration to challenge a company’s entitlement to IRR whenever it does not satisfy the new function, risk, cost, and control requirements or these are not aligned with its legal registrations and relevant contractual terms. Thus, instead of applying a comparability analysis in the facts and circumstances of the particular case, these provisions would effectively presume that many common transactions within multinational enterprise groups are inherently non-arm’s length in nature. This would substantially expand the discretion of tax administrations to disregard the actual transactions and contracts entered into by the taxpayer and would have the practical effect of requiring the taxpayer in such cases to change either its transactions or its transfer pricing.

Three aspects of these proposals as advanced in the Discussion Draft are of particular concern: (i) the statement that the bearing of costs related to intangible development, “without more,” creates no entitlement to IRR; (ii) the requirement that the specified “important” functions all be “physically” performed by the company claiming IRR “through its own employees”; and (iii) the heightened standard of “control” established by the Discussion Draft which the entity claiming IRR must exercise over those “important” functions and activities that might be outsourced to other associated enterprises.

**Bearing of Costs**

The Discussion Draft requires an IRR claimant to bear certain costs in order to have an entitlement to IRR, but states, as a prescriptive matter, that the bearing of costs, even when coupled with legal ownership, will not create an entitlement to IRR. It is hard to see how this statement can be regarded as consistent with the arm’s length principle, given that at arm’s length the provision of risk capital deployed to develop intangible property undeniably attracts a reward when the investment succeeds, and absorbs the loss when it fails.\(^8\) When an entity bears costs with associated entrepreneurial risk, it should receive the IRR return attributable to the intangible.

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\(^7\) The Discussion Draft proposes to require that the conduct of the parties be aligned not only with the terms of their contracts but also with “the terms of the legal registrations.” As this focus on legal registrations is not reflected in the current Guidelines, it would be helpful to clarify whether this new terminology is intended to change the interpretation of the Guidelines and, if so, how.

\(^8\) This position also seems fundamentally at odds with the cost contribution or cost sharing provisions of current law in some jurisdictions and of the Guidelines. See, e.g., U.S. Treas. Reg. §1.482-7; Guidelines, paragraph 8.9 (“whether in cash or in kind”).
We are encouraged, however, by recent public remarks which indicate that the question of how to properly reward the provision of risk capital is very much a continuing topic for discussion. Those remarks indicated that the current Discussion Draft is not intended to preclude remuneration of the provision of risk capital generally. The Draft reportedly is intentionally silent on the issue of whether and how funding should be remunerated if it is not accompanied by the performance of functions and control and the bearing of risks, because WP6 is seeking comments on this issue. Delegates are said to still be considering whether an entitlement to IRR or only a risk-adjusted anticipated return on costs incurred is most appropriate way to reward the funder. Comments are sought particularly on how to reward “passive investments.”

While funding of the activities leading to development or enhancement of an intangible may not be the only factor relevant to IRR entitlement, it is an inherently risky entrepreneurial function that directly contributes to the earning of income. It should, accordingly, be rewarded as more than a “passive investment.” The bearing of costs in connection with the development or enhancement of an intangible clearly contributes to the generation of the IRR associated with that intangible and should create an entitlement to ongoing returns generated by that intangible. The magnitude of the return to the provision of risk capital generally should be determined with reference to the riskiness of the investment, as is the case in the marketplace. To ensure clarity, the Discussion Draft should be amended to state these points explicitly.

In most cases, the entrepreneurial provision of risk capital indeed will be accompanied by the performance of or exercise of control over functions. Presumably, an entity which combines those activities should be allocated the resulting IRR. In this case, there should be no distinction drawn between performing those functions through contractors, including related parties, and through employees. Thus, for example, there should be no concern regarding a situation in which “important” R&D management functions are performed outside of the country in which a related R&D center is located, even if the funding entity is located in a third country. The tax administration of the country in which the R&D center is located should have no grounds to object depending on whether the R&D management functions are performed in the same country where the funding entity is located or in a third country.

“Important Functions”

The Discussion Draft sets an unreasonably high functional threshold for allocating any IRR to an entity. These provisions are likely to prove especially problematic for many modern multinational enterprises, which, for legitimate business reasons, normally centralize service

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functions globally or regionally in one or several group companies and often outsource functions to unrelated parties (including not-for-profit organizations such as universities).

More importantly, as a matter of principle, this prescriptive approach to identifying functions which are required to be performed by a legal entity’s own employees departs from basic transfer pricing principles. We acknowledge that in some cases, the actual conduct of the affiliated group entities may be so divergent from the relationships as expressed in the intercompany agreements that it could be appropriate for a tax administration to disregard those agreements. But in the absence of such facts, the taxpayer’s agreements generally should be respected, as required by the Guidelines, and the purpose of the transfer pricing analysis should be to understand the actual functions performed, assets used, and risks assumed by the entity and then, based on a comparability analysis, determine what the return to that entity should be, based on those actual functions, assets, and risks.

A proper transfer pricing analysis can accommodate a wide range of divergent factual scenarios, and will consider all of the comparability factors specified in Chapters I and III of the Guidelines. There is no doubt that an entity that performs functions, uses assets, or assumes risks that demonstrably attract a lower return in the market will be rewarded under existing transfer pricing principles with lower compensation than an entity with more substantial functions, assets, and risks. The Discussion Draft could properly note that the comparability analysis must pay close attention to the actual functions, assets, and risks profile of the entity or entities in question. Thus, for example, an entity which performs more of the proposed “important” functions presumably would earn a return greater than one which performs fewer, other aspects being equal. It does not seem appropriate, however, to create a factual mandate as a prerequisite to an allocation of IRR.

All cross-border transfer pricing examinations, of course, will involve transactions with a nonresident entity. In many cases which a tax administration may choose to examine, a nonresident entity will be the party to the transaction which should be entitled to some or all of the IRR. In such cases, the effect of this Discussion Draft will be to require tax administrations to perform factual examinations of the activities of the nonresident entity, which will pose significant administrative challenges.

We are also concerned that this Discussion Draft may encourage some tax administrations to pursue the application of the profit split method in common circumstances, such as in many license transactions, where that method has not been regarded as appropriate in the past. Where

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10 Guidelines, paragraphs 1.64-1.69, 9.168.
11 These comparability factors include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties. See Guidelines, paragraph 1.36.
a method that does not depend on the functions, assets, and risks profile of the nonresident entity is the most appropriate method under Chapter II of the Guidelines and one side of the transaction can be reliably benchmarked, the Discussion Draft should confirm that one-sided methods such as the transactional net margin method may continue to be applied.

**“Control” Over Own Functions and Functions Performed by Associated Enterprises**

As OECD officials have acknowledged, the “control” requirement set forth in the Discussion Draft differs from that adopted in 2010 in Chapter IX of the Guidelines. Chapter IX treats control as a “relevant” but not determinative factor to evaluate the arm’s length nature of the taxpayer’s risk allocation. Moreover, Chapter IX acknowledges important limitations in this regard in the context of Article 9 matters. Specifically, Chapter IX notes the inappropriateness of disregarding legal entity rights and boundaries when identifying the bearers of risk:

The reference to the notions of “control over risk” and of “financial capacity to assume the risk” is not intended to set a standard under Article 9 of the OECD Model Tax Convention whereby risks would always follow capital or people functions. The analytical framework under Article 9 is different from the AOA that was developed under Article 7 of the OECD Model Tax Convention.

Chapter IX sets a lower bar in evaluating control over functions, and permits these functions to be exercised by directors rather than by employees and to be outsourced to a greater extent. Finally, Chapter IX importantly acknowledges that its statements regarding unrelated-party behavior are based on experience and that control would not be a helpful factor for risks over which neither party has significant control.

Although paragraph 41 of the Discussion Draft cross-references the Chapter IX discussion of control, its proposed new control requirement (which appears to apply both to control over functions performed by the entity’s own employees, as described in paragraph 40, and functions performed by associated enterprises, as described in paragraph 41) would set a materially higher threshold, requiring the party claiming IRR to exercise control over the bearing of risks and costs as well as over the performance of specified functions and prescribing the persons that may exercise the control. These new requirements clearly aim to limit IRR entitlement where the performance and management of functions are performed by different companies within a multinational group. However, even multinational group companies that perform substantial functions are unlikely to meet this higher threshold.

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13 Guidelines, paragraph 9.21.
This heightened concept of control seems particularly at odds with arm’s length behavior. As in all transfer pricing matters, the question here should be to determine what happens at arm’s length when two enterprises engage in transactions comparable to those of the taxpayer. In many cases at arm’s length, unrelated entities are engaged to perform work in their core competency without direct supervision or “control” by their counterparty. There is, of course, nothing unusual in a case where all details of an activity are performed under the control of the entity which employs the personnel with the requisite skills. If that transaction occurs between associated enterprises, the transfer pricing rules should not endeavor to recharacterize the relationship, as long as the “control” exercised by the principal is of a sort that could be observed at arm’s length.

It is entirely appropriate, of course, for a tax administration to closely examine the return allocated to an associated enterprise which is performing the function in question. In appropriate cases, adjustments might be made based on a comparison to comparable entities performing comparable functions. We believe, therefore, that the Discussion Draft should state that the principal focus of whether a resident entity should be allocated IRR should be a close analysis of the functions, assets and risks of that entity.

Proposed Approach

Tax administrations may well have legitimate base erosion or profit shifting concerns regarding particular transactions or structures, or unresolved concerns regarding low-tax jurisdictions. We note that many of the Discussion Draft’s requirements appear to be aimed at specific cases and do not provide the general guidance that is needed for the majority of cases. One obvious difficulty with redefining the arm’s length principle in an attempt to address such issues is that it is overbroad: the arm’s length principle applies to all related party transactions and in over a hundred jurisdictions. To avoid disturbing the well-settled understanding of the arm’s length principle in the great majority of cases, any base erosion or profit shifting concerns raised by particular structures or transactions should instead be identified and addressed directly through appropriate targeted provisions.

If the IRR concept is retained, the Discussion Draft should be revised to permit the functions required for IRR entitlement to be performed by any member or members of an MNE group or by an unrelated party or parties, subject to payment of an arm’s length remuneration.

The Discussion Draft’s guidance on control should be revised to follow the guidance adopted in 2010 in Chapter IX. If the approach of the Discussion Draft on control is retained, it should be refined and expanded to provide affirmative guidance for the great majority of cases, in which the issue is whether a company has the required minimum levels of control over functions, risks, and costs, among other factors, to support its entitlement to IRR.
3. Treatment of Comparability Factors

The Discussion Draft helpfully identifies a series of factors as comparability factors that cannot be treated as intangibles, although they may affect the valuation of a transfer of intangibles. It indicates that the transfer pricing treatment of these factors, including market conditions, location-based advantages, and corporate synergies, remains under discussion by WP6 and will be addressed in a forthcoming draft.

However, a number of statements in the Discussion Draft appear potentially to undercut this distinction.

Example 19

For instance, Example 19 effectively treats both location savings and tax rate differential in the same manner as intangibles for valuation purposes. The Discussion Draft clearly states at paragraph 24 that location advantages are not an intangible. However, in Example 19, the full location savings from the outsourcing of manufacturing are added to the deemed value of the intangible through a valuation technique based on a discounted cash flow, where the cash flow being measured is the entire “residual” above the routine manufacturing profit. This approach raises several concerns. First, by measuring the entire residual cash flow, rather than cash flows attributable to the specific transferred intangibles, the valuation sweeps in other drivers of profit (or loss) that may have nothing to do with the subject intangible property. In so doing, the approach effectively negates the distinction between factors such as location savings and the subject intangibles, and ultimately, the Example could be read to suggest, as a definitional matter, that location savings and these other factors effectively are intangibles subject to transfer and direct valuation.

Second, the example is concerning because, in the absence of any comparables or market evidence, the example assumes that the seller can extract 100 percent of the location savings from the buyer. In the example, this adds $134 million to the “value” of the IP. If the purpose is to determine the “value” of the IP, this approach has several problems. For example, assume that Pervichnyi engages in a contract manufacturing relationship and attributes an additional $134 million of value to its IP to account for lower manufacturing costs arising from location advantages alone (rather than from the technology). If manufacturing costs rise, and nothing else changes in the market, Pervichnyi’s IP will lose “value” solely for this reason, and not because of competitive margin erosion from competing IP, amortization, or similar IP-specific factors. If this were to occur, the “value” of the underlying IP will have been distorted by the improper inclusion of value attributable to other profit drivers.
In Example 19, the full present value of the differential in tax rates is also added to the intangible value. In the example, this adds $210 million to the “value” of the IP and effectively makes the buyer pay the seller’s taxes. Thus, a potential buyer with a different tax rate will, according to the Draft, value the IP differently, and the difference could be quite substantial as a proportion of the total. Again, this approach distorts the underlying market value of the IP by including value attributable to extraneous factors.

Franchise arrangements provide an illustration of why the notions in Example 19 are inconsistent with arm’s length transactions involving intangibles. Franchisors typically define a bundle of IP that includes trademarks, trade dress, know-how, and other elements that are made available to potential franchisees. In exchange for receiving this bundle, franchisees may pay an initial fee, and then typically remit a percentage of revenues to the franchisor, much like a royalty. Franchisors generally offer a standard package of IP to all franchisees in exchange for a fixed rate. Franchisors do not charge higher franchise fees to franchisees located in jurisdictions with lower corporate tax rates, nor do they charge lower fees to franchisees located in high-tax jurisdictions. Franchise rates do not vary based on the wage rates across jurisdictions. If Example 19 were reflective of reality, such differentiation would be common. The fact that it is not demonstrates that unrelated parties do not value IP or negotiate in the way suggested by Example 19.

**Assembled Workforce**

The Discussion Draft notes that:

> Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm’s length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.\(^{14}\)

Although the Discussion Draft thus generally points to treatment of an assembled workforce as a comparability factor, it fails to confirm unambiguously that an assembled workforce does not constitute an intangible. The removal of a clear statement to that effect from the inadvertently released near-final version of the Discussion Draft compounds this uncertainty, which should be remedied by reinserting the deleted statement.

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\(^{14}\) Discussion Draft, paragraph 25.
Mr. Joseph L. Andrus  
September 13, 2012

It is not entirely clear why the Discussion Draft addresses assembled workforce issues at all, as they relate to services rather than to intangible property. If the Discussion Draft must address assembled workforce, a key question is how it can be demonstrated that a given employee group is uniquely qualified, and further, that the arm’s length price for services is affected by this in a way that can be established through a comparability analysis. Every business has an incentive to hire and develop a group of employees that is optimally suited to deliver the functions required in that business, taking into account market factors related to the value of the goods or services produced and the costs of the employees and other resources employed to produce them. One cannot separate the value of the employees (as one type of productive resource) from the market for their output. For example, a company may have hired a group of scientists who, individually, are brilliant and innovative. But if the ideas they generate do not lead to commercially viable products, then the “value” of these scientists is limited. Thus, one cannot judge the uniqueness of a workforce using non-market criteria. Further, each employee is incentivized to seek the best personal economic outcome for himself or herself through compensation. Thus, a truly brilliant scientist who does produce commercially viable and valuable ideas will negotiate higher personal compensation than another scientist who does not, all other things being equal. This higher “value” is then reflected in the individual’s personal income. As a result, tax administrations are able to capture the value of highly unique and valuable individuals through their taxation of personal income.

This being the case, for there to be additional income at the corporate level related to an assembled workforce, there must be something beyond the individual employees themselves that creates and embodies value, something that is owned and controlled by the corporation. If this is the case, then the intangible in question is not the group of employees but, instead, something else owned and controlled by the company. It is conceivable that there are forms of know-how and trade secrets that would satisfy this requirement, depending on the facts and circumstances of the case. Where this is the case, however, the transaction to be valued would relate to the know-how and trade secrets themselves, and not to a group of employees.

That said, the Discussion Draft is correct that having an assembled workforce, along with other assembled resources, may in some cases provide a benefit as compared to a company just starting operations. As the Discussion Draft states, any such benefit would relate to savings in expenses and difficulty in hiring and training employees. For this reason, the valuation community has, for decades, viewed such a benefit as subject to valuation based on a careful analysis of costs saved.

If the Discussion Draft continues to treat the existence of an assembled workforce as a benefit conferred on an associated enterprise, it should clearly confirm that it is only a comparability factor and that its value should be based on costs saved, and not on other hypotheses of value.
Other Provisions

The Discussion Draft also refers, in paragraph 126, to locational advantages and market differences as “important factors” in determining an arm’s length price in situations where reliable comparable uncontrolled transactions cannot be identified. This impression is reinforced by the open-ended discussion in paragraph 127 regarding the effect of unique internal transactional structures on intercompany profits. These provisions suggest that there may be a risk that such factors will be treated in the same manner as intangibles for valuation purposes, as in Example 19.

Finally, the amendment of the title of Chapter VI of the Guidelines to read “Special Considerations for Intangibles” rather than “Special Considerations for Intangible Property” and the use of the term “intangibles” throughout the Discussion Draft exacerbates the confusion between transferable property and comparability factors. The Discussion Draft acknowledges that even goodwill is transferable along with other assets, so there is a property element to all transactions in which a transfer is recognized. The concept of “property” should be preserved to maintain the proposed distinction from comparability factors.

In summary, while the Discussion Draft appropriately acknowledges that comparability factors may affect the valuation of transferred assets, we are concerned that it could be read to signal that such valuations may be performed in a manner that effectively negates the distinction between comparability factors and intangibles. If the distinction between intangibles and comparability factors is to be meaningful and administrable, it must be maintained clearly for both definitional and valuation purposes.

4. Goodwill

The Discussion Draft sets out a useful framework for identifying intangibles by requiring that they be “capable of being owned or controlled for use in commercial activities.” Yet, in treating goodwill as an intangible, the Discussion Draft undermines this framework by creating significant ambiguity about what is meant by the term and how goodwill should be addressed in a transfer pricing context. As discussed below, the Discussion Draft raises both definitional issues and valuation issues that merit further consideration.

Goodwill Definitional Issues

The Discussion Draft correctly acknowledges that the term goodwill can be used to mean many different things. It even notes several conflicting understandings, including the well-established concept of goodwill as a residual amount for certain accounting and valuation purposes. However, instead of clarifying the meaning of “goodwill” for purposes of transfer pricing, the
Discussion Draft states that no definition is needed and that it does not intend to provide one. We believe that by failing to do so, the Discussion Draft falls short in important ways that could undermine its analysis generally. The lack of agreed parameters for the scope of the goodwill concept obviously heightens the risk of disputes regarding its interpretation.

The Discussion Draft itself uses the term goodwill to mean different things, which stands to create additional confusion and uncertainty for taxpayers and tax administrations. For example, paragraph 19 first mentions goodwill as one of a group of intangibles associated with a “brand.” Certainly, particularly in IP law contexts, “goodwill” is taken to mean the awareness and reputation that a trademark has obtained in a given market. This kind of goodwill is inextricably linked with the trademark itself.

The notion of goodwill is also narrowly construed in Example 14, at least on the facts as stated. Specifically, in this case, “goodwill” is associated with bearing advertising costs, and in that way, can be understood to relate to trademark/brand reputation and awareness, as opposed to a broader, vaguer definition.

A broader concept of goodwill, as associated with patents, trademarks, and “other intangibles,” appears in Example 13 of the Discussion Draft. This example asserts without definition or explanation that the Country B operations have “developed substantial goodwill and ongoing concern value.”

In Example 15, “goodwill” arises in the context of a purchase price allocation (PPA) for an acquired business. To understand what goodwill means in this context, one must refer to the accounting valuation literature that governs purchase price allocations. That literature establishes goodwill as a residual amount, the difference between the price paid for an entire business as a going concern and the value of specifically identifiable tangible and intangible assets. Because of the rules of financial accounting, this definition of goodwill captures a wide range of elements, including control premia, synergies, workforce in place, going concern value, errors in the valuation of tangible and identifiable intangibles, and other amounts not required to be separately identified for accounting purposes. Goodwill in PPAs also may capture value paid for hoped-for future profits that would arise, if at all, from future investments and initiatives not yet undertaken. This residual concept makes it difficult to see how goodwill could be effectively distinguished in practice from the comparability factors that the Discussion Draft clearly indicates are not intangibles, such as synergies. If the concept of goodwill is retained without appropriate definition, there is a risk that an acquisition definition of goodwill will be used as the

\[15\] A similar issue is raised by the Discussion Draft’s references to “ongoing concern value,” often in conjunction with its references to “goodwill.”
basis for adjustments, although it does not correspond to an asset that is subject to transfer pricing.

The Discussion Draft takes the firm position that accounting definitions and valuations are not relevant for purposes of transfer pricing. Yet it seems to embrace the notion that goodwill somehow changes hands between related parties. If accounting definitions and valuations are not relevant for transfer pricing purposes, then that concept should be followed consistently.

TPWG members continue to believe that it would be more appropriate to require that all “intangibles” be separately transferable items of property. The task of transfer pricing should be to identify and value all of the intangible assets that are capable of being owned or controlled for use in commercial activities and that are transferable by a single enterprise, either separately or in combination. This would preclude treatment of goodwill and going concern value as intangibles because they can be transferred only with the assets to which they relate and would draw a clearer distinction between intangibles and comparability factors.

At a minimum, the Discussion Draft should be revised to require that all intangibles be transferable, even if not separately, in order to maintain the distinction that the Discussion Draft otherwise draws between intangibles and comparability factors. Other items should not be treated as intangibles for transfer pricing purposes because unrelated parties would not pay for them at arm’s length.

In addition, to avoid confusion and disputes, we recommend that the term goodwill be deleted from the Discussion Draft entirely, other than to clarify its exclusion.

To the extent that “goodwill” is used to refer to the reputational value of a company or a trademark, then the term “reputational value” should be adopted in place of the term “goodwill.” Any license of a trademark also includes its reputational value, as the two cannot be separated, so that value would be captured in the trademark royalty.

To the extent that “goodwill” is meant to capture the “ongoing concern value,” if any, of a functioning, economically integrated business unit involving the transfer of assets, bundled with the ability to perform certain functions and bear certain risks, then the term “ongoing concern value” should be adopted in place of the term “goodwill.” Further, the Discussion Draft’s proposal to treat “goodwill” as a compensable intangible should be applied only to actual (not deemed) transfers of ongoing concerns. It should not be applied to actual or deemed transfers of a particular asset or assets without an actual transfer of the associated ongoing concern. For this purpose, the term “ongoing concern” should be defined, as in Chapter IX, to refer to “a functioning, economically integrated business unit” involving the “transfer of assets, bundled
with the ability to perform certain functions and bear certain risks,” and no reference to “goodwill” is required.

Any other use of the term “goodwill” should be eliminated from the Discussion Draft, because most other interpretations arise in an accounting context, which the Discussion Draft has indicated is irrelevant, and would confuse intangibles with comparability factors.

**Goodwill Valuation Issues**

The Discussion Draft also raises a series of difficult valuation issues relating to goodwill.

First, the Discussion Draft does not adequately take into account the fact that the price paid in an acquisition context may be higher than the intrinsic value of the assets of the acquired company for reasons that do not present transfer pricing concerns or relate to the acquired company alone. The approach suggested by the Discussion Draft presumably is intended to support adjustments based on acquisition price, which raises several concerns.

It may be that tax administrations see purchase price allocations (PPAs) that assign a significant value to “goodwill” and believe that this must reflect value that has already been created by the acquired business and, therefore, should be subject to current taxation. The Discussion Draft itself argues that goodwill should be treated as a compensable intangible because the term goodwill, like the term “ongoing concern value,” is often used “to describe an important and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred.” However, just as the Discussion Draft maintains that the taxpayer’s purchase price allocation is not relevant to valuing particular assets, the acquisition price should not be used by tax administrations to determine the value of “goodwill” for transfer pricing purposes. This is both because the values assigned in a PPA are not necessarily arm’s length values of intangibles subject to transfer pricing, and because the notion and value of goodwill in such PPAs is not indicative of intangible assets subject to transfer pricing and current taxation.

A principal reason why PPA “goodwill” is not indicative of assets or values that should be compensated between related parties is that it essentially captures the difference between what valuation professionals refer to as “fair market value,” which is the value of an asset (or group of assets) in the open marketplace, and “investment value,” which is the value of an asset or a group of assets to a particular buyer-seller combination. Thus, goodwill based on acquisition price reflects the aspirations of the specific buyer and seller and all of the errors and omissions that go

16 Guidelines, paragraph 9.93.
17 Discussion Draft, paragraph 22.
along with making a bet on whether a certain strategy and acquisition will be successful. Investment value diverges in this respect from the arm’s length principle, so goodwill values that take investment value into account should not be considered relevant for transfer pricing purposes.

Example 19 illustrates some of the concerns that this presents. The fact that the IP values derived in Example 19 are directly and substantially affected by the presence (or absence) of locational advantages and different tax rates suggests a belief that that there is no general market value for IP, and that IP instead has a unique value in the hands of any particular party. This has numerous implications. One implication is that typical fair market value valuation standards would not apply. The typical approach used in such valuations assumes a “hypothetical buyer and seller,” in which each party has full information and is under no compulsion to transact. Mechanically, in such valuations, inputs such as the tax rate are set at generic levels, not directly tied to either the buyer or the seller’s tax rates. This is done because, in the marketplace, there may be many buyers and many sellers, and they would not disclose their respective company-specific circumstances in a negotiation. Even in the absence of such disclosures, transactions still take place, which demonstrates that, at arm’s length, buyers and sellers do not rely on the level of information assumed by Example 19. In this way, Example 19 is not consistent with the arm’s length standard.

A particularly troubling implication of Example 19 is the fact that it seems to preclude a taxpayer from using a CUP method, unless the taxpayer could establish that both parties to the transaction had identical cost structures, tax rates, and other variables. Since that information is not available to the parties to an arm’s length negotiation, and certainly is not available in public disclosures, CUPs would not appear to satisfy the requirements of Example 19, even if the CUP were a transaction entered into by the taxpayer with an unrelated party.

Another reason why amounts identified as “goodwill” for PPA purposes should not be presumed to be compensable for transfer pricing purposes is that, as is well documented, companies often pay a “control premium” to acquire another company. This control premium is usually attributed to the acquiror’s desire to have the full ability to redeploy the acquired assets in the way it sees fit, which it could not do if it had a minority interest in the target company. Control premia have been routinely measured to be between 25 percent and 45 percent of a given purchase price. In a PPA, this control premium falls into “goodwill,” and yet does not itself represent a discrete asset that has the ability to produce income and that can be transferred. Of course, no control premium is needed when operations are altered or intangible assets are transferred between related parties, as control already exists within the related group.

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Amounts identified as goodwill in the PPA context typically also include other expected or hoped-for benefits of the acquisition, which may or may not materialize. Synergies are always sought in mergers or acquisitions but, as research has demonstrated, are seldom achieved. It would, therefore, be inappropriate to treat such amounts as compensable for transfer pricing purposes.

Expected benefits are realized only, if at all, through the future investment of resources and business skill and the successful bearing of entrepreneurial risk. These elements are akin to a business opportunity, which the Discussion Draft acknowledges is not property. They relate to future entrepreneurial endeavor and are not inherent in any specific asset. Therefore, their value cannot be ascribed to a specific asset or allocated to the acquired entity. Treating such elements as compensable for transfer pricing purposes and valuing them based on acquisition price would be especially problematic where there have been significant interim changes in the economy generally or the industry sector.

A second concern is that the Discussion Draft takes the position that the value of goodwill does not disappear and is not destroyed in an internal business restructuring. This is stated most clearly in Example 15, as follows:

The full value of [the acquired business] should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. . . . It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.19

One potential reading of this statement is that any amount assigned to goodwill in a purchase price analysis should, instead, be assigned – in full – to one or more of the existing identified tangible and intangible assets of the acquired entity. Indeed, Example 15 effectively concludes that a purchase price premium must be included in a buy-in.

This statement rests on the erroneous assumption that the element described in that example as “goodwill” was (i) an asset, and (ii) an asset owned by the acquired entity. As noted above, the amount which an acquirer decides to pay for a business entity can be influenced by factors related to elements external to the assets of the acquired entity. For example, an acquirer which wishes to build upon its favorable position in the marketplace by acquiring a synergistic product line is seeking to earn a return on its prior investment in its market position, not from the exploitation of the business assets of the acquired entity. If there is a premium for market synergies and the nonresident acquirer has been owning its intangibles and developing its

19 See also Discussion Draft, paragraph 5.
market, then the synergy value for the nonresident market is owned by the nonresident, not the acquired resident entity. The nonresident entity should not be expected to pay for any such synergy value.

The analysis of this issue in the transfer pricing context has been clouded by the financial accounting practice of categorizing as “goodwill” even elements which are simply not explainable as related to any particular asset. The ultimate result of the financial accounting classification of some part of the purchase price as “goodwill” is that the goodwill asset appears on the consolidated balance sheet of the group. In fact, that treatment may be appropriate where the acquisition was intended to make a further investment in a previously existing market advantage of the acquiring group. In that sense, the capitalized goodwill asset relates to the group’s prior business advantage as opposed to an asset which was specific to and owned by the target entity. Prior to the acquisition, after all, there would have been no suggestion that the target should have a large goodwill asset on its books.

Accordingly, we believe that the statement that “value does not disappear, nor is it destroyed, as part of an internal business restructuring” should be deleted from the discussion draft, as it assumes as a general matter that no element of a purchase price would be attributable to any economic element other than an asset of the acquired entity. Instead, it would be appropriate to state that the value of the tangible and intangible assets of an acquired business should be determined through a functional and financial analysis, that assesses the value of the identified intangible property itself.

Example 13 illustrates other difficult valuation issues raised by this approach. How could it be known that the operations involved in the internal restructuring had developed “substantial value”? If the operations were publicly traded, then the market value of the company might be compared to the book value of its assets. The difference between these values would be an indication of the value of all the self-created intangibles, together with the market’s expectation of future value creation. However, it is exceedingly rare for one party within a related group to be publicly traded, and certainly is not the case in this example, in which the operations were originally conducted in branch form. Thus, no reliable, objective measure of “substantial goodwill value,” even together with expected future value, is likely to be available in internal restructuring cases.

A third concern is that the Discussion Draft effectively suggests that goodwill represents expected synergies that belong entirely to the acquired entity and should be paid for by the acquirer. This is a new proposition that does not seem intuitive. The purchase price that an acquirer chooses to pay to capture a synergy value based on the acquirer’s existing business

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20 See, e.g., Discussion Draft, Example 15.
represents an investment by the acquiror in an asset of the acquiror, not of the seller or the target entity. The realization of synergies depends on the acquiror’s ability to use the asset and on its continued investments in and risk-taking with respect to the asset.

The Discussion Draft’s positions on goodwill raise a number of additional practical issues that would need to be addressed in any event before they can be implemented. For example, guidance would be needed on how to take into account that benchmarking already accounts for some measure of goodwill, as the comparables presumably reflect goodwill as well. In addition, although the Discussion Draft states that an intangible may have a negative or zero value, it does not provide guidance on how to address declines in value or losses resulting from transactions involving intangibles. It is important for the Discussion Draft to confirm even-handed treatment of these issues.

5. **Hindsight Issues**

Both the Discussion Draft and the contemporaneous Request for Comments of the Secretariat of Working Party No. 6 of the OECD Centre for Tax Policy and Administration on Certain Timing Issues Related to Transfer Pricing indicate that WP6 is deliberating on how to address the extent to which information regarding subsequent events may be viewed as relevant to an evaluation of the arm’s length nature of the compensation for a transaction that has already occurred.

In our experience, taxpayers generally perceive both “upside” and “downside” valuation risks whenever long-term transactions are involved and may protect themselves against both over- and under-valuing the intangible by using a contingent compensation mechanism that varies the payment based on productivity. However, the suggestion, in the Secretariat’s request, that tax administrations should in some circumstances “be permitted to assume the existence of a renegotiation, price adjustment clause, milestone payment, or other risk sharing mechanism within an agreement between controlled parties” seems potentially overbroad.

The TPWG agrees that it may be appropriate in some circumstances to permit certain information that becomes available about subsequent events to be considered by both tax administrations and taxpayers. To prevent an inappropriate or one-sided use of hindsight, however, such information should be available for use only in the following circumstances:

a. Information about subsequent events should be used, if at all, only to address situations where valuation of intangibles was highly uncertain as of the date the controlled transaction occurred;

b. Information about subsequent events should be used only to test the reasonableness of the taxpayer's projections and business assumptions at the time of the transaction, and
should not be used to revalue the transaction on the basis that the taxpayer should have been able to foresee the actual results;

c. Both tax administrations and taxpayers should be permitted to take such information about subsequent events into account (and any domestic law restrictions on self-initiated taxpayer adjustments should be waived for this purpose); and

d. Tax administrations should be permitted to take information about subsequent events and subsequently available information about contemporaneous events into account only if they are prepared to engage in good faith in MAP proceedings with treaty partners to avoid any resulting double taxation and waive the application of any treaty or domestic law time limitations that would otherwise preclude MAP consideration in the case concerned.

6. Examples

We note that the Annex to the Discussion Draft provides an uncommon number of Examples, which we believe can be potentially useful in illustrating the intended operation of the Discussion Draft text. However, we believe that, as proposed, many of the Examples likely would create confusion instead. While we do not necessarily always disagree with the conclusions they draw, we believe that the analysis suggested by many of the Examples either does not align clearly with the principles stated in the Discussion Draft or, in some cases, appears to conflict directly with those principles or to state additional substantive principles not supported by the Discussion Draft. We respectfully suggest that the Examples and the Discussion Draft be more closely aligned to avoid creating unintended conflicts and confusion.

In addition to the specific comments offered above on Examples 13, 15, and 19, we would like to offer the following general comments on the Examples as a whole:

- A number of the Examples do not reflect any consideration of what independent parties do or would do in comparable circumstances. These apparent departures from the arm’s length principle should be remedied. This is a particular concern with Examples 2, 5, 11, and 15.

- The Examples generally do not start with reference to the contractual terms in place between the parties, and some even suggest a general disregard for, and willingness to recharacterize, the parties’ contractual terms in circumstances where they should be relevant under Chapters I and IX of the Guidelines. This is a concern with, for instance, Examples 1, 11, and 12.
• The Examples take conflicting positions on the relevance of cost bearing. Some Examples, such as Examples 1 and 14, appear to disregard cost bearing entirely, which seems inappropriate. Others, such as Examples 4, 5, 6, and 8, overemphasize cost bearing relative to other factors identified by the Discussion Draft as relevant.

• Examples such as Example 14 place undue weight on the performance of selected functions and the exercise of control, while disregarding other factors that remain relevant according to the proposed Chapter VI text.

• Several of the Examples, including Examples 5, 7, and 14, suggest an analysis that turns primarily on the profitability of one of the parties, sometimes even relative to prior profits from controlled transactions. This is not an appropriate basis for determining an arm’s length compensation under the Guidelines.

If conformed more closely to the text of the Discussion Draft and the Guidelines, however, we believe that the Examples could be very useful in illustrating the intended operation of the principles set forth by the OECD. This could benefit not only taxpayers and OECD member tax administrations but also the many non-OECD economy administrations that seek to apply the arm’s length principle.

7. Intended Legal Effect

The Discussion Draft does not state its intended legal effect or effective date. However, the OECD has taken the position in the past that the Guidelines provide an interpretation of pre-existing treaties that is relevant for open years in the past as well as for future treaties and periods.

We believe that this approach would raise serious concerns if applied in this context. It would be curious to have the provisions of the Discussion Draft presented as mere clarifications, especially since WP6 is said to still be actively debating many of its proposals. In addition, as noted above, the Discussion Draft sets forth a number of prescriptive rules that have not previously appeared in the Guidelines. For example, it takes the position in the boxed text preceding Section B that:

neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.

This statement is followed by an assertion that “[t]his view is consistent with other sections of the Guidelines and does not reflect an intention to depart from the principles of Article 9.”
seems unlikely that there will be universal agreement with this view, or with certain other provisions of the Discussion Draft if retained in their current formulation.

There is also a serious question about the extent to which the Discussion Draft may be applied by countries with inconsistent domestic law provisions, such as the provisions of U.S. Internal Revenue Code section 367(d) or the provisions in many countries prescribing that goodwill does not transfer without a transfer of the entire business or ongoing concern. Those countries whose domestic laws do not incorporate the Guidelines by reference may, therefore, find themselves more limited than others in their ability to apply the provisions proposed by the Discussion Draft.

*   *   *   *   *

We understand that WP6 is continuing its deliberations and is planning to consider comments on this Discussion Draft and issue a more complete discussion draft in 2013 that also addresses other important issues, including the transfer pricing consequences of items treated as comparability factors rather than as intangibles and potential changes to the discussion of cost contribution arrangements in the current Guidelines. The Treaty Policy Working Group looks forward to the opportunity to continue to provide input on these important issues as the process moves forward.

Respectfully submitted,

For the Treaty Policy Working Group:

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cc: Ms. Michelle Levac, Chair, OECD Working Party No. 6 and Special Sessions on Transfer Pricing of Intangibles
September 15, 2010

Mr. Joe Andrus  
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Dear Mr. Andrus,

True Partners Consulting, in cooperation with its global network of affiliates (collectively “True Partners International” or “TPI”), welcomes the opportunity to provide commentary to the OECD with respect to its undertaking of a possible revision of Chapters VI of the Transfer Pricing Guidelines (“TPG”) concerning Special Considerations for Intangibles (“IP”).

Intangibles are clearly a very important topic within the transfer pricing realm and therefore we welcome the OECD’s initiative to hopefully clarify certain issues pertaining to the transfer of IP. In the following sections, we share our ideas for the development of more cohesive international guidance.

Best Regards,

Michael Heckel, Rölfs RP Rechtsanwaltsgesellschaft GmbH (Germany)  
Les Secular, True Partners Consulting (UK) LLP  
Daniel Falk, True Partners Consulting LLC (U.S.)  
James Chang, True Partners Consulting International (China) Co., Ltd.  
Herve Bidaud, Artemtax International (France)  
Kay H. Lee, Sungjee Accounting Corporation (Korea)  
Natalia Operti, Studio Manzoni Pagliero Vanz e Associati (Italy)  
Michal Majdanski, BT&A Group (Poland)
A) Comment on Paragraph A of the proposed Chapter VI “Identifying intangibles”

The title of the proposed version of Chapter VI of OECD Transfer Pricing Guidelines (“TPG”) changes from “Special Considerations for Intangible Property” to “Special Considerations for Intangibles”. The label and the language of the current Chapter VI appears to be applicable only to the “intangible properties” encompassed in the definition provided in paragraph 6.2 of the TPG. Since the identification of the intangibles is a critical step in the transfer pricing analysis, and the term “intangible” in the economic world refers to a broader range of non-material assets, it is not limited to the category of intangible properties illustrated in section 6.2 of TPG. Therefore, we concur with the proposed intent of expanding the application of Chapter VI which clarifies the definition of intangibles as “something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities”.

We also concur with the OECD approach of disassociating the legal and accounting definition (and treatment) of intangibles from the identification process under those proposed by the Working Party. There is currently no universal legal position defining the term “intangibles”, nor is there any international cohesion on the accounting treatment of intangibles which would ease the process of identification of intangibles. Since such coordination among countries is rudimentary, we share the “neutral” approach proposed by the OECD of grounding the identification process on a “substance over form” methodology, which is not limited by definitions used in legal or accounting contexts; which may vary from country to country. The identification process of a specific intangible is then focused on the actual intention of the parties involved with a critical role played by the comparability and functional analysis, and the understanding of how the intangible is being exploited in the MNE’s operations.

In summary, the proposed version of Paragraph A clarifies the intention of the OECD to confine the application of Chapter VI to those intangibles which are the object of a stand-alone use or transfer, in cases other than the business restructuring. In Paragraph A.4 the OECD provides illustrations of items which are often considered Intangibles. Even though the OECD clarifies that the illustrations are not considered to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles, we see potential in expanding the proposed listing of items to include categories of intangibles which are frequently encountered in business; or of intangibles which are not easy to define due to their own features, such as customer related intangibles (e.g. customer lists, customer contracts, customer relationships, distribution channel, etc.) and contract-related intangibles (e.g. license agreements, non-compete agreements, etc.).

B) Identification of Parties Entitled to Intangible Related Returns

In our view, general comments relating to the identification of parties entitled to intangible related returns should be supplemented with the following remark: such identification may significantly influence the conclusions on the selection of the tested party and transfer pricing
methods used to determine the arm’s length compensation for associated enterprises. Furthermore, it should be indicated that the identification of parties entitled to intangible related returns may in some cases affect the transaction model in business relationships between associated enterprises (e.g. using two separate transaction flows (sale of trade goods and trademark license) instead of one transaction flow (sale of trade goods).

1. Registrations and contractual arrangements

According to section B.1 30 of the TPG, “legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns. The terms of a transaction may be found in written contracts or in correspondence and/or other communications between the parties. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises”.

Since intangibles (as defined in Section A, Chapter VI of TPG) may not be explicitly referenced in written contracts or other documents, we are of the opinion that the TPG should provide guidance on what the starting point should be for the above-mentioned deduction of the contractual relationships of associated enterprises regarding such intangibles. For instance, such deduction may be based on the MNE group’s value chain.

Alternatively, the contractual relationship between associated enterprises may be implied from the analysis of functions, risks and costs relating to the MNE group’s business operations, including the analysis of functions, risks and costs relating to the intangibles identified prior to, or during such analysis. In such a case, the verification of the alignment of the functions performed, assets used, risks assumed and costs incurred by the MNE group members to develop, enhance, maintain and protect intangibles, and the allocation of entitlement to the intangible related returns in the relevant registrations and contracts would not be necessary. This is referenced in section B.2. 37 of the draft TPG which states that “the parties’ conduct should generally be taken as the best evidence concerning the true allocation of entitlement to intangible related returns.”

2. Functions, risks and costs related to intangibles

Section B.2.43 of the draft TPG discusses the inclusion of (technical, legal and other) risks relating to successful research and development initiatives or marketing activities, and ensuring that they are captured in the arm’s length arrangement.

In our opinion, section B.2.46 of the TPG should indicate that the arm’s length compensation to an associated enterprise(s) may also be considered in cases where the enterprise bears the risks related to the intangible under the control of the of MNE group member claiming entitlement to intangible related returns (e.g. legal (formal) owner of patent rights which incurs costs of the
defense against third party claims of infringement) or uses assets related to the development, enhancement, maintenance and protection of the intangible.

3. Arm’s length compensation for functions performed by associated enterprises related to the development, enhancement, maintenance or protection of intangibles

In our view, section B.3.48. of the TPG should not only refer to the performance of functions related to the development, enhancement, maintenance or protection of intangibles by associated enterprises, but should also refer to risks assumed and assets used by those enterprises in this respect.

In our opinion, section B.3.49 of the TPG should indicate that a marketer/distributor may also be compensated for its marketing activities by including marketing expenses in any other transaction flow as part of the transfer pricing mechanism, e.g. purchase of trade goods. Consequently, section B.3.50 of the TPG may be supplemented by an example of a limited risk distributor engaged in some marketing activities.

We recommend that section B.3.52 of the TPG elaborates on situations involving the performance of research and development activities, similar to the case of marketing activities under section B.3 51 of TPG.

4. Disregard of transactions, registrations and contracts

No comments.

5. Transfer pricing adjustments in cases involving entitlement to intangible related returns

In our view, section B.5.55 of the TPG should indicate that intangible related returns may be allocated by tax authorities in order to assure that each member of the MNE group is properly rewarded for its risks, functions and costs. Depending on circumstances, they may be allocated by either (i) correcting transfer pricing in existing transaction flows (e.g. by correcting the price of the trade goods purchased by the distributing entity from the associated enterprise if an intangible (trademark) is involved in such transaction), or (ii) allocating returns by creating “virtual” transaction flows (e.g. assuming that one party should have paid a royalty or service fee to the other party as if the intangible or the right to use the intangible was transferred).

6. Illustrations

No comments.
C) Transactions involving the use or transfer of intangibles

1. Transactions involving the use of intangibles in connection with the sales of goods or services

We are of the opinion that the examples presented in sections C.1 60 and C.1 61 of the TPG should be supplemented with an explanation on how the use of intangibles that are not to be transferred between associated enterprises affects the selection of the tested party and transfer pricing method (similar to the TPG’s comments presented under section C.1 75 on the selection of the transfer pricing method in the case of intangible transfer).

2. C.2 Transactions involving transfers of intangibles

In our view, the example presented in section C.2 69 of TPG would be useful as it would provide some guidance on when intangibles should or should not be separated as mentioned in section C.2 70 of TPG.

In our opinion, section C.2.72 of TPG should provide guidance on whether and (if so) in what cases it would be possible not to disaggregate the price of a package contract (tangible and intangible elements) in order to confirm that both elements of the transaction are in line with the arm’s length principle (e.g. due to the lack of reasonably reliable comparables in connection with one or both elements).

3. C.3 Illustrations

No comments.

D) Determining Arm’s Length Conditions in Cases Involving Intangibles

1. Conducting a comparability analysis in a matter involving intangibles

In our opinion, the term “realistically available option(s)”, is all inclusive. In order to avoid theoretical and protracted discussions between tax authorities and taxpayers it should be enough that the realized option is reasonable. This option should not be compared to any other, potentially contradictory option, as long as the taxpayer can clearly exemplify that that this option complies with the arm’s length standard.

The example in D.1.82 reflects the reciprocity in the negotiation process between the two independent parties. The economic rationale should be more in the foreground, as the analysis of every conceivable option available.
An example of how to consider the impact on the profitability described in D.1. 86 would be desirable.

As they are referred to several times throughout the TPG draft, “Section D.1.(vi) intangibles” should be properly defined for purposes of this section.

2. Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

Please consider deleting the last sentence of D.2. 110. Alternatively, please discuss in more detail why this valuation is not appropriate for transfer pricing purposes. In general, please consider expounding upon D.2. 110 and why it does not conform to the arm’s length principle.

In this connection we would like to mention that the cost / benefit ratio of the valuations has to be considered. For intangibles with a smaller value, existing recent valuation could be applied. If the results are reasonable, it should be considered arm’s length.

We could not follow D.2. 111. This paragraph seems to imply that valuations for tax purposes are less relevant than valuations for business planning purposes. If this is not the intention of the Paragraph, it can be deleted as it does not provide sufficient guidance.

D.2. 116 is generally reasonable from an arm’s length point of view, except independent third parties would probably not apply these rules for sharing their profits either. Especially if there are valuable intangibles involved.

3. Determining arm’s length prices for transactions involving the use of intangibles in connection with sales of goods or services

No comments.

4. Determining arm’s length prices for transactions involving the transfer of intangibles or rights in intangibles

D.4. 148 describes, in general, the calculation of cash flows. Please note that cash relevant expenses will be subtracted from revenue in order to arrive at the respective cash flow.

Paragraph D.4. 155 assumes similarly to D.2. 111, implies that projections for tax purposes are of lesser value than projections for business and/ investment purposes. This assumption should not be taken as a matter of fact, and if it remains what are the consequences for the acceptance of the projections results.
5. Illustrations

See comments to examples 18 to 22.

Example 1:

This is an approach which is followed by several tax authorities, and is reasonable based on certain circumstances.

However, it should be noted that there are certain instances where an arm’s length party with capital resources will outsource important functions relating to the development, enhancement and maintenance of intangibles. Our concern is that this example may lead the reader to believe that the party entitled to the intangible related returns must perform these important functions. However, there are numerous examples of arm’s length parties entering into arrangements, whereby a party provides the capital (and sometimes a high level idea), registers, monitors and defends the TM/patents; and thus own the economic and legal rights to the resulting intangibles. This draft document, in our opinion, diminishes the importance of the capital contributor in arm’s length dealings. Arm’s length transactions, whereby capital contributors assume the intangible related returns include:

- **Venture capitalists**, who supply cash to companies (with the ideas and personnel in place, but who lack the capital necessary to research, implement, and test their innovations);
- **Certain start-up businesses**, who sell ownership rights in exchange for capital (or services). This may not relate to a single intangible – but the concept is the same;
- **Publicly traded institutions** - on the same merits as the previous example. These entities are seeking capital from the equity markets in exchange for shares, and are thus offering the related profits from the enterprises intangible and tangible property (while this does not necessarily relate to intangibles exclusively, the situation here grants the capital provider intangible related returns for the provision of equity); and
- **Government agencies and select companies** worldwide offer grants to scientists, engineers and technicians, for which the payor exploits the intangibles developed and enjoys the “intangible related return.”

Section B, where this situation is discussed, offers numerous caveats like “depending on the facts and circumstances” and “part, or all, of the intangible related returns” (i.e. leaving room to offer a portion of the intangible related return to another party, rather than characterizing them as a “captive service provider”). Furthermore, we understand that the goal of the working party is to eliminate the potential abuse of highly liquid MNE lending money to an entity domiciled in a favorable tax jurisdiction, who then funds vital projects in other jurisdictions and consequently owns the intangibles; thus being entitled to the intangible related returns. We would all probably agree that this is an obvious sham transaction, and should be denied based on the facts and circumstances.
However, we suggest that the working party reconsider some of the language and modify the example, so that it does not lead a particular tax authority (and/or taxpayer) to believe that this guiding “rule”, supersedes the arm’s length principle, as it pertains to the outsourcing of research and development and marketing programmes which are vital to the company’s success. Similar to our position on the safe harbour, we believe that contradicting the arm’s length principle is not a suitable alternative when setting proper intercompany policies.

**Example 2:**

In this case, there is a lack of clarity with respect to the functions which company S is supposed to undertake based on limited risk relationship. A clear contractual arrangement fixing the respective obligations of the parties would have avoided this mismatch.

In all probability the risks concerning Product X have not been correctly evaluated at the time of the agreement, and thus lead Primero to the conclusion that Company S did not bear significant risks, which may explain why Company S was acting as a limited risk entity. A rebilling of the recall and product liability costs should be incurred by Primero. In addition the parties should consider documenting the terms of their arrangement.

**Example 3**

192. Although Company S’s marketing activities are completely controlled by Primair, when looking at comparable independent cases with similar agreement conditions (as Company S), but are under no control by Primair (as in Example 4), it can be generalized that it is reasonable to believe that a certain level of marketing activity will be needed to establish the R brand in that specific market (some minimum amount). Under such circumstances, if Company S is not under contract, with regard to the marketing activities provided for in 189 (if the contract was conditioned upon not receiving control over the marketing activities), then Company S would have incurred a certain level (some minimum amount) of marketing expenditures. Accordingly, the mark up should take place after the compensation (with regard to Company S’s marketing expenditure and risk) is deducted.

**Example 8**

212. Company S has an opportunity to benefit in the form of added value in certain areas when importing unbranded watches and undertaking secondary processing. With respect to this additional benefit, it should be considered whether the added value proportionately offsets the royalty. If the royalty is excessive, then the appropriate added value should be computed from comparable independent cases, and Company S should be compensated in the form of a reduced royalty.
Example 10

218. “…. hires its own R&D staff. The R&D centre reports …..” should be changed to “…. hires its own R&D staff. The Company S R&D centre reports …..”.

Example 11

224. As Company T bears the risk of future R&D, Company T should be entitled to a portion of the reward against the risk. Company T doesn’t maintain control, but bears the underlying risk.

Example 12:

Please include the alternative that the sales agreements (including a license to sell the products in Asia and Africa) are subscribed to the related distribution entities and Pirmani (not Company S). In such a case, if the goods are bought to a different entity than Pirmani, the distributors might pay for the: (i) price of the goods and a (ii) license fee.

Example 13:

Paragraph 230 ends as follows: “In conducting a transfer pricing analysis related to the amount to be paid by Company S to Ilcha, for the tangible assets transferred and the licensed right to use the intangibles in country B, the goodwill and ongoing concern value of the going business transferred to Company S should be taken into account”.

The example could be more explicit. Instead of saying “should be taken into account” it can state “should reduce such amount”.

Example 14:

Company S is not entitled to intangible related returns as it has not created any goodwill with respect to Product Y. Consequently an affirmative transfer pricing adjustment on the prices charged by Första would be appropriate.

Nevertheless, as it is a mere reinvoicing entity, Company S should also be reimbursed by Första for the advertising costs paid to the affiliated distribution companies.

Example 15:

Paragraph 238 states that “the full value of that business should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T”.
Nevertheless, it must be taken into account that “some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately” (paragraph 67). In our example, the sum of the value of the tangible and intangible assets transferred to Company S and the value of the tangible and intangible assets and workforce retained by Company T might be less than 100.

**Example 16:**

It should be mentioned that it can be really difficult to distinguish the portion of compensation corresponding to the services received from Zhu employees and those corresponding to Zhu’s proprietary software. Both forms of compensation should be calculated on an aggregate basis.

**Example 17:**

No comment.

**Example 18:**

(Paragraph 248) The granting by Osnovni of an exclusive and perpetual license to Company T for intangible rights related to the Company S products can be considered as a transfer of an intangible, rather than a grant or use.

(Paragraph 249) In some countries (e.g. Spain) the value attributed to intangibles in a purchase price allocation performed for accounting purposes is based upon the arm’s length principle. As a result, such an analysis should be considered for transfer pricing purposes.

**Example 19:**

The figures and the explanation of this example are really clear. Other examples should also make us of numerical data, as it helps exemplify the issue.

**Example 20:**

This is an excellent example for Tax Authorities that attempt to review (inflate) market value during extraordinary periods.

**Examples 21:**

In this case it is also clear that the contract was not negotiated under the arm’s length principle, as it did not offer an annual review clause based upon the uncertainty of the intangible.
Example 22:

This illustrates the same fundamental flaw as described in example 21.

True Partners Consulting LLC and its affiliates assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader’s particular situation. This memorandum is a summary discussion and is limited to the described facts. The conclusions and recommendations contained in this memorandum are based on our understanding of the facts, assumptions, information, and documents referenced herein and current tax laws and published tax authorities in effect as of the date of this memorandum, all of which are subject to change. If the facts and assumptions are incorrect or change or if the relevant tax laws change, the conclusions and recommendations would likewise be subject to change. True Partners Consulting LLC assumes no obligation to update the memorandum for any future changes in tax law, regulations, or other interpretations and does not intend to do so. Only the specific tax issues and tax consequences described herein are covered by this memorandum, and any other federal, state, or local laws of any kind are expressly outside the scope of this memorandum.

We are required by regulation to inform you that any tax advice contained in this communication (or in any attachment) is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of: (i) avoiding U.S. federal, state, or local tax penalties or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed in this communication (or any attachment).
September 14, 2012

VIA EMAIL AND REGULAR MAIL

Mr. Joseph L. Andrus  
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France  
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Re: Comments on Proposed Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines / Comments on OECD Draft on Timing Issues Relating to Transfer Pricing

Dear Mr. Andrus:

On June 6, 2012, the OECD’s Working Party 6 issued an interim draft (the “Discussion Draft”). USCIB appreciates the willingness of the OECD to release the interim draft and schedule another public consultation. This commitment to working with business and other interested parties will enhance the value of the final product for all concerned.

USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and regulatory coherence. Its members include U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

General Comments

We understand that the Discussion Draft is a work in progress and that the document is not a consensus document. There is much in the document that USCIB agrees with. We welcome, for example, the recognition that the principles of Chapters I through III apply equally to transactions involving intangibles; the recognition that it is

1 Discussion Draft paragraph 3.
important to identify the relevant intangibles with some specificity; and the recognition that the principles of Chapter VI apply exclusively for transfer pricing purposes.

In particular, we commend the acknowledgement in paragraph 12 of the Discussion Draft that the manner in which a transaction is characterized for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subject to withholding tax under Article 12. Accordingly, we suggest that the final draft contain a further clarifying statement that the classification distinctions which currently exist in the Article 12 Commentary are not affected by this project. We do note, however, that many transactions in non-tangible goods which give rise to business profits under the Article 12 Commentary should not be regarded as transactions in intangibles for transfer pricing purposes. For example, we note that cases involving user transactions in software, digital goods and similar products should not be treated for transfer pricing purposes as payments made in remuneration for intangibles, even though there may be no physical component of the transaction.

Items Not Addressed by the Discussion Draft

While USCIB appreciates the ability to comment on this Discussion Draft, one difficulty that we face is that it is hard to evaluate how these rules will operate in practice given the number of important topics that are not currently addressed. These topics include the treatment of location savings, market specific advantages and cost contribution arrangements. We are providing comments on certain of these topics and look forward to the opportunity to offer additional comments during WP6’s continuing consideration of these and other topics.

With respect to location savings and market specific advantages, there can be no doubt that there are different returns to different functions and transactions in different geographical locations. The world does not encompass a single seamless global market. A variety of factors, including political boundaries, result in different returns in different markets. Low wages (or other location savings or dis-savings) should be taken into account in determining the arm’s length price; however, low wages in and of themselves do not lead to higher profits because competitive pressures will generally lower profitability margins by passing those cost savings on to consumers. The issue of appropriate prices or returns in any particular jurisdiction is entirely an empirical issue. Therefore, it must be determined by observation. That is, if a multi-national enterprise, operating at arm’s length, can expect a higher return in one geographic area compared to another (whether due to location savings or other market specific advantages) this will be reflected in the results derived from proper functional analysis and proper use of

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2 Discussion Draft paragraph 11.
3 Discussion Draft paragraphs 12 and 52.
4 Discussion Draft box on page 3.
appropriate transfer pricing methods. In many cases there will be local market comparables available from the operations of local independent enterprises. If so, location (or market) specific savings or dis-savings should be allocated between the controlled parties based on comparison to arm’s length transactions. In some cases the savings (or dis-savings) will be allocated to the local market participant, in other cases to the non-local market participant and in still other cases they will be shared. Thus, we believe there is no need for special guidance on location savings or market specific advantages in Chapter VI. If, however, guidance is deemed necessary, it should make clear that there is no per se rule that “excess” profits due to local market conditions automatically accrue to an affiliate conducting business in that country (or vice versa).

With respect to cost contribution arrangements, the rules contained in the Discussion Draft and the existing rules under Chapter VIII of the Transfer Pricing Guidelines on cost contribution arrangements are potentially inconsistent. The box on page 12 of the Discussion Draft provides: “neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within the MNE group to retain the benefits or returns with respect to intangibles without more.” Clearly, CCAs permit a participant in such an arrangement to earn a return based on funding the development of intangible property. USCIB also believes this answer is correct. Cost contribution arrangements exist in arm’s length business dealings between unrelated parties and the results of such arrangements in controlled party situations should continue to be recognized as long as the arrangements met the criteria set forth in Chapter VIII and the domestic rules of the countries involved. Further, as discussed below in the context of paragraph 40 of the Discussion Draft, ownership and financing may be entitled to a risk related return outside of a CCA and whether that ownership and financing is considered an “intangible related return” or not the risk associated with ownership and financing should be properly taken into account.

General Comments on Section A

Transfer pricing rules are administered in the first instance by multi-national enterprises in setting prices for transactions. The results of those transactions are then examined by tax authorities. Although the Transfer Pricing Guidelines are primarily intended for use by tax authorities in MAP proceedings, the Guidelines are also used by taxpayers as a reference point for establishing arm’s length prices (or determining arm’s length profits). Therefore, vagueness in concept or definition should be avoided in order

5 The OECD Transfer Pricing Guidelines, hereinafter the Guidelines or TPG.
6 This Discussion Draft may also be inconsistent with the US regulations on cost sharing.
7 Example 11 of the Discussion Draft illustrates this rule. Although there is no CCA in example 11, we are concerned that the failure to recognize the return to financing implies that Company T is not entitled to a risk-based return, whether labeled an “intangible related return” or something else.
to provide clear guidance to both taxpayers and tax authorities about what is expected for arm’s length pricing.

In our view, there are two categories of intangible property: owned intangible property and controlled intangible property. Intangible property that is owned or controlled by a taxpayer may be transferred independently and therefore is the appropriate subject of the TPG. Business attributes or notions\(^8\) cannot be transferred apart from the whole line of business with respect to which the attributes or notions relate. Thus, business attributes or notions such as, for example, goodwill, going concern value and workforce in place, should be excluded from application of the TPG unless transferred as part of a transfer of a group of assets constituting a business to which such business attributes or notions would attach. Defining an intangible as a “something” that has commercial value is too vague and subjective as the definition allows a taxing authority to create an intangible for purposes of asserting additional tax where no such intangible asset may exist by using a valuation method that creates an unidentified residual profit that is deemed to be the “commercial” value of the “something”, which in turn becomes the “intangible”.

**Intangibles and profit based methods -- The mere presence of excess profit should not define the existence of an intangible**

In many cases, “excess profit” occurs as the result of bearing risk. A large and often the greatest part of the profit or loss allocable to an entrepreneur may be attributable to its assumption of business risk. Risk is not an intangible. Rather, risk is a consequence of owning an asset or managing a function over time. The Transfer Pricing Guidelines recognize and provide for the appropriate treatment of risk in a number of places. “The assumption of increased risk would also be compensated by an increase in the expected return, although the actual return may or may not increase depending on the degree to which the risks are actually realized.”\(^9\) Further, Chapter IX of the Transfer Pricing Guidelines goes into great detail concerning the nature of risk and the return to risk. Chapter VI seems to downplay the importance of risk in determining the appropriate return. Although risk is mentioned at various points in the Discussion Draft, the critical nature of risk is not recognized. At arm’s length parties can

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\(^8\) Transfer Pricing and Intangibles: Scope of the OECD Project: D.3(iv) paragraph 19. We use this term in our letter only because this term was used in the scoping document for this project. We continue to use this term because the Discussion Draft subdivides business attributes and notions into those that are considered intangibles and those that are not. The elements categorized as “business attributes and notions” normally do not constitute property, and as such cannot themselves be transferred in a controlled transaction other than as part of the transfer of an entire line of business in which these attributes or notions reflect the residual value of that business. We caution that the use of the term should not suggest that such “attributes or notions” constitute protected intangible property.

\(^9\) TPG Chapter I, paragraph 1.45, Part I: Special Considerations for Risk.
earn high returns (or losses) for taking risks. The Guidelines already recognize that risk taking is itself a “function” or comparability factor. The Discussion Draft needs to clarify that profits (or losses) due to the bearing of entrepreneurial risks are not to be treated as excess profits due to the presence of vaguely defined intangibles.

The Discussion Draft recognizes that certain market characteristics (such as disposable income in a specific market or the size or relative competitiveness of the market\(^\text{10}\)) that cannot be owned or controlled should not be treated as intangibles. USCIB agrees with this conclusion. In this regard, the Discussion Draft should emphasize that careful analysis needs to be undertaken to ascertain why excess profits are being created. If excess profits arise as a result of exploiting favorable market conditions, such excess profits should not be deemed to be intangible related return and the party entitled to that return should be determined based on the functional analysis rather than merely being allocated to the one or the other party.

Specific Comments on Section A

Paragraph 3 of the Discussion Draft should reference Chapters VIII and IX of the Guidelines as well as Chapters I, II and III.

Paragraph 4 of the Discussion Draft should be revised to clarify that the analytical steps set forth in parts (i) through (iv) of that paragraph should proceed in the order written. That is, an intangible asset should be identified as a first step. Determination of the arm’s length consideration for the transfer or use of an intangible should only occur after the intangible has been identified, the parties that are entitled to the return attributable to the intangible have been identified and the type of controlled transaction at issue has been identified. In this vein, we have seen many instances where vaguely defined classes of “intangibles” have been identified as existing due to the creation of expected income using formulaic applications of valuation methodologies. In addition, there are many cases where intangibles (especially marketing intangibles) have been deemed to exist solely because certain levels of marketing or R&D expenditures have been exceeded. We disagree with both of these positions.

Paragraph 5 of the Discussion Draft should be revised to define an “intangible” as an asset- not a “something”-, which is not a physical asset or a financial asset, and which is capable of being owned or controlled and transferred for use in commercial activities. An intangible asset will usually be subject to legal protection to exclude non-owners or non-permissive users from exploiting that asset. Because ways of doing business and intellectual property laws are constantly evolving, accounting and legal descriptions of existing intangible assets should not be controlling for purposes of determining the existence of an intangible. Nevertheless, to provide clarity and a

\(^{10}\) Discussion Draft paragraph 8.
framework for analysis, legal and accounting definitions of intangible assets should normally be the reference point for defining what constitutes an intangible.

USCIB generally agrees with the principles of paragraph 6 of the Discussion Draft. Whether an expenditure is treated for accounting purposes as creating an asset recognized on a balance sheet is not controlling for purposes of determining whether an intangible asset exists, or what the value of that asset may be. This is why we think the Discussion Draft should refer to accounting concepts and legal concepts to determine whether an intangible asset exists. However, the fact that an expenditure (such as R&D) may not lead to the recognition of a balance sheet asset does not imply the reverse conclusion is true (that every expenditure must create an intangible asset). For example, there should be no implication that marketing expenditures (such as advertising) beyond some defined level of turnover automatically results in a valuable marketing intangible belonging to the party incurring the expenditure. This principle is enunciated in paragraph 10; USCIB is concerned, however, that the Discussion Draft does not follow it in all cases. Whether such a marketing intangible exists, who the owner of that intangible is and what compensation is required as a result of owning or exploiting the intangible should be determined based on the general principles set forth in other parts of the Discussion Draft not merely the level of expenditure incurred.

USCIB is concerned with the principles enunciated in paragraph 7 of the Discussion Draft. We think that chapter VI rightly should only deal with assets that are separately transferrable. As developed below, we recognize that there are certain business attributes (e.g. “goodwill”) that may be effectively transferred as part of a transfer of a line of business but that are not separately transferrable. We think such business attributes are sufficiently different from what are we commonly described as “intangible Assets” that they should be dealt with in the context of “business restructurings” rather than in Chapter VI. Further, it would be a rare case where an

11 See Discussion Draft, paragraph 197, example 5 which seems to rely exclusively on the level of marketing expenditures to justify an intangible related return.

12 The Discussion Draft seems somewhat inconsistent if the approach on marketing expenditures is compared and contrasted with the box before section B. That is, with respect to marketing the Discussion Draft seems to take the position that funding marketing, especially at high levels, results in the creation of a marketing intangible and the entitlement to “intangible related returns.” Nevertheless, the language in the box states that “neither legal ownership nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.” The correct answer in both cases is that entities that have capital at risk should have an opportunity to earn a return that reflects that risk. The return may not materialize because of business inefficiencies or risk being realized, but the opportunity for such risk related return should be recognized. The return may not be an “intangible related return” because capital is a financial asset, but investors decide to invest based on their risk tolerance and the expected return from the investment. That is, investors will only make risky investment if the potential return is commensurate with the risk.
intangible would exist when the asset does not have legal protection and where the asset is not transferrable separately. For example, under US law (the Lanham Act), a trademark cannot be transferred separately from the goodwill of the business associated with the trademark. Nevertheless, trademark rights can be licensed separately and the owner of the trademark can seek legal redress to exclude others from exploiting the trademark. We have grave concerns about recognizing a “something” as an intangible asset that is not subject to being transferred separately (or with goodwill) and that does not enjoy some level of legal protection.

USCIB agrees with the principles of paragraph 8 of the Discussion Draft. We agree that market conditions that are not capable of being owned, controlled or transferred should not be treated as an intangible. We think that beyond what is written, the Discussion Draft should specify that if there are additional profits attributable to local market conditions, those profits should be earned by the parties to a controlled transaction based on evidence of how uncontrolled parties acting at arm’s length divide the profits attributable to local market conditions. There should be no per se rule that “excess” profits due to local market conditions automatically accrue to an affiliate conducting business in that country (or vice versa).

USCIB generally agrees with the conclusion of paragraph 13 of the Discussion Draft that “labels” attached to various types of intangibles should not be controlling for transfer pricing purposes. However, we think this paragraph should make clear that categorization of an intangible for another purpose may be relevant for purposes of a transfer pricing analysis. For example, when either a TNMM or a residual profit split method is used to test the profits of a Taxpayer, it does matter whether some or all of the Taxpayer’s intangible assets are classified as “routine” intangibles. In this instance, the term “routine” is used to signify that the method used (TNMM or the first step of a residual profit split) has already taken the return for the intangible into account. Similarly, all other things being equal, the arm’s length return attributable to an expired patent or an enforceable patent for a successful pharmaceutical product would not be expected to be the same, so that it matters whether rights in a particular type of intellectual property are classified as “enforceable” or not.

Section A.4 of the Discussion Draft sets forth a number of examples that USCIB thinks are generally helpful. We recommend that the OECD follow the approach set forth in section 936 (h) of the Internal Revenue Code, which enumerates a long list of items normally classified as an intangible asset followed by a “catch-all” category of unidentified items that derive value from intellectual content independent of services of any individual. While we are sensitive to concerns over having an exclusive list of types of assets that are classified as an intangible, we are also sensitive to the disputes that

13 In section D of this letter we discuss the importance of characterizing a given intangible as “routine” or “non-routine” for purposes of valuing and pricing the transfer of the intangible.
would arise if there was no common consensus of what types of assets are generally considered to be intangible assets.

USCIB thinks that paragraphs 17 and 18 of the Discussion Draft, concerning trademarks, brands and trade names, as written, and in particular the examples, over simplifies the analysis of trademarks and similar types of marketing intangibles as compared to the more nuanced analyses set forth in the current Transfer Pricing Guidelines at Paragraphs 6.10- 6.12 and 6.36.

Under US and English common law, trademarks are closely associated with goodwill and the legal protection afforded this type of intellectual property serves a different purpose than legal protection afforded other types of intellectual property. Trademarks were historically provided legal protection primarily to protect the consumer of the product or service to which the mark was attached or attributed. Therefore, whether the owner of the trademark exercised control over the quality of the trademarked good or service has typically been critical to the protection of the legal rights of the trademark owner. It is not correct (at least under US or English common law) that a trademark becomes enforceable merely through a registration process. Courts generally recognize that trademark value accrues as a result of multiple factors including consistent product quality, advertising and marketing, packaging, customer service and other factors. Our concern is that the draft seems to dispense with this nuanced approach that has developed over many years in favor of examining a few factors, such as the level of marketing expenditures.\textsuperscript{14}

A trade name may be closely associated with an accepted trademark and may be valuable. However, one would not normally expect that a royalty should be paid merely for incorporating a subsidiary of a company with a well known trade name. Absent close association with a trademarked good or service, we would not normally expect that a trade name standing alone would be considered a compensable intangible.

We also have concerns over treating a Brand as an intangible apart from the trademarks attached to a product or service or the goodwill attributable to the business in which the brand is used.

USCIB agrees with paragraph 20 of the Discussion Draft that licenses may be intangibles. We believe, however, that the analysis is not sufficiently clear. Consistent with the general rule that the legal form of a transaction that has economic substance is given effect for tax purposes, it is appropriate to recognize that a licensee has an intangible asset (that is, the license) consisting of the rights that are embodied in the

\textsuperscript{14} In particular, the examples illustrating section B seem to focus exclusively on the level of marketing expenditures for purposes of determining the party entitled to the intangible related return.
license—assuming that the license is assignable. We also think it is appropriate for tax authorities to analyze the rights and obligations of the licensor and licensee as part of a comparability analysis for purposes of determining the appropriate arm’s length return of the licensee, as well as for purposes of determining the arm’s length consideration to be paid to the licensor. However, paragraph 20 of the Discussion Draft should be clarified to provide that transactions which do not grant the licensee material market exploitation rights normally should not be regarded as a license of intangible property for purposes of the TPG. For example, a user agreement which allows the use of a copy of software or other content, without the right to copy and distribute to the public such software or content, should not be regarded as a transfer of intangibles for purposes of the TPG.15

USCIB thinks the Discussion Draft needs to distinguish between situations where identifiable intangible assets, which are capable of valuation, are transferred and those situations where entire businesses or lines of business are transferred. We agree that goodwill and ongoing concern value may be transferred as part of the transfer of an entire business or line of business and those cases are appropriately handled under Chapter IX. However, goodwill and ongoing concern value are not normally transferrable separately or afforded legal protection as separate assets. Indeed, they are more nearly analogous to those background conditions that may affect arm’s length pricing (such as market conditions described in paragraph 8 of the Discussion Draft) but are not intangibles for purposes of Chapter VI as they are not separately owned, controlled or transferable. Consequently, as set forth in detail in our comment letter of September 26, 2011, goodwill and ongoing concern value should not be considered to be intangible property for purposes of a transfer pricing analysis. Thus, we disagree with the treatment of goodwill and ongoing concern value set forth in paragraphs 21 and 22 of the Discussion Draft. As previously noted, we believe these “business notions and attributes” need only be dealt with in Chapter IX.

Further, the discussion in paragraphs 21 and 22 reveal that goodwill and ongoing concern value are different in kind from the intangible assets that are the proper subject of Chapter VI. Paragraph 11 establishes the reasonable expectation that it is possible “to identify the relevant intangibles with some specificity…it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions.” Yet the discussion in paragraphs 21 and 22 acknowledges that this reasonable goal is unobtainable in this context. Paragraph 22 provides “[i]t is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes.” Paragraph 21 sets forth four different possible meanings for goodwill and ongoing concern value; this seems to USCIB to be a perfect example of vaguely specified or undifferentiated intangibles. Potential administrative difficulties aside, the lack of precision in this definition reveals that goodwill and ongoing concern value are different in kind from conventional intangible property that is the proper subject of Chapter VI. We suggest that this imprecision is a direct result of the terms “goodwill” and “ongoing concern value”

15 Extracted from OECD Model Tax Convention 2008, COMMENTARY ON ARTICLE 12.
referencing a variety of ill-defined “business notions and attributes” that, by their nature, are not separately identifiable, let alone commercially transferable in the ordinary course of business. The lax definition proposed by the Discussion Draft would permit tax authorities to label any excess return as goodwill or ongoing concern value and subject the transaction to review under Chapter VI. This is not appropriate.

In the situation in which an entire business or line of business is transferred, common accounting valuation methods classify the excess of the purchase price of an entire business over the sum of the value of identifiable assets as being paid for goodwill or ongoing concern value. Goodwill is the expectation of future business, which expectation may not be realized. For this reason, accounting rules generally require re-evaluation of goodwill and allow for the writing down of goodwill (impairment) when the expectation of future business is not realized. Consistent with the principle that transactions with economic substance should be recognized for tax purposes as structured, we do not think that specific transfers of intangible assets should be treated as “akin to a sale” of all or part of a business (thereby transferring goodwill) if the transactions was not structured as a sale of the business.

USCIB agrees with the conclusions paragraphs 23 and 24 of the Discussion Draft that synergies and market specific characteristics should not be classified as intangible assets. We think that these items, if they exist, should be treated as items to be taken into account in a comparability analysis.

USCIB also thinks that the OECD ought to clarify that “profit potential” or the “expectation of future profit” is not an intangible. Like synergies and market specific characteristics, “profit potential” is not something that can be owned or controlled. Certainly identified assets, including real intangibles such as customer lists, can create a potential for profit; however, that potential would be reflected in the value of those assets. Profit potential does not exist separate and apart from the things that create the potential profit. Further, if the contrary view were to be adopted, such a position would virtually ensure double taxation. If the “potential profit” is currently taxed, then how is the actual profit taxed when realized? What if the “potential profit” turns out not to exist?

USCIB believes that paragraphs 25 and 26 of the Discussion Draft are deliberately ambiguous concerning whether assembled workforce is an intangible asset. USCIB does not think that a long term contract to supply the services of assembled workforce can (or should) be classified as an intangible asset. The value of an assembled workforce is realized through the performance of services. Thus, the question of arm’s length consideration for the “use” of an assembled workforce should be determined through analysis of arm’s length charge paid for the services performed.

16 See TPG, Chapter IX, paragraph 9.65 provides “[a]n independent enterprise does not necessarily receive compensation when a change in business arrangements results in a reduction in its profit potential or expected future profits. The arm’s length principle does not require compensation for a mere decrease in the expectation of an entity’s future profits.”
by the workforce. Moreover, an assembled workforce is rarely “transferred” other than in the context of the sale of a business.

Nor do we think that the transfer or secondment of individual employees should be treated as a transfer of an intangible, such as know-how. Determining whether a transferred employee or group or employees was “taking with her or them” any trade secrets or unique knowledge to the new employer would require a degree of intrusiveness in a tax examination that we think is unadministrable. Moreover, we think that both the transferring and receiving businesses receive real benefits through international employee assignment programs, but the benefits of these programs are difficult to measure.

**Specific Comments on Section B**

USCIB initially responds to the comments in the “box” preceding Section B, paragraph 27 which states:

*Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more. This view is consistent with other sections of the Guidelines and does not reflect an intention to depart from the principles of Article 9.*

USCIB agrees that legally cognizable ownership rights are not always necessary to create a commercially transferrable intangible asset. However, we believe that legal ownership is a significant factor in applying the arm’s length standard to any cross-border transfer of an interest in an intangible. Just as legal ownership is a fundamental premise in determining what a charge for the use/sale of intangible property should be between unrelated parties, so too should legal ownership be the starting point in determining the arm’s length charge among related parties.

USCIB agrees with the result of Example 3 that the Subsidiary S does not earn intangible related returns from marketing since it does not bear risk of intangible development despite it performing some routine marketing functions. This is also consistent with our view that the parties that legally own and fund the development of any intangible (see comments on CCA above and paragraph 40 below) are entitled to a return that reflects the risk associated with the funding activity associated with the intangible development.

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17 Paragraph 30 of the Discussion Draft provides that “legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns.”
With regard to the second paragraph of the “box” which provides:

*This approach could be expressed in different ways in the Guidelines. As drafted, Section B., below, identifies a concept of intangible related returns and suggests that such returns should follow the contributions to the value of the intangibles. The same approach could perhaps also be described without reference to a concept of intangible related returns, by requiring the compensation of the various functions, assets and risks of the MNE members to be consistent with the intangible value they create.*

USCIB thinks it is unnecessary for WP6 to create a special term for an arm's length price for intangibles as opposed to other intercompany transactions. This is particularly true given the Discussion Draft provides that Guidelines definition of the term intangible has no meaning outside of the Article 9 context. As developed further below particularly in the context of the discussion of paragraph 40, USCIB thinks that the new label can actually be a source of confusion and ambiguity. Instead, the use of the term of “arm's length price”, “royalty”, “license fee” etc. should be sufficient.

With regard to the third and last paragraph in the “box” which provides as follows:

*Business is requested to comment as to whether the formulation contained in section B. successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks.*

USCIB will provide specific comments to the paragraphs in Section B. Generally, we think the economic principles are inadequately communicated with regard to the residual value of an overall business operation and how that portion, if any, should be associated with intangibles which are incapable of being moved or separated from a business operation in the context of determining an arm's length charge for transfer pricing purposes. For example, it is important to recognize that in many cases residual value (or loss) may be attributable to the legal owner of the intangible that bears the risk of financing the intangible. We believe the current draft will devolve in some cases to a de facto formulary apportionment where one country argues for a share of synergistic values based on allocation of the intangibles it has created in whole or part if a new standard is created that does not rely on legal ownership and the risks borne by the legal owner.

The principles¹⁸ of paragraph 27 of the Discussion Draft could be alternatively captured by recognizing that a related party may license the use of intangible property

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¹⁸ The party or parties entitled to an intangible related return must be identified and such identification should be based on an analysis of the relevant facts and circumstances.
and may, depending on the facts and circumstances, be entitled to some level of intangible related returns with respect to its use of the licensed property. In this regard, many of the watch examples could be rephrased depending on whether the distributing subsidiary licensed the rights to market the Brand R watches and undertook functions consistent with that license or whether it agreed to provide services to distribute the watches.

Paragraph 28 defines the intangible related return as the economic return from business operations involving the use of that intangible after deducting the costs and expenses and returns to business functions other than the intangible in question. Thus, the Discussion Draft seems to suggest that a residual profit split may be required to calculate the intangible related returns to the intangible owner. USCIB thinks a residual profit split may not always be required and thus a requirement to determine returns to other functions may be unnecessary and administratively excessive. The starting point in determining the economic return from intangibles ought to be a functional analysis and a search for comparables. It is our view that the Discussion Draft is too focused on the exceptional case, where comparables are not available and some form of residual analysis/profit split may be required. However, in many cases transfer pricing of intangibles does not require this type of analysis. The Discussion Draft ought to be redrafted to eliminate this bias.

In addition, the definition in paragraph 28 is particularly susceptible to the blurring of economic return attributable to the presence of the intangible and the bearing of entrepreneurial risk, as discussed above. Working Party 6 should establish non-financial business criteria derived from a functional profile to differentiate between these two sources of economic return.

With regard to paragraph 29, USCIB agrees that MNEs should reasonably document their intercompany transactions including executing license agreements and contracts consistent with the intentions of the related parties. USCIB cautions that the level of intercompany agreements should not mirror that of an unrelated parties as the arm's length standard does not require MNEs to mimic unrelated party behavior. Paragraph 29 should be expanded to explain that a user of intangible property, a licensee, may not always be entitled to all intangible related returns due to maintenance or enhancement of licensed intangible property. For example, it is common practice among unrelated parties that derivative works accrue to the licensor.

Regarding paragraph 30, tax administrations should not require review of internal emails regarding the use of intangibles if more formal intercompany agreements exist, absent some evidence that the terms of the intercompany agreement are not being honored.

Regarding paragraph 34 USCIB reiterates that the level of intercompany documentation to convey intangible rights among related parties should not be as detailed as may occur among unrelated parties.
USCIB agrees\(^{19}\) that the conduct of the parties should align with the parties’ form and that tax administrations should respect such transactions under these circumstances. USCIB is concerned that tax administrations that lack actual business experience will improperly substitute their judgments about what an unrelated party might do under broadly comparable circumstances. For example, a licensee may undertake short term functions which lead to short term losses in order to push its licensed property for longer term gains. In this regard, the Discussion Draft should provide that testing the intangible related returns over the life of the intangible property may be required.

USCIB is concerned that the conduct of the parties can be misconstrued by tax administrations to overrule the legal agreements of the parties. There is not sufficient guidance to demonstrate that performing day-to-day activities is not sufficient to entitle the entity performing such day-to-day activities to intangible related returns in contravention of the parties’ legal agreement. Paragraph 38 should include a statement to the effect that “if intangibles are not transferred but are allowed to be used in a commercial transaction, the fact that maintenance, enhancement (e.g., a derivative work) or protection of the intangible property occurs does not otherwise create a right to intangible related returns to the party performing such incidental functions.” Guidance as to the definition of “incidental functions” should also be provided.

With regard to paragraph 40, USCIB is concerned that the lack of specificity about what are the “important” functions that should be performed by the owner/licensor of intangible property will lead to unnecessary controversy. USCIB believes that if the owner/licensor of the intangible property engages in the key entrepreneurial risk taking activities with respect to the intangible that ought to be enough to support that person earning the intangible related return. USCIB believes that more examples of the range of acceptable management of important functions are required and to this end provides the following chart:

<table>
<thead>
<tr>
<th>Intangible development</th>
<th>Outsourced functions</th>
<th>“Important” functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patenable or copyrighted products</td>
<td>Various levels of research and development among related and unrelated parties</td>
<td>1. Determine strategy to develop one or more patenable or copyrighted products; 2. Make periodic decisions regarding the continued funding of such intangibles; 3. Bear costs in whole or in part to fund the research and development 4. Manage potential returns on investment for such products throughout the group</td>
</tr>
<tr>
<td>Marketing intangibles</td>
<td>Design of creative aspects of trademark related (“brand”) intangibles</td>
<td>1. Determine need for marketing campaign; 2. Design of overall execution strategy; 3. Bear costs in whole or part to undertake development or refinement of marketing intangible</td>
</tr>
</tbody>
</table>

\(^{19}\) Discussion Draft paragraph 37 provides “it is important to examine whether the conduct of the parties is in alignment with the terms of the legal registrations and contracts”.

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Further, the role of financing is unclear in paragraph 40 nor is it clarified by the language in the box on page 12 of the discussion draft. Paragraph 40 is subject to at least two potential interpretations. The first interpretation is that the party that bears financial risk with respect to the development or exploitation of an intangible asset is not entitled to share in the potential upside (or downside) risk associated with the intangible asset. Presumably, there would be some return to financing but it could not be associated with the success or failure of commercial exploitation of the intangible asset. The second interpretation is that the party that bears financial risk with respect to the development or exploitation of an intangible asset is entitled to share in the potential upside (or downside) risk associated with the intangible asset, however, that return is not considered an “intangible related return” because the financial contribution, whether debt or equity, is not an intangible and therefore is not entitled to the “intangible related return.”

USCIB believes that the first interpretation is inconsistent with current OECD principles (it does not properly account for risk) and US law. Transfer pricing principles do not restrict the manner in which taxpayers carry out their business. They may move functions and assign risks as they deem appropriate. Transfer pricing only requires that parties compensate related parties at arm’s length for assets and services provided. The first interpretation would effectively restrict the financing party to receiving a non-risk weighted debt-like return. Such a restriction would be inconsistent with the right of the parties to structure transactions as they see fit provided they clearly reflect income. Financing business ventures can be risky and taking on that risk ought to be appropriately rewarded, assuming the business is successful.

USCIB believes the second interpretation would be consistent with OECD principles because it would permit taxpayers to structure their transactions as they deem appropriate and properly take that structure into account in determining the arm’s length price. In order to eliminate this ambiguity, the language of paragraph 40 and the box on page 12 of the Discussion Draft ought to be clarified.

USCIB also believes that some part of the confusion on this issue stems from the language “bears the cost of intangible development”. There may be several ways that an entity could “bear the costs of intangible development” and depending on how the transaction is structured, the results could vary significantly for transfer pricing purposes. One way to “bear the costs” would be equity fund the entity developing the intangible. A second way would be lend funds to that entity either on a recourse or non-recourse basis. A third way would be to participate in a CCA. A fourth way would be to reimburse the entity for costs associated with the development in exchange for an ownership interest in the resulting intangibles. More clarification is required about the meaning of “bear the costs”.

Equity funding the entity developing the intangible obviously does not create transfer pricing issues. The other three methods clearly do. The OECD’s TPG guidelines do not provide special rules for debt instruments, but under the general
principles of determining the arm’s length price (in this case interest rate), the risk associated with the transaction ought to be taken into account. If the taxpayer lends money to an entity developing intangibles, and that loan will only be paid back if the development effort is successful shouldn’t that risk factor be taken into account in determining the appropriate interest rate?

Paragraph 47 should be clarified. USCIB would agree that the financial capacity to bear risk is a necessary but not a sufficient condition for an entity to earn intangible related returns. USCIB would suggest that the revised Discussion Draft note that the provision of financing may be the key to the development of new intangibles to which a residual profit or loss should be ascribed. USCIB would presume that the entity providing the financing would also be the legal owner of the intangible property. USCIB would add that the management of such risk as described in Chapter IX paragraphs 9.23 through 9.26 is also required. USCIB would further add that a licensee that bears costs (e.g., performs services) that are otherwise reimbursed at arm’s length is not entitled to intangible related returns other than those provided by the intercompany agreement.

USCIB generally agrees with the principles of paragraph 48. USCIB thinks it should be clarified that there is not necessarily a relationship between how much activity occurs and the relative intangible related returns. One entity could perform numerous routine maintenance and indirect activities that enhance the intangible and still not be entitled to more than a routine return.

Regarding paragraph 49, further guidance should be provided whether trademarks licensed into a particular market require intangible related returns when such trademark or related intangible has no initial market recognition.

USCIB believes that paragraph 52 requires further elaboration to avoid potential confusion and unnecessary controversy. A contract research and development entity may not be entitled to intangible related returns if it follows the terms of the intercompany agreement and bears no risk of loss associated with the intangible development. Similarly, a contract manufacturer that improves yield through process improvements may not be entitled to intangible related returns as such improvements may have also been expected and obtainable from third party contract manufacturers. Specifically, USCIB recommends that derivative works created by a licensee be explicitly noted as not being entitled to intangible related returns.

USCIB agrees with paragraph 53 of the Discussion Draft that in the extraordinary circumstances described in paragraphs 1.64 – 1.69, contractual allocations of entitlement to intangible related returns may be disregarded by tax authorities.

Consistent with our view of paragraph 40 of the Discussion Draft, USCIB suggests that paragraph 54 be modified by deleting the words “perform and”.

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USCIB would modify the principles of paragraph 55 to make transfer pricing adjustments to comport with the parties legal agreements. Thus, if an entity performs important functions associated with the defense of an intangible, the costs of that party should be reimbursed through a transfer pricing adjustment rather than through the allocation of intangible related returns to the party performing such functions. The “conduct” standard in the Discussion Draft can just as easily be viewed as requiring the parties to ensure that related party transactions be compensated at arm’s length per the terms of the legal agreement. If a related party fails to make such charge for whatever reason, this should not lead to the conclusion that the parties' legal agreements should be disregarded or materially altered. Rather the proper response is to require the arm’s length charge as per the agreement.

USCIB would comment that the OECD discussion draft is at odds with the US transfer pricing regulations under section 482. Section 482 explicitly excludes “value” for intangible property that is substantially dependent on the performance of services of any individual. Thus a substantial portion of goodwill and going concern and workforce-in-place may be excluded from the value that could be attributable to other intangibles as described in Section C of the Discussion Draft. USCIB believes that the US position on this point is correct and encourages WP6 to endorse that position.

Comments on Section C

USCIB agrees with the principles set forth in paragraphs 66 and 67. However, the Discussion draft provides very little guidance on when it is appropriate to aggregate intangibles or when intangibles are so intertwined that it is not possible to transfer one without the other. More guidance on when aggregation is appropriate or required is needed. The appropriate level of aggregation may depend on the transfer pricing method that is selected. Methods based on comparable transactions typically do not lend themselves to aggregation since pricing is explicitly or implicitly done at the

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20 Section 1.482-4(b) Definition of intangible. – For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual--

1. Patents, inventions, formulae, processes, designs, patterns, or know-how;
2. Copyrights and literary, musical, or artistic compositions;
3. Trademarks, trade names, or brand names;
4. Franchises, licenses, or contracts;
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
6. Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties
Transfer pricing methods based on comparable functions lend themselves to a moderate level of aggregation simply because it is functions rather than transactions that are being benchmarked. Transfer pricing methods that involve discounting projected income to present value are most compatible with a high level of aggregation since these methods simply look to value of cash flow generated by a business as a whole.

**General Comments on Section D**

The discussion draft requires a two-sided functional analysis. In many cases, the use of a two-sided financial analysis is unnecessary. USCIB is concerned that even though methods other than profit split are provided for, the conditions for their application and the two-sided analysis will encourage tax authorities to overuse a profit-split method. For example, the comparability requirements for CUTs are extremely strict. Therefore it is unlikely that taxpayers would be able to prove the existence of a CUT. Similarly, although the discussion draft provides that financial valuation techniques may be used when there is no CUT, the restrictions on the use of such methods may make them extremely difficult to use in practice, encouraging tax authorities to employ a profit split method. Routine reliance on profit split methods will make compliance extremely difficult. In order to ensure that the profit is split in a way that does not give an answer that is greater than 100% of the total profit, taxpayers are likely to rely increasingly on competent authority agreements. Competent authorities are unlikely to have the capacity to deal with a significant number of additional cases. USCIB believes that while the profit split method has a role to play in arm’s length pricing, over reliance on the profit split method moves in the direction of formulary apportionment with all of the attendant problems.

USCIB believes that the valuation difficulties are rooted in the Discussion Draft's focus on Section D.1.(vi) intangibles and that the key difficulty is that definitionally these intangibles are "not similar to intangibles used by or available to parties to potentially comparable transactions". It seems, therefore, that the starting point in valuing these intangibles is not comparability but the two-sided analysis and that process has been extended to all intangibles. Although we generally agree that it is not necessary to categorize intangibles, there are important differences in valuation between routine and Section D.1.(vi) intangibles. More focus needs to be devoted to routine intangibles including recognizing that the cost approach has a relevant role to play with respect to routine intangibles. These guidelines will apply to all transfer pricing transactions, not just those involving Section D.1.(vi) intangibles, and need to provide guidance suitable for all transactions.

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21 Discussion Draft paragraphs 80 and 81.
22 Discussion Draft paragraphs 90 through 104.
23 See TPG, Chapter I, section C.
USCIB believes that Chapter VI is too focused on the negative aspects of the transfer pricing methods with respect to intangibles. We believe that Chapter VI should take a more balanced approach as was done in Chapter II. That is, Chapter VI should point out both the advantages and disadvantages of the various methods in order to permit identification of the most appropriate method in often challenging real world conditions.

Specific Comments on Section D

USCIB is concerned about the principle expressed in paragraph 80 that the transfer pricing analysis must consider options realistically available to each of the parties. In some cases, the realistic alternative principle seems directly contrary to the notion that the transaction be priced in accordance with the functional analysis. That is, a taxpayer must determine the price for the functions, assets, and risks that are actually undertaken by each of the parties to the given transaction. USCIB is also concerned about the potential administrative burden that might be imposed by this requirement. In some cases, it may be possible to identify a realistic alternative. In others, realistic alternatives may be very hard to identify. Further, it is possible that multiple “realistic alternatives” might be identifiable but none will, in fact, represent easily analyzed alternatives to the transaction actually undertaken. Further, if comparable transactions are available, it is unclear what additional benefit is provided by a realistic alternative analysis. More guidance needs to be given on when a realistic alternative analysis is appropriate or practical. We suggest that the Guidelines include an explicit reminder along the lines of Chapter IX paragraph 9.64 that not all hypothetical possibilities must be considered and specific examples of how this concept can be practically applied.

Paragraph 81 of the Discussion Draft provides that “A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles.” While a two-sided analysis is preferred for identifying the economic character of functions, assets and risks borne by all parties of an intercompany transaction, some aspects of a two-sided test are not always feasible. In particular, identification of the integrated financial statements for an intercompany transaction is not always feasible. Chapter III of the Transfer Pricing Guidelines distinguishes between a two-sided comparability analysis and a two-sided financial analysis. USCIB believes that it is important that this distinction be preserved. Many industries consist of multiple levels value chains and do not, as a part of their

24 The reference to the notion of options realistically available is not intended to create a requirement for taxpayers to document all possible hypothetical options realistically available. As noted at paragraph 3.81, when undertaking a comparability analysis, there is no requirement for an exhaustive search of all possible relevant sources of information. Rather, the intention is to provide an indication that, if there is a realistically available option that is clearly more attractive, it should be considered in the analysis of the conditions of the restructuring.

25 Transfer Pricing Guidelines paragraphs 3.18 through 3.23.
management or statutory financial statements, prepare financials that identify costs and profits for all participants of an intercompany transaction. That is, identification of the profit of all parties within a specific cross-border transaction is unavailable. As an example, many large global manufacturing companies may enter into a licensing arrangement for engineering using a CUT, global services under a CCA, parts and component manufacturing using a CUP, assembly operations under a CPM, and management services under a variety of methods. In this situation, the company cannot identify the integrated profitability across the various levels of market, making the financial analysis component of a two-sided functional analysis impossible. At best, the company can often determine the ‘simple’ or ‘routine’ party’s profit contribution (say distributor) and perhaps the assembly company’s profit contribution. Profit associated with upstream operations such as engineering, component manufacturing etc. is often unavailable. It is our experience that this problem is common in many large global enterprises.

In addition, some intangible transactions are sufficiently straightforward that a one-sided test is sufficient. For the above companies, it is often possible to compute arm’s length prices with a qualitative functional analysis to identify the key entrepreneurial functions and their respective owners. For owners of routine intangible assets, such as a distribution entity, it is often appropriate to complete a functional analysis and any adjustment for distributor-owned intangible assets based on the information of one-sided functional analysis only.

USCIB thinks that the paragraph 83 of the Discussion Draft is unclear whether the transfer pricing analysis is done on a pre-tax or post-tax basis. Paragraph 83 specifically notes that “MNE groups seek to optimize resource allocation, at least on an after-tax basis.” This might be read to mean that transfer prices are determined on an after-tax basis. However, it is clear that the arm’s length price paid by one related party to another is a pre-tax price (that is it is the price that produces income subject to tax). We believe that what the drafters probably intend by this language is that in evaluating their realistically available options, the parties, like any investor, must be assumed to evaluate their options on an after-tax basis. However, the evaluation goes to the issue of determining what pre-tax amount the parties are willing to pay or accept.

We think this concept is reflected in example 19, but example 19 is difficult to understand. For example, paragraph 256 provides that “Pervichnyi would certainly not sell the intangible at a price that would yield an after-tax return lower than 594….(emphasis added). In other words, it describes selling the intangible (a pre-tax amount concept) at a price that would yield a certain post-tax result.

Nevertheless, notwithstanding its importance and the opportunities for confusion, this point is not made very clearly. Paragraph 83 should be revised to say very clearly that the realistically available options are evaluated on an after-tax basis but are being used to determine a pre-tax amount. This point could also be clarified in Example 19. Among other things, paragraph 256 might describe the minimum sales
price Pervichnyi would have to receive (on a pre-tax basis) in order to achieve its minimum expected after-tax return of 594.

USCIB suggests that WP 6 modify the third criteria on infringement contained in paragraph 102 of the Discussion Draft. As phrased, the paragraph covers situations where the subject IP may be subject to legal ownership or right to use challenge. Another important consideration is whether a potential CUT was negotiated under the threat of infringement. The royalty rates and other terms and conditions are affected greatly by whether the circumstances surrounding the third party transaction are under the threat of infringement or if they are negotiated under a technology transfer or ‘right of use’ basis. Royalty rates under threat of infringement are often based on legal remedies and potential judgments, such as cease and desist motions or statutory fines as per infringement fines under U.S. trademark and copyright law that do not occur among related parties. Therefore, the negotiated rates under such a legal threat may not be consistent with the rates, terms and conditions negotiated in the normal course of business. As an example, the negotiated settlement for over $680 million between Research in Motion and the patent owner NTP in 2006 was not based on the intrinsic value of the technology but rather on the threat of a cease and desist motion.

USCIB is concerned that paragraph 108 of the Discussion Draft is based on “a clear understanding of the MNE’s global business processes”. We believe that the Discussion Draft should draw a distinction between a global transfer pricing policy and a global analysis. Many MNEs establish global policies, particularly for more routine functions such as charging out headquarters costs. Because these policies are global, taxes are not a factor in determining the arm’s length price. Thus, the prices are less likely to be successfully challenged and ought to be entitled to deference26. This is different, however, from a global analysis of the taxpayer’s business to determine the arm’s length price for a particular transaction. Independent parties often use a bilateral (rather than global) analysis to determine pricing. Further, MNE’s do not necessarily have global transfer pricing information readily available. In such cases it would be difficult for MNEs to develop a global analysis when the transactions may be legitimately priced on the basis of comparables and on the traditional bilateral approach.

USCIB believes that a major weakness of the current Discussion Draft is the limited role envisioned for the family of Cost Methods.27 There are only three generally accepted valuation methods – income, market and cost – and each one has an

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27 Paragraphs 112 and 113 of the Discussion Draft. There are a variety of cost methods in standard use, much like there are multiple methods to compute the income method or the market method. Typical methods are the replacement cost, reproduction cost and historical cost. For transfer pricing purposes the cost method is often computed on a ‘cost-plus’ basis, that is the replacement cost is computed with an appropriate arm’s length mark-up.
important role in intangible asset valuation. By making no distinction between ‘routine’ and ‘non-routine’ intangible assets, the Discussion Draft unnecessarily limits the importance of Cost Methods.²⁸

Cost methods are often the only reliable method to value intangibles because self development of the intangible is often the only realistic alternative, especially for routine intangibles. Often parties in third party negotiations will determine their best alternative to a negotiated agreement, or “BATNA”. Often the BATNA will be based on the cost of self development. Examples of this include negotiations for use of a third party distribution network, enhancements to an existing product or compound especially where the legal IP rights are narrow enabling a ‘design around’, databases and customer lists and certain types of software, and supply or labor contracts.

Cost-based methods have particular use in valuing non-separable intangible assets. Since no market approaches are available for workforce, goodwill or going concern assets, only income and cost methods are available. In many circumstances it is much more straight-forward and reliable to estimate the value of a non-separable intangible based on the cost to reproduce that intangible than attempting to identify an income stream, particularly if the asset in question is routine.²⁹

Paragraph 113 of the Discussion Draft raises comparability issues with the Cost Method such as “...effect of time delays associated with deferred development on the value of the intangible” and “...legal protections or exclusivity characteristics.” While these are potential concerns, it is important to consider two criteria. First, a routine intangible asset by its nature is of limited income potential because it can in principle be outsourced to another provider at a market-determined price that will limit the upside (and downside) profit or loss. As such, a routine intangible asset is much less price sensitive to a time delay. Second, the cost analysis can include an explicit adjustment for lost profits associated with startup costs and delayed market entry. Such analyses are common in damage estimates of IP infringement analyses.

In addition, the relevance and appropriateness of a cost method must be made in comparison with the reliability of other available methods. The Discussion Draft in paragraph 149 – 170 provides a lengthy list of criteria and issues to be taken into account in applying an income method, including guidelines for use of projections,

²⁸ For purposes of discussion within these paragraphs on cost methods, a routine intangible is defined as an intangible asset that can in principle be outsourced and therefore subject to a benchmarking comparability analysis. Therefore these routine intangibles do not earn residual income as defined in paragraph 28 of the Discussion Draft. Non-routine intangibles, in contrast, are key success drivers of the business that cannot be outsourced and therefore earn the residual returns as defined in paragraph 28.

²⁹ The income method is more difficult to use for non-separable assets since there is no external royalty rate available to base the income associated with the non-separable intangible asset.
growth rates, discount rates, and useful life estimates among other factors. A similar list could be developed for cost methods and market methods.30

Lastly, paragraph 113 of the Discussion Draft states that “[c]ost based valuations generally are not reliable when applied to determine the value of partially developed intangibles for transfer pricing purposes.” In valuation practice, the opposite is often the case. Our practitioner experience is supported by a noted valuation handbook. “Because this (cost) approach does not reflect the earning potential of the asset, it is often used for embryonic technology or other assets where no specific application or benefit can be identified.”31

Paragraphs 122 through 124 of the Discussion Draft address issues of comparability adjustments. In particular, paragraph 124 provides that “comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors.” USCIB has a few concerns with this list. First, if locational advantages are to be taken into account, then so should locational disadvantages. Second, it seems that many of these items are identified as comparability factors rather than intangibles in section A. However, as noted above, paragraph 25 seems deliberately ambiguous concerning whether an assembled workforce is an intangible. USCIB believes that assembled workforce should be not treated as an intangible and therefore it is appropriate to include it here, in a list of comparability factors. However, paragraph 25 should also be clarified to provide that an assembled workforce is not, by itself, an intangible. Finally, the term ‘business strategies’ is broad and vague and will lead to interpretation conflicts. This term is used only twice in the Discussion Draft (here and in paragraph 108). USCIB believes a more accurate way of expressing this concept ought to be found.

Paragraphs 128 through 130 of the Discussion Draft deal with the application of the profit split method.32 As noted in our general comments on Section D, USCIB believes that the Discussion Draft is placing too great a reliance on the profit-split method. USCIB believes that the Discussion Draft ignores real problems (discussed below) with the profit-split method and that is exemplified by the changes from

30 One such framework for Cost Methods is provided by Reilly and Schweihs Valuing Intangible Assets, McGraw Hill, 1998. Reilly and Schweihs acknowledge the important role of cost methods in intangible asset valuation and provide two broad criteria: inclusion of all costs, including the entrepreneurial incentive to motivate the agent to develop the intangible and the current economic state of the intangible asset as expressed by its relative obsolescence.


32 Paragraph 129 of the Discussion Draft incorporates by reference the guidance in paragraphs 2.108 through 2.145 of the existing TPGs. Some of the discussion below refers to those paragraphs.
paragraph 6.26 of the existing TPG to the language in the Discussion Draft. Both paragraph 6.26 and 128 provide that use of a profit-split method may be appropriate where both parties make unique and valuable contributions. Paragraph 6.26 goes on to note that there may be practical difficulties in its application. This acknowledgement is missing from the Discussion Draft. The application of the profit-split method to intangibles should be consistent with Chapters I through III of the TPG. As the OECD noted:

The OECD does not intend that the revisions of the Guidelines require more extensive use of profit split methods nor does it believe that the language of the revised Guidelines appropriately can be read to impute such a requirement. Profit split methods need not be applied to corroborate the results of other methods in every case. However, profit split approaches can be useful and can be the most appropriate transfer pricing method in some instances, following the criteria identified in paragraph 2.2 of the revised Guidelines.33

This principle should also be applied in the context of the transfer pricing of intangibles. That is, the profit-split method is just one method among a number of OECD approaches discussed in the TPG. The guidelines of Chapter VI do not require more extensive use of the profit-split method, but recognize its utility in appropriate cases.

Many industries face difficulties in computing an integrated value chain financial statement for the intercompany transaction. Transfer pricing practitioners also face difficulties in developing reliable methods to apply the profit split method. In particular, the transactional profit split method as developed in the OECD Guidelines Chapter 2 is difficult to apply due to the rare use of the profit split among unrelated parties. As a consequence, most profit split analyses, including residual profit split analyses, rely upon two subjective approaches.

First are accounting based capitalization and amortization models that have many of the attributes of cost method models. These complex models typically capitalize and amortize historical spending on intangible asset development among the related parties and use this as the basis to share intangible related income. These models have many of the same limitations as cost methods, including an assumption of a linear relationship between intangible cost and value.

The second commonly used class of profit splits involved nuanced variations of ‘rules of thumb’, use of which the Discussion Draft discourages. Indeed, use of the 25%

33 Response of the Committee on Fiscal Affairs to the comments received on the September 2009 draft revised Chapters I-III of the Transfer Pricing Guidelines, 22 July 2010.
rule is often similar to a profit split analysis, and the OECD should use care to ensure that taxpayers and tax authorities do not use the profit split method as an inappropriate ‘backdoor’ to a rule of thumb. USCIB, as noted above, is concerned that wide spread use of the profit split method may devolve into some form of formulary approach.

Thus, USCIB believes that the Discussion Draft should, like the existing guidelines, acknowledge that the profit-split method has limitations and should therefore acknowledge that other methods have a role to play. Paragraphs 143 and 144 of the Discussion Draft deal with the application of profit split methods in connection with partially developed intangibles. Paragraph 143 describes how the profit split methods may be applied and then generally rejects those methods. USCIB suggests that the criteria and issues discussed here are no more (or less) difficult or onerous than the general application of the income method, and therefore this analysis does not add substantially to the Discussion Draft. Since the Discussion Draft previously rejected use of cost methods for partially developed intangibles, taxpayers are left with little guidance for how to address this important subset of intangible asset transfers.

Paragraphs 154 through 158 of the Discussion Draft deal with the accuracy of financial projections. In paragraph 155 the Discussion Draft states that “[i]t is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.” USCIB believes it is important that forecasts used in valuation analysis be grounded on the most reliable, unbiased assessment of the range of future sales, costs, investments, and profits from the use of the intangible. A forecast used for non-tax purposes is subject to its own potential biases, be it for investment community use, loan covenant, or financial reporting purposes, and is not inherently more reliable than a tax forecast. What is important is not the source of the forecast but rather the consistency of that forecast with the specific business dynamics within the company and industry and the nature of the competitive forces in play, including the nature of the product or service market, customer relationships and sales channels, supply or labor conditions, and regulatory environment. USCIB believes, therefore, that the quoted sentence should be deleted.

Paragraphs 164 through 167 of the Discussion Draft deal with the useful life of intangibles and terminal values. This issue may be relevant when the intangible itself is transferred rather than licensed or used in the performance of services. USCIB suggests that a simpler method of approaching this problem might be to determine the likely length of the realistic alternative of a license agreement.

34 As an example certain forecasts used for financial reporting purposes are limited to only 5 years of sales and expenses which may be insufficient for a tax-based analysis.

35 This issue may also be relevant in licensing agreements where the royalty rate is determined by dividing the present value of income by the present value of revenue.
Paragraphs 174 through 177 of the Discussion Draft deal with arm’s length pricing when valuation is highly uncertain at the time of the transfer. This language is largely unchanged from current version of Chapter VI (paragraphs 6.32 through 6.35 of the Guidelines). Both the current Guidelines and the Discussion Draft provide that tax authorities may determine that parties to the transaction might have included a renegotiation clause in an agreement dealing with a transaction whose consequences are highly uncertain.

Changing the terms of the transaction arrived at by the taxpayer (if respected by the taxpayer) is not generally within the power of tax authorities. Further, it is inconsistent with “ex ante” nature of the arm’s length standard. It is the experience of USCIB members that OECD countries do not assert this authority in the context of a MAP case with another OECD country. Therefore, this language is unnecessary.

If, however, the OECD decides to include language requiring renegotiation, then appropriate limitations should be included in order to prevent the use of hindsight. Language along the lines of: “The mere fact that the assumptions and projections which were used in the determining the arm’s length price did not or only partly materialized may not be relied on to make adjustments under these Guidelines provided the parties to the transaction used best efforts to determine the arm’s length price.”

Comments on the Examples

USCIB believes that the examples are an extremely important part of the guidance provided by the Discussion Draft. At the point we are only providing general comments for two reasons. First, we are hopeful that the substantive rules of the Discussion Draft will be revised. Such a revision would necessarily result in the examples being revised in concert. Second, USCIB members needed to reach agreement on these comments, which was itself a lengthy process and did not provide sufficient time to provide detailed comments on individual examples. However, USCIB has the following general comments on the examples.

USCIB believes that the examples illustrating the principles of the Discussion Draft highlight some of the difficulties that taxpayers and tax administrators will face in implementing these rules if they are adopted as proposed.

Although the examples are not intended to illustrate section A, it seems that significant parts of section A are ignored. First and most importantly, paragraph 11 provides that:

In a transfer pricing analysis of a matter involving the use or transfer of intangibles, it is important to identify the relevant intangibles with some specificity. The functional analysis should identify the economically significant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. While it may be appropriate to
aggregate intangibles for purposes of determining arm’s length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm’s length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified economically significant intangibles in the MNE’s global business, should support the determination of arm’s length conditions.

The examples do not generally identify the intangibles with specificity. Nor do they generally analyze the MNE’s global business (unless we are to assume that the global business is bilateral arrangement set forth in the examples). USCIB believes that a functional analysis of the bilateral relationship may be sufficient, so, the examples are not necessarily wrong, but they may be inconsistent with the guidance provided by the Discussion Draft. USCIB believes that paragraph 11 should be modified to permit a bilateral analysis (rather than a global analysis) in appropriate cases.

The examples also do not seem to properly account for prior activity. That is, Chapter VI is supposed to account for the development, enhancement, maintenance and protection of an intangible. If these activities take place in different years, then a functional analysis looking only at the current year may not properly account for the intangible related return. That is, if an MNE develops an intangible in years one through three and permits a related party to make use of that intangible in year four, then the prior development may have to be properly taken into account and not merely the current activities of the related party. Many of the examples seem to focus only on the current year and neglect the prior activities.

Paragraph 30 of the Discussion Draft provides that the legal registrations and contractual arrangements are the starting point for determining which members of the MNE group are entitled to intangible related returns. If the examples are to illustrate how this principle applies, then the examples should provide details, which are generally lacking, concerning these legal relationships.

The examples do not generally consider realistic alternatives, although taxpayers are routinely expected to do so. Further, paragraph 81 of the Discussion Draft provides that “a one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles.” Despite this requirement, many of the examples look at only one side of the analysis. USCIB believes that many of the examples do not take these steps because in many cases it is unnecessary and impractical to do so. USCIB believes paragraph 81 should be modified to permit a one-sided comparability analysis in appropriate cases.

The marketing examples (examples 3 through 8) in particular seem to focus on the level of marketing expenditures. This seems inappropriate since the Discussion Draft provides that merely bearing costs does not entitle an entity to intangible related returns and paragraph 10 provides that “not all marketing activities result in the creation or enhancement of an intangible.” If this is the case, the Discussion Draft should indicate why beyond the level of marketing expense, the drafters believe an intangible
has been created. Clearly, excess expenses can arise from other causes, including business inefficiencies or a market penetration strategy.

It might also be useful to add more specific headings to the examples that indicate what principle or paragraphs of the Discussion Draft the examples are attempting to illustrate.

Comments on Chapter 3

Simultaneously with the release of the Discussion Draft on Intangibles, the OECD also released a Discussion Draft proposing changes to Chapter III on timing issues relating to transfer pricing. USCIB members have prepared an initial response to this Discussion Draft; however, given the need to prepare extensive comments on the Discussion Drafts on intangibles and safe harbors, we have not been able to develop these comments as fully as we would like. We may, therefore, prepare supplementary comments on this issue.

Paragraphs 3.69 through 3.71 of this Discussion Draft refer to “the arm’s length price setting approach” and contrast it with the “the arm’s length outcome-testing” approach. The meaning of the former is fairly clear. It means an approach based solely on information available (including information reasonably foreseeable) at the time of the transaction. This method is common. Taxpayers routinely and appropriately use this approach when using an identified CUP for purposes of setting an intercompany price.

The proper interpretation of the “outcome-testing” approach is less clear. It refers to pricing confirmations based on information available at the time the tax return is prepared. USCIB believes the “outcome-testing” approach should be redrafted to make clear that in the case in which a transaction occurs in Year 1, a taxpayer can use the information that becomes available post Year 1 year end, but prior to filing its tax return (when due, with extensions) to test and substantiate the arm’s length nature of the Year 1 transactions, and to the extent the information indicates the transactions were not at arm’s length, the taxpayer may adjust the transactions to conform with arm’s length pricing prior to filing the tax return for Year 1 (when due, with extensions).

Since it is often not possible to know whether a taxpayer’s operating margin falls within the arm’s length range of comparables for the “same time” prior to year end, it is desirable to encourage tax administrations to respect taxpayer initiated adjustments to prices reported post year end but prior to filing their tax return when these adjustments are made to conform their prices and financial results to the requirements of the arm’s length principle.
The other possible interpretation of the “outcome-testing” approach would require taxpayer to take into account transactions occurring before the tax return is filed, whether they took place in Year 1 or Year 2 (or Year 3 if the tax return is not filed until some day in Year 3) so long as the transactions occurred before the tax return is filed. USCIB does not think this is intended; however, this point should be made clearer in paragraph 3.70.

Assuming our interpretation of the “outcome testing” approach is correct; USCIB agrees that either approach is compatible with the arm's length standard. The arm’s length “outcome-testing” approach simply makes use of information, not available at the time of the transaction, with respect to transactions that occur up to the time the tested transaction occurred (after-acquired information). Since two unrelated parties acting at arm’s length would likely be subject to (and set a price based on) the market forces that are embedded in the after-acquired information, we think use of this information is not inconsistent with the ex ante arm’s length standard. Since both the “price setting” approach and the “outcome testing” approach are both consistent with the arm’s length standard, taxpayers ought to be able to choose the method they prefer taking into account their transfer pricing methodology and the administrative burdens of the two methods.

In practice, there is a third approach which is found in certain countries. We term it as the “arm’s length outcome-testing extended” approach. In this case, the tax authorities expect taxpayers to demonstrate arm’s length compliance based on data available at the time of audit and not data available at the time the tax return is prepared. As a result, taxpayers end up performing comparable searches twice – once at the time of preparation of the tax return and another at the time of audit. Additionally, this imposes an unreasonable standard on taxpayers and one that is inconsistent with International Accounting Standards and the arm’s length standard. USCIB views this approach as different from the situation described in paragraph 6.35, where “a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set pricing.” It should be made clear that in the latter case, however, the taxing authorities would not be adjusting prices based on new pricing information. The tax administration may only take new pricing information into account in exceptional cases (typically involving intangibles) and if the tax administration bears the burden of showing that independent enterprises would have reasonably foreseen the development precipitating the adjustment.

As a final comment, the substituting of the phrase “at the same time” for “during the same period of time” in paragraph 3.68 should be clarified as not limiting the use of
multiple year analyses in favor of single year analyses for purposes of testing the arm’s length nature of a taxpayer’s transactions.

Sincerely,

William J. Sample  
Chair, Taxation Committee  
United States Council for International Business

Cc:  Pascal Saint-Amans, Director of CTPA, OECD  
     Grace Perez-Navarro, Deputy Director of the CTPA, OECD  
     Marlies de Ruiter - Head of Tax Treaty, Transfer Pricing and Financial Transactions Division (TTP), OECD  
     Manal Corwin, Deputy Assistant Secretary (International Tax Affairs), Office of Tax Policy, U.S. Department of Treasury  
     Michael McDonald, Financial Economist, Business and International Taxation Division, Office of Tax Policy, U.S. Department of Treasury  
     Michael Danilack, LB&I Deputy Commissioner (International), Internal Revenue Service
Dear Mr. Andrus,

VNO-NCW is pleased to have the opportunity to provide comments and recommendations on the OECD Discussions Draft “Revision of the special considerations for intangibles in chapter VI of the OECD Transfer Pricing Guidelines and related provisions (hereinafter referred to as: “Draft”).

Many of our member companies deal with the complexities around transactions involving intangibles all over the world on a daily basis. We therefore very much welcome the extensive work done by OECD Working Party No. 6 to provide more guidance on this complex topic.

General remarks

As for any other intercompany transaction the starting point for the examination of the intangible intercompany transaction should be the legal agreement. However, the Draft starts by stating that a transfer pricing analysis for intangibles should be based on what would be agreed upon between independent parties for comparable transactions, rather than focusing on accounting and legal definitions. In other parts of the Draft the legal (and accounting) principles are given more priority. This leads to unclear guidance which might lead to unnecessary discussions between tax authorities and tax payers on the analysis performed.

The definition of an intangible as something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in
commercial activities in our view is not an acceptable definition on account of being too vague. “Something” is a vague indication. It is required to define items which are capable of being owned or controlled for use in commercial activities more clearly.

The Draft includes a categorization of intangibles. Remarkably the categorization section A.3. also includes sections which describe elements such as group synergies and market specific characteristics which may affect the prices paid, but are not regarded as intangibles. We fully agree with the conclusion that the elements need to be taken into account in the comparability analysis, but would prefer to see these being reflected in Chapter III of the guidelines and sections on comparability. The inclusion of these comparability factors in the intangibles categorization section seems to hint at a new undefined category of elements which should be taken into account in determining arm’s length prices. In our view an asset is either a tangible or intangible asset and therefore should as such be taken into account in the functional analysis, or as an “influencing element” in the comparability analysis.

On two occasions (section 26, 3rd bullet and example 17), the Draft implies that the transfer of a single employee could be seen as a transfer of valuable know-how which should be paid for. In order to align the Draft with the reasons for adopting the arm’s length principle as described in section 1.8 of the OECD TP Guidelines, we strongly suggest removing this suggestion from the Draft. A transfer of one individual (as a normal international assignment) should not be taken into account for transfer pricing purposes, as this could damage the international traffic and movement of employees around the world, and the development of people and could therefore damage economic growth around the world.

The Draft often refers to services which should be taken into account in assessing transactions with intangibles. Services are not to be confused with intangibles. Guidance on how to treat services should in our view be part of Chapter VII – Special considerations for intra-group services - or should be bundled in an additional Section which provides guidance on how to treat services related to intangibles.

We appreciate the guidance and examples provided in the Draft; however we encourage the OECD to include clearly defined borders in the Draft and to simplify examples. More clarity could be provided in our view on for example the definition of intangibles and the use of accounting principles. A
simplification of the examples included in the Annex could lead to basic principles to be used in the transfer pricing analysis.

With respect to the selection of the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles, the current wording in our view puts too much emphasis on the use of the profit split method. We are concerned that this will lead to unrealistic documentation requests. This concern could be dealt with by providing clear examples of situations in which traditional transaction methods are to be prevailed.

In par. 170 it is mentioned that “it is important to account the perspective of both parties to the transaction in this regard and to consider how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee following the transfer in determining the arm’s length price”. We suggest adding that in many third party transactions, transferor will not pay the transferee and vice versa for any tax advantages or disadvantages. Therefore, it can for TP purposes be ‘arm’s length’ not to account for the relative tax advantages or disadvantages.

Valuations

The Draft indicates that valuations contained in purchase price allocations are not relevant for transfer pricing purposes. This could be deemed contradictory as the paper also advocates the third party principle. Contract allocations are widely considered as the most “tangible” method of identifying third party transactions / valuations. Similarly to the relevance of legal and accounting principles, purchase price allocations should be seen as indicators or starting points, whilst none of them are in general a decisive factor.

The OECD mentions in pars. 110, 238, 249 that valuations of intangibles contained in purchase price allocations performed for accounting purposes are indeed not relevant for TP purposes. However, no concrete alternatives are given, except that reference is being made to the arm’s length principle. Therefore – as stated above - these purchase price allocations should be a good starting point as they are also based on an economic (accounting) analysis. For TP purposes, a thorough examination of the underlying assumptions can also be performed regarding these valuations/allocations (in line with main principle/guideline of par. 109). Therefore, we suggest to redraft this statement that “purchase price allocations are irrelevant for TP purposes”, to “the application of purchase price allocation methods, may be particularly useful when properly applied and when based on appropriate assumptions and in line with the arm’s length principle.”
Considerable attention has been placed on the comparability analysis, including functional analysis, and the two-sided approach throughout the Discussion Draft (a/o pars. 118, 126, 146). When discussing the financial valuation methods, the OECD notes that “caution should be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm’s length prices or values for TP purposes without a thorough examination of the underlying assumptions” (110). In our view this means that accounting valuations, including for example the use of WACC as a discount rate etc., can be applied, but a (sanity) check of the underlying assumptions for TP purposes should be performed in order to establish if the transaction/calculation is at arm’s length. We believe that this view should be stressed more clearly and consistently in the Discussion Draft by referring a.o. to number 109 as main principle / guideline “the application of income-based valuation techniques, ……., may be particularly useful when properly applied, based on appropriate assumptions and in line with the arm’s length principle.”

Discounted cash flow calculations

The OECD mentions in number 169 that “prices for TP purposes must typically be determined on a pre-tax basis”. However, in example 19 illustrating the application of the principles set out, the analysis is done on an after-tax basis from both the perspective of the transferor as well as the transferee. It seems that this is not fully in line with number 169, therefore, we propose that the Working Party reviews the consistency of this example with the principles set out in 169.

Examples

We propose to bring example 7 more in line with example 6 by adding to the explanation of example 7 that the adjustment for an arm’s length transaction could also include a reduction of the price paid by Company S to Primair for R watches.

Example 12’s conclusion is not correct. If the related distributors are based in country B (which is not defined), there is nothing wrong with the contract between S and Primarni. The question should also be raised whether S should be considered into this set of transactions as the better answer is that this is a matter between Primarni itself and the related distributors.

Examples 16 and 17 of the Annex partially focus on IT skills of employees. Example 17 focuses on the skills how to use the software and not on the development of. The hidden suggestion in the document is that each employee is a unique and valuable asset for whose transfer need to be paid. It could seriously damage the global economy and development of talent by creating
such barriers. OECD should acknowledge that in a third party situation, any employee can resign in a very short period and take up a new employment without large sums of compensation being paid between the old and new employer. Compensation of salary cost with a modest service type mark-up should be sufficient.

Furthermore by discussing these examples in the context of Chapter 6 instead of Chapter 7 (IC services), OECD is creating the impression that a new breed of services / value creating activities exists in the context of an intangible, which doesn’t fit in Chapter 7, even though the statement is made in the beginning of the document that these activities are not intangibles.

Example 18 doesn’t define the location of company T. If T is based in the same country as Osnovni, OECD is trying to define the local tax treatment, which for example if a fiscal unity / tax grouping exists may not be appropriate.

Yours sincerely,

J.M. Lammers
MEMORANDUM

To: Mr. Pascal Saint-Amans, and
    Mr. Joseph Andrus
    Centre for Tax Policy and Administration
    Organization for Economic Co-operation and
    Development
    2 Rue André Pascal
    Paris, France

From: Scott Wilkie
      Blake, Cassels & Graydon LLP

Date: 30 September 2012

RE: Comments on the OECD Intangibles Project

I am writing to offer comments on the 6 June 2012 to 14 September 2012 Discussion Draft (the
"Discussion Draft") published by the Organization for Economic Co-operation and Development
("OECD") entitled “Revision of the Special Considerations for Intangibles In Chapter VI of the OECD
Transfer Pricing Guidelines and Related Provisions”. The comments are made strictly in a personal
capacity and are not intended as, and should not be construed as those of Blake, Cassels & Graydon
LLP of which I am a partner, nor should they be attributed to any organizations with which it is associated
or to any of our colleagues or clients.

The comments are premised upon an understanding of the practical objectives served by, and influences
on, the OECD Transfer Pricing Guidelines and an awareness of the critical importance, in the transfer
pricing area particularly, of influential and consistently respected international guidance being readily
available, and, as much as possible, incontrovertibly accommodated by countries’ tax and private law so
as to have the effect intended for it by the OECD and its Members and to be reliable as determinative
guidance by taxpayers in order to avoid tax controversy.
These comments on the Discussion Draft are offered from the perspective as a lawyer, with an eye to anticipating how the guidance concerning “intangibles” in the Discussion Draft would have legal effect. It is anticipated that others will offer more specific, and in some respects differently oriented, comments on the Discussion Draft, reflecting their direct business experience as taxpayers or insight obtained from other professional disciplines.

OPENING OBSERVATIONS

The OECD’s study of “intangibles” marks a significant and welcome advance in refining the application of the Transfer Pricing Guidelines to complex business circumstances.

The OECD’s work in this area is acutely important because it corresponds to the increasingly common possibility that the inherent “production” and “entrepreneurial” elements of an integrated MNE group identified with “intangibles” of various kinds may be disengaged contractually – “unbundled” – and given effect as discrete transfers in relation to disaggregated profit centres. The result is to subdivide MNE groups functionally and geographically apart from how they are organized structurally, to an extent possibly not anticipated by the arm’s length standard when it originated. The OECD’s examination of intangibles, not merely of what we describe as “transaction intangibles” but more significantly all manner of transmissions of value not undertaken directly through the medium of property transfers or the performance of services, unavoidably engages a broader examination of the arm’s length standard, even if this is not the express purpose or overt focus of the Discussion Draft.

For purposes of these comments, a distinction is made between what is referred to as “transaction intangibles” and “non-transaction intangibles”.

“Transaction intangibles” are considered to be rights of various kinds that have an existence other than “for transfer pricing purposes” (a phrase used in the Discussion Draft). Transaction intangibles can be “traded” or otherwise transacted in or deployed by way of various kinds of transactions contemplated by the law. These types of assets are nothing new; they have long been recognized and valued in conventional business and legal contexts.
“Non-transaction intangibles”, in contrast, connote inherent attributes that are not, as such, items of trade. “Non-transaction intangibles” typically comprise dimensions of knowledge, experience, goodwill and going concern value. These kinds of “intangibles” are in important respects closely identified with economic and transfer pricing theory about the nature and distinctiveness of business organizations. They derive from and reflect implicit economic interactions within an MNE group that give rise to unique knowledge, “know-how”, experience and the like which are valuable because they are not generally known or accessible to others. They contribute to the MNE group’s existence as a business organization and a “firm” in the economic sense. They also contribute to distinguishing an MNE from others with which it competes and to which it might be compared. Unlike transaction intangibles, non-transaction intangibles do not fit neatly into traditional theory and practice. It is noted at the outset that though “synergies”, as the Discussion Draft identifies them, no doubt influence and are manifest in the nature and value of “intangibles” generally and “non-transaction intangibles” in particular, these comments should not be construed as resisting the OECD’s inclination, in the Discussion Draft, not to treat “synergies” as intangibles or advocating a contrary approach in the sense that the Discussion Draft would address “intangibles”. That said, however, it is difficult to ignore “synergies” even if they would not be accorded the significance in this context attributed to other “intangibles”. An approach that would not require them to be parsed in a transfer pricing analysis but still would allow their influence on a transfer pricing analysis formulated according to Chapters I to III of the Transfer Pricing Guidelines to be recognized would, it is suggested, be desirable.

Not surprisingly, drawing hard lines between the two types of intangibles is challenging as a practical matter in some contexts. The features of an MNE group that define it as an economic actor and are essential to allow it and its constituent members to conduct business – its “intangible” essence, often described casually as “soft intangibles” – necessarily influence and are reflected in transactions with third parties in which the value of those “intangibles” is realized, irrespective of how the group and its members are organized. This observation lies at the heart of these comments, and bears directly on the concerns expressed below with respect to the efforts of the OECD in the Discussion Draft to give “non-transaction
intangibles”, in particular, a distinct existence whether or not this can be implemented by and within the tax and private law systems of OECD Member countries.

**KEY THEMES**

There are two key themes in the following comments which have material practical connotations for transfer pricing analysis generally and for the Discussion Draft in particular.

First, if the guidance in this area is ultimately to serve the intended objective of bringing clarity to the subject area, and thereby facilitating possibilities for efficient and meaningful exchanges of views and threshold agreement among OECD Member countries facing double taxation issues, it is essential to evaluate and determine whether and to what extent the guidance offered in the Discussion Draft would be accommodated by OECD Members' tax and private law. Acknowledgment of the legal basis upon which OECD Member countries' law would accommodate “intangibles” as cognizable “objects” of taxation which can be transmitted or otherwise deployed in ways recognized by applicable tax systems is essential to the ultimate effectiveness of the new guidance. Moreover, the adoption of generally applicable guidance by the OECD and the administration of consistent and legally effective practices by its Members are both critical to the continuing effectiveness, and indeed relevance, of the arm’s length standard itself. It is respectfully suggested that even a modest degree of uncertainty is not tolerable, either for taxpayers or tax authorities, given how significant a transfer pricing disagreement can be and how pervasive “intangibles” issues are in practice in the administration of transfer pricing.

Second, the Discussion Draft reflects a premise that “intangibles” comprise not only intellectual property to which the law gives status and definition (“transaction intangibles”), but also various intangible features intrinsic to MNEs as business organizations that seamlessly are embedded in any transactions an MNE and its group members undertake, (“non-transaction intangibles”). Consequently, unlike the analysis of typical property transfers, the Discussion Draft raises two distinct issues for a transfer pricing analysis:

(a) an initial definitional issue concerning the economic and commercial identity of a taxpayer – which affects how readily it and its transactions may be compared to others; and
(b) the more common features of its commercial actions – “transactions” – to which the Transfer Pricing Guidelines customarily apply. This is an unavoidable implication of “intangibles”.

The analysis in the Discussion Draft related to “non-transaction intangibles”, in particular, serves to elucidate the kind of economic and functional analysis typically needed in functional analyses, and would play its most valuable role as additional rigor for the application of transfer pricing analysis particularly as it may reflect profit-oriented analyses (for example, under a profit split method or according to the Transactional Net Margin Method (“TNMM”) or more generally in testing the application of a transactional method). What is suggested is an avenue in this regard for reinforcing the direction and force of the work of the OECD in addressing the significance of “intangibles” for transfer pricing analysis and the application of Article 9 of the OECD Model Tax Convention.

INTEGRATION OF TRANSFER PRICING GUIDANCE AND APPLICABLE LAW

The guidance in the Discussion Draft will be effective only to the extent that OECD Member countries’ tax regimes share the Discussion Draft’s underlying premise – specifically, whether their systems contemplate, specifically and not merely aspirationally, transmissions of intangible value, as comporting with legally recognized “taxable objects” conveyed according to arrangements that the tax law treats as “tax recognition events”. While the Transfer Pricing Guidelines, like the OECD Model Tax Convention and Commentaries, have enjoyed considerable respect as helpful extrinsic interpretive aids, generally they are merely guidance, and do not constitute law unless adopted as such as some Member countries have chosen, to some extent, to do. Indeed, generally any actual legal authority is paramount over these extrinsic sources. Principles of predictability and certainty, which underlie many Member countries’ tax systems, require this paramountcy of law over extrinsic guidance, no matter how compelling or well-developed the guidance may be. Accordingly, the OECD’s guidance can be effective in practice only if it rests on principles and concepts that OECD Member countries’ laws comprehend in their tax and private law. Otherwise, the utility and effect of the guidance, no matter how valuable in principle it may be, will be impaired.
The tax and private law regimes of OECD Member countries should not, and in any event cannot, be expected or assumed to somehow “accommodate” treating “non-transaction intangibles” such as “ongoing” concern value, goodwill, various manifestations of knowledge and the like, as addressed in the Discussion Draft, in the same manner as “transaction intangibles” that derive their very existence from such regimes.

“Non-transaction intangibles” are, in significant part, “functions” or elements of “functions”, not “things” or even, themselves, services. A conventional application of the Transfer Pricing Guidelines, however, starts with transactions in property and services which have established status already supplied by the law and accordingly are transactions in taxable objects. They then propose various methodologies to test the adequacy of a taxpayer’s reported income arising from those transactions. There is usually a predictable correspondence between the underpinnings of a transfer pricing inquiry relying on the Transfer Pricing Guidelines and the legal characteristics of transactions as Members’ legal regimes would apply. The application of the Transfer Pricing Guidelines becomes more difficult when a transmission of value occurs in a manner other than a standard transaction involving property or services. It is an unavoidable implication of “intangibles” that this sort of value transmission is not merely ancillary to a normative transfer pricing analysis, but in fact lies at or close to its heart. Functions as such are not generally taxable objects of trade – “transaction intangibles”. The “intangibles” in question may not even be recognized by legal or other conventions as giving rise to enforceable rights. The adoption of hypotheses or fictions that simulate transactions is required in order for the Transfer Pricing Guidelines to be applied in a customary and accepted way. The Discussion Draft’s treatment of “functions” – aspects of overt and implied interactions within an MNE group - as transaction objects, can be expected to test the adequacy of Member countries’ tax and private law to give effect to “intangibles” as conceived in the Discussion Draft.

This is foreseen as risking the practical utility of the OECD’s valuable work on intangibles. Also foreseen is the possibility of more, and more difficult mutual agreement procedure cases under tax treaties, raising complex questions not only about whether taxation is in accordance with a treaty, but what the very basis of taxation should be in the first instance under a treaty partner’s law. There also may be reasonable
doubt about the effectiveness, even as extrinsic interpretive aids, of commentaries associated with the
OECD Model Tax Convention, which it is submitted include the Transfer Pricing Guidelines, if they are
thought to extend rather than simply explain notions found in prevailing law.

Treating “functions” as taxable objects transmitted by way of synthetic exchanges, explicitly without
reference to controlling legal and accounting conventions, could raise such a doubt. A further concern is
whether prospects for effective relief from duplicative taxation would be diminished, or at least made more
difficult, in the absence of a consistent point of reference for discerning the objects of a taxable event
under treaty partners’ tax and private law.

THE ROLE OF ECONOMIC AND FUNCTIONAL GUIDANCE ON “INTANGIBLES”

The Larger Context: Reorienting the Discussion Draft

It is useful first to turn to the larger context framing the Discussion Draft, which seems to accord with the
approach being taken in the proposed revision to Chapter VI of the Transfer Pricing Guidelines and with
the approach that is recommended below. These comments apply most directly to non-transaction
intangibles, though in view of the difficulty in readily parsing the intangibles aspect of an MNE group’s
existence in relation to its transactions, these comments should not be considered to be so limited. The
most suitable way to extend guidance on intangibles, particularly non-transaction intangibles, “for transfer
pricing purposes” seems in fact to be foreshadowed by how the OECD’s work in transfer pricing is
otherwise evolving more generally.

Business practices of MNE groups are increasingly “globalized”. They reflect an emphasis on functional
aspects rather than legal-organization features of business. This necessarily raises questions for transfer
pricing analysis and administration extending beyond those associated with normative transfers of goods
and services with which the Transfer Pricing Guidelines, as generally applied, can more easily contend. It
is therefore possible, that analysis sensitive to features of profit-oriented approaches may feature more
prominently in applying, or testing the application of the Transfer Pricing Guidelines.
Three OECD developments, namely, (i) the recent revision of Chapters I to III which acknowledge a more prominent role of “profit-based methods, (ii) the analytical approach taken in Chapter IX with respect to features of “business restructuring”, and (iii) the recently commenced study of transfer pricing simplification and the possible utility of “safe harbours”, may offer insight into how the functional and economic guidance related to “intangibles”, and particularly “non-transaction intangibles”, so thoroughly and thoughtfully examined in the Discussion Draft, might be incorporated somewhat differently, or with a somewhat different methodological orientation, in the Transfer Pricing Guidelines.

First, there is an underlying acknowledgement in the Discussion Draft that certain dealings within or features of MNE groups challenge the efficacy of typical comparative transaction analysis on which the Transfer Pricing Guidelines are built. This is particularly important where the object of a value transfer is not captured as a typical commercial or taxable “transaction” - in other words a legally effective exchange as commonly understood. This requires, then, the initial step, of conceiving such an event in order to apply the Transfer Pricing Guidelines. This would point in the direction, possibly, of profit oriented approaches or influences featuring more prominently in transfer pricing analysis.

Second, particularly in the context of non-transaction intangibles, the focus in the Discussion Draft is on functional analysis, and the economic measurement and apportionment of returns associated with contributions by MNE group members operating together in ways and with implications that are not in themselves “transactional”. This is articulated most forcefully in paragraphs 2, 3, 40, 41 and 108, seeming to frame or at least reflect the influence of what amounts to a profit – oriented, or at least profit sensitive approach. Directionally, the Discussion Draft offers new rigor to difficult functional analysis by setting down certain specific “markers” or “factors” pertinent to intangibles generally and “non-transaction intangibles” in particular which ought not to be ignored and, in fact, will be expected to be addressed in a transfer pricing analysis that in any event takes place within the framework of the methodological approaches recommended in the Transfer Pricing Guidelines. The Discussion Draft also identifies economic inputs to their creation and perpetuation, which, the Discussion Draft suggests, ought to be specifically taken into account in deciding how to apportion returns (and losses) among contributing members of an MNE group. This perceived outlook in the Discussion Draft is consistent with Article 9 of...
the Model Tax Convention as the statement of the arm’s length standard, with reference to evaluating profits despite the forms of methodological guidance in the Transfer Pricing Guidelines recommended to assist the implementation of the arm’s length standard.

The text box preceding Part B of the Discussion Draft together with paragraphs 40 and 41 among others, in fact reflect the OECD’s view that members of a commonly controlled group inevitably collaborate directly and indirectly to support valuable transactions with third parties, not only through transfers among group members that rise to the level of “transactions”, but also fundamentally by being a collective for which inherent “non-transactional intangibles” are defining characteristics and contributions. In likening certain transmissions of economic value to transactions, the Discussion Draft might best be thought simply to adopt a convenient device to add precision and definition generally to functional analysis, and particularly to the application, where appropriate, of a profit - oriented methods, for example, profit splits or the TNMM even if only to complement and test the application of other possibly more reliable transactional methods in certain cases.

Central Concern

A central concern is that left as is, the Discussion Draft effectively could be seen as creating a self-standing sub-regime in the Transfer Pricing Guidelines to deal with “intangibles” generally and “non-transactional intangibles” in particular as, or as comporting with, tax objects not easily or necessarily accommodated by Member countries’ existing tax law and private law.

It may be the case that the OECD would not be concerned about the compatibility of the Discussion Draft’s approach and its Members’ tax and private law regimes. The OECD’s method for ascertaining income attributable to a “permanent establishment” according to the “Accepted OECD Approach” (“AOA”) reflects a concentration on “economic” income, contrasted with income for tax purposes. It relies on synthetic transactions or fictions that may not be respected when computing income for tax purposes under the tax laws of OECD Members. In that context, for example, correspondingly synthetic charges for such dealings may be disregarded as expenses in computing income under Member countries’ tax law even though they would have been taken into account in computing attributed “economic” income. As the
OECD foresees in that context, though, this can essentially institutionalize unresolved duplicative taxation, absent accommodation through foreign tax credit or a bespoke mutual agreement procedure. The OECD anticipates this possibility in the AOA context; new Article 7 and the related Commentary adopt a specific response for this purpose apart from that set out in Article 23 of the Model Tax Convention.

If indeed the OECD foresees the adoption of analytical notions entailing a similar inchoate misalignment between “economic” income and income for tax purposes because of reliance on simulated or fictional commercial transfers of simulated or fictional tax objects “for transfer pricing purposes”, it is suggested that, as it did with the AOA, the OECD address in this context also how incipient disagreements would be resolved quickly and predictably, taking into account possible shortcomings in countries’ relevant tax and private law.

*Another Approach*

Important elements of the Discussion Draft, notably in Parts B and C, are directed to assimilating transmissions of economic value associated with “non-transaction intangibles”, even as they may be present in or associated with “transaction intangibles”, to a familiar transaction paradigm underlying the Transfer Pricing Guidelines, without regard to legal and accounting conventions applied in other contexts to identify the object and method of a transmission of “value”. This is perceived more as, and more useful as, specific guidance on how a functional analysis should be performed in the context of Chapters I to III of the Transfer Pricing Guidelines, with reference to factors that inhere in the operations of MNEs within their groups.

An alternative or possibly at least more targeted approach that would (i) fully engage the existing outlook and analysis in the Discussion Draft, (ii) be faithful to the over-arching focus of Article 9 of the Model Tax Convention, and (iii) avoid any connotation of a reconstitution or restatement of the Transfer Pricing Guidelines for “non-transaction intangibles” by way of simulations or fictional constructions in relation to “transactions” and “objects” of transactions that, apart from this immediate context, may or do not exist, would be to move the guidance in the Discussion Draft to a more suitable place in Chapters I – III. It is to
be noted, however, that this is not meant to suggest that the OECD re-examine, restudy or revise those Chapters or Chapter IX.

This way of addressing “non-transaction intangibles” in particular seems, however, to offer the most promise for the influence intended for the Discussion Draft, as a refinement of or supplement to Chapters I to III, informing how a thorough functional analysis should be performed and the circumstances in which features of a profit-sensitive analysis could be applied, without testing the limits of the tax and private law of Member countries to absorb this guidance with as little controversy as possible. It identifies specific factors that are to be taken into account in performing and documenting a functional analysis, sensitive to the influence of “intangibles”, and in setting prices that compensate group members for their contributions collectively to commercial transactions with third parties.

It is therefore suggested that the proposed changes to Chapter VI should be specifically and explicitly adapted and adopted as supplementary methodological guidance for Chapters I – III rather than being formulated in a way that possibly may reflect elements of a separate and potentially disharmonious transfer pricing code for “intangibles” that overlaps with, but might be seen to adopt notions different from, the core Transfer Pricing Guidelines. This would hopefully avoid possible concerns about the Discussion Draft which need not arise if, as thought to be the case, the Discussion Draft is most usefully seen as indicative but prescriptive and objective guidance, essentially elaborating on how a profit method or supplementary profit – oriented analysis would be applied to evaluate and take account of the aspects of taxpayers and their relations that are not transactional and do not involve transfers that can be readily explained using legal or accounting constrictions.

Adopting this outlook on the Discussion Draft is entirely consistent with the OECD’s evolved acknowledgement of the utility of profit- oriented analysis found elsewhere in the Transfer Pricing Guidelines. It would be unnecessary to postulate economic transmissions of perceived “intangible” value through functions that must be treated akin to commercial transfers of “objects” – goods or services that have status apart from the economic underpinnings of transfer pricing theory – in order to elaborate on the reference to “something” in paragraph 5 of the Discussion Draft. It would also help to alleviate
concerns about whether the notion of “intangibles related returns” establishes a new kind of profit measurement, perhaps in the nature of a notional or implied royalty, license fee or cost share return. And finally, it would avoid having to develop a separate superstructure on which a bespoke “intangibles” regime would sit, with reference to necessary supporting conventions directed not only to defining “transactions” and functions as taxable objects, but also, for example, explaining what it means to “control” something that otherwise does not enjoy existence as a normative property right.

This approach would also mitigate concerns that transfers involving “transaction intangibles” would be disregarded when the conduct of MNE group members coincides with the manner in which they have formulated their relationships, for example by way of cost sharing, contract research, licenses and other contractual arrangements. The OECD clearly is sensitive to this point. These arrangements would still fall to be evaluated by applying Chapters I to III of the Transfer Pricing Guidelines as supplemented by functional analysis targeting “intangibles”. The fact that the Discussion Draft already offers respect for arrangements involving “intangibles” that satisfy this condition suggests that the primary focus of the Discussion Draft, in any event, is on determining the share of profit that is reasonable in the circumstances and is determined in a sound methodological way that reflects the direction of Chapters I to III of the Transfer Pricing Guidelines. It is respectfully submitted that this approach would also fairly balance the unique role of “intangibles” as both defining characteristics of taxpayers, but also objects of normative commercial transactions. I would anticipate that focusing less on whether the origination and deployment of “intangibles” are “transactions” or “transfers” and more on the functional contributions made and responsibilities undertaken by MNE group members in the course of their integrated operations and collective commercial and economic existence will allow the Transfer Pricing Guidelines to apply more coherently, and with a greater prospect of influencing positively OECD Members’ tax law, than if the current course set out in the Discussion Draft is confirmed.

The OECD and its Members are encouraged to give careful consideration to how well the approach taken in the Discussion Draft would be accommodated by Members’ tax and private law. In that connection, the OECD might also consider publishing an annex to the Transfer Pricing Guidelines however it is
determined ultimately to import the Discussion Draft’s examination of “intangibles” setting out the basis on which Member countries would expect to apply their tax legislation to implement the Discussion Draft.

It is hoped that these comments will be helpful to you and I would be pleased to elaborate on them at your request. It is also hoped that the point of view expressed in these comments will be debated at the upcoming November meeting to consider the Discussion Draft and comments on it, and I would welcome an opportunity to participate in that debate.
To  Mr. Joseph L. Andrus  
Head of Transfer Pricing Unit

Subject  Discussion Draft for Intangibles Dated June 6th 2012

Dear Mr. Andrus,

WTS GmbH is pleased to provide you with comments regarding the revision of special considerations for intangibles in chapter VI of the OECD Guidelines and related provisions (IP Draft) dated June 6th 2012. We highly appreciate the general intention of the IP draft and its structure. Please find in the following our remarks to the single chapters.

1  Identifying intangibles

We accede to the finding that the identification of intangibles should be rather independent from definitions under (local) accounting purposes or definitions under Article 9 of the OECD Tax Convention (sec 6). On the other hand such an approach has to be strengthened by a very clear definition of relevant intangibles under the IP draft.

In this context the categories for intangibles identified in sec 14 seq. are very helpful for transfer pricing purposes. One important finding is that certain "assets" such as group synergies, market specific characteristics and secondments are generally not qualified as intangibles. The fact that the list of categories is non exclusive will pose questions when discussing the existence of intangibles in practice.

The treatment of goodwill will require further analysis. In sec. 22 it is explicitly stated that it is not necessary to find a precise definition of goodwill for transfer pricing purposes. On the other hand goodwill should be recognized “when it forms an important and monetarily significant part of compensation” in the transfer of assets in an operating business. According to the IP draft goodwill should also be recognized when it is transferred by means of a trademark or license.
We propose that goodwill should only be relevant for transfer pricing purposes when it is allocable to identifiable intangibles. If it is not, the goodwill might refer to some kind of group synergies or even to some kind of excess payment which should not constitute an intangible for transfer pricing purposes. Accordingly, non allocable goodwill should not be taken into account for transfer pricing purposes. We propose to include these findings in sec. 22.

The discussion about goodwill shows that it is important to identify and name relevant intangibles for transfer pricing purposes with some specificity (sec. 11). We propose to strengthen this requirement, in a way that an intangible should be clearly separable and therefore identifiable. IAS 38 could give guidance on this approach.

We support the concept of "premium earning intangible" meaning that only intangibles should deserve a separate compensation when the intangible should earn a premium return to an enterprise, over and above the normal returns (sec. 9).

We propose to include in this sec. 9 that an intangible should be relevant for transfer pricing purposes, when certain returns can be allocated to the intangible e.g. by calculating an excess premium.

We will later show that the concept of the premium earning intangibles as comparability criterion will be misguiding in practice, due to the non availability of data. Further, as correctly stated, intangible related returns may be negative, positive or zero (sec. 28) and an excess premium will not identify intangibles generating negative or zero "excess" returns.

2 Parties entitled for intangible related returns

Regarding the identification of parties entitled to intangible related returns we appreciate that intangible related returns should be allocated to the entity which performs the relevant intangible functions, risks and bears the respective costs (sec. 37).

More emphasis should be given to the absorption of development costs of intangibles.

We agree to the fact that the absorption of costs alone (for development of intangibles) should not entitle the bearer of the cost for the intangible related returns (sec. 47), but we do not recognize the necessity of significant other functions beside some financial and project management functions to do so. It has to be highlighted that the bearer of the developing costs should also bear the risks relating to a future failure of the development process (development related investment risk) as long as he has the personnel and financial capabilities to perform the project management functions and to bear the development related investment risk. The development related investment risk might even be the main risk relating to intangibles and reference should be made to the development related investment risk in sec. 42-44.
Further, the development related investment risk is independent from the location of the physical performance of developing activities. For an investment the investor in the intangible should receive part of the intangible related returns (sec. 46 should be amended respectively).

Especially, the reference in sentence 4 sec. 40 that important (R&D) functions will be physically performed through own employees should be deleted. It is also a commonly found business practice between third parties that development activities or marketing activities are outsourced to third parties. We propose to delete sentence 4 of sec. 40 since it is contradictive to sentence 1 and 2 of sec. 40.

3 Transactions involving the use or transfer of intangibles

3.1 C1 Transactions - Transactions involving the use of intangibles in connection with sales of goods or services

We do not see the necessity for the creation of a new category of intangible related transactions.

The example of sec. 60 saying that patents used for car manufacturing should be taken into account when selecting the most appropriate transfer pricing method for the sales function of cars to customers is misleading. The usage of manufacturing related intangibles will not have an impact on the functions performed by a limited risk/routine distributor in the example. One could also argue that the routine distributor uses no (manufacturing) intangible and that there is no transaction where manufacturing related intangibles are used at all. Thus, any margin related comparability analysis for the routine distributor as tested party should not take into account the patents used by the manufacturer, when identifying comparables of a routine car distributor¹.

C.1 should be revised or it should be explicitly stated how non transferred/used intangibles should be taken into account in the examples of sec. 60.

¹ Although there might be an impact when performing a CUP analysis.
3.2 C2 Transactions - Transactions involving transfers of intangibles

For intangibles used/transferred we see some issues to be solved within the paragraphs on the grouping of transactions (sec. 68 et seq.). As said above an intangible should only be relevant when it is clearly identifiable and separable. It is a well known fact that the value of intangibles on a combined basis can differ from the value of the sum of stand alone intangibles. Therefore the grouping of intangibles can lead to the valuation of synergies which should not constitute intangibles according to the IP draft.

We propose to think about an approach to identify intangibles as a kind of return generating units. Under such an approach single intangibles should be grouped together until it is possible to allocate specific, measurable returns to the grouped intangibles.

4 Determining arm's length conditions in cases involving intangibles

4.1 General

We generally agree to the finding that a valuation of intangibles should take into account the perspective of the transferor and transferee as well (sec. 83).

We also accede to the fact that the existence of comparables alone does not render (a database) comparability analysis as impossible, as long as the comparables “own” the same types of intangibles. The hint that in many cases the uncontrolled entities will have the same types of intangibles as the tested party at their disposal is extremely helpful in practical discussions.

The existence/“usage” of sec D.1.(vi) intangibles is said to constitute a reason to reject a potentially comparable transaction (sec. 125). To our understanding a D.1.(vi) intangible is described by the following criteria (sec. 105):

1. Not similar to intangibles “used” by potential comparable
2. Yields greater future expected return than without the intangibles => seems to be related to the premium return of section 9
3. Would be remunerated in dealings between independent parties.

These three criteria are helpful from a theoretical perspective but the second one cannot be used to decide whether a potential comparable should be accepted or rejected.

In a comparability analysis you need to know which potential comparables should be included in the analysis. Then you will derive a comparable arm’s length return for the transactions.
Only when knowing the comparable arm’s length return you can judge whether an intangible earns a return above that. Only then you know whether criteria two is met for a comparable. Therefore you can only perform a comparability analysis when you have already a result of such an analysis, meaning that criteria two is recursive and needs to be revised.

Additionally, we advice not to include any profit/return related comparability criteria, since the aim of a comparability analysis is to identify the comparable profits/return of by identifying comparable transactions. The usage of profit/return related comparability criteria will make a comparability analysis recursive.

The findings of this paragraph can be discussed on the Primair examples (3-8) in the annex of the IP Draft and are further elaborated below.

4.2 Use of development costs for valuation of intangibles

Taking into account our findings regarding the development related investment risk in chapter 2 we propose to revise sec. 112. Especially in an early stage of the development process a cost based valuation is a good way to value an intangible, which then consists mainly of the referring development related investment risk. A cost based valuation approach could also be acceptable for non D.1.(vi) intangibles.

4.3 Primair examples 3-8

4.3.1 General

Example 5 handles a marketer with extensive market development functions. In sec. 199 it is said that the marketer will be able to generate the benefits and suffer losses from its market development activities under its contracts.

In the next section it is assumed that comparables are available. The expenditures of the tested marketer are “substantially in excess” compared to that of the independent marketers.

4.3.2 Existence of comparables

Although the Primair examples (3-8) show the theoretical concepts well, they all assume that comparable data is available, reflecting the specific contractual situation, which differs in each example.

We have to remark that in practice it will be difficult to effectively differentiate potential comparables to the functions and risk profiles shown in the Primair examples. In practice it can happen that the available comparable data for marketers/distributors/licensees might be the same for all discussed marketers examples. The difference with respect to the single contractual conditions will in practice most likely not be reflectable in a database comparability study.
When performing a database comparability analysis under the criteria of paragraph 4.1 you have to ask whether the single comparables are "owning” D.1.(vi) intangibles. If this is the case a comparability analysis should not be possible according to sec. 125.

If you do not know whether a comparable is a D.1.(vi) IP “owner” (e.g. by some business report) you can only evaluate this fact by comparing the return of non D.1.(vi) intangible owners with the return of D.1.(vi) intangible owners. Potential comparables generating significantly more return than the return of non D.1.(vi) intangible “owners” should then be qualified as D.1.(vi) intangible owners. But to do this comparison you already need to know which comparables are using D.1.(vi) intangible. This criteria is either not necessary because you already know the involvement of D.1.(vi) intangible or the criteria is of no help to differentiate between the potential comparables.

### 4.3.3 Adjustments

In example 5 it is argued that the far more extensive marketing expenses of the tested party should lead to an adjustment of the margins of the tested marketer. The market development expenses are assumed to increase the value of its parent’s intangibles.

This conclusion is not complete. The correct way would be to decide based on a function and risk analysis whether the tested marketer or its parent should receive the benefits of the generated “excess” intangibles.

If the **parent** should receive the generated excess intangibles, only then the potential comparables are comparable and the argumentation of example 5 leading to a transfer pricing adjustment is valid.

If the **tested marketer** should receive the benefits of the D.1.(vi) intangible the potential comparables are not comparable since they do not bear the same amount of market development activities for generating their own (D.1.(vi)) intangibles. A transfer pricing adjustment can then not be based on the results of the potential but rejected comparables. Additionally, the potential comparables will most likely not reflect the investment/return situation of the tested marketer in potential D.1.(vi) intangible. Under its long term exclusive contract the tested marketer has a high incentive to invest in his potential future results of the market, which might constitute excess intangibles (e.g. a local brand) at the tested marketer. As long as the tested marketer benefits from this intangibles e.g. via expected higher sales and profits there is no need for a transfer pricing adjustment.

Example 5 also shows the **timing aspects** appendant to the generation of intangibles. Generally, the generation of intangibles is combined with high investment cost and uncertain future profits and/or losses. This economic investment structure can most likely not be covered by comparable data, since the state of the investment cycle will not be reflected in the comparables.
Another reason for comparatively low/high margins of tested marketers which own D.1.(vi) intangibles could be realized losses or returns from previously generated intangibles. A transfer pricing adjustment to the margins of potential comparables for not owning D.1.(vi) intangibles would then be misleading as well. The example shows that comparable data from databases should not be used for non standard/ unique/D.1.(vi) intangibles.

Further, in example 5 it is rather misleading to use deviations between the tested party and potentially comparable data to judge who should be entitled to the remuneration of intangibles. This can only be done by a proper function and risk following comparability analysis.

Since the other Primair examples follow the same logic we propose to revise them where necessary.

4.4 Valuation issues (sec D.4.(iv))

We generally agree to the approach to rely on standard comparability analysis and the profit split method for the remuneration of intangibles wherever possible. We have shown above that a comparability analysis in the IP Draft for intangibles can be recursive, especially with respect to D.1.(vi) intangibles.

Therefore more emphasis should be given to Net Present Value (NPV) techniques. NPV techniques will generally be the method of practice when D.1.(vi) intangibles are involved in a single transaction or when performing a profit split analysis. In the following you will find our bullet point remarks to some of the valuation issues mentioned in the IP draft:

- A profit split analysis not relying on NPV techniques will most likely cover for the timing aspects descriptive for intangible transfer transactions. Sec.142 should make this clear.
- Sec 147 should be further specified with regard to valuation techniques to be applied. We have found no guideline on how to separate the intangible relevant cash flows from a given business. A clear reference to the multi period excess earning method or the relief from royalty method would be extremely helpful. Without such a reference and a clear definition of what should be qualified as intangible a segregation of cash flows will become highly arbitrary. At this place the above proposed approach to group intangibles on the basis of return generating units will become important again, since it will only be possible to use NPV methods when some “returns” can be allocated to the separated and identified intangibles to be valued. This approach will also render the application of NPV valuation techniques for standalone goodwill as impossible. Such an approach would use some kind of residual cash flow not allocable to single intangibles.
- Another unclear issue is the inclusion of taxes to the cash flows to be discounted. Sec. 148 can be read in a way that cash flows should be based on operating income only. Sec. 169 is clearly stating that a NPV calcula-
tion is typically performed on a pre tax basis. Then example 19 (which is the only explicit example of a NPV calculation in the IP Draft) uses income after tax as “cash flow” which is discounted. We propose to streamline the IP Draft, clearly stating that NPV valuations should be performed on a pre tax basis2.

- The introduction of two sided valuation techniques in sec. 148 needs to be elaborated. As we understand, this concept is similar to the German concept of a "hypothetical CUP" which poses a lot of questions in its practical implementation. The last sentence in sec. 148 "In these cases the arm's length price will fall somewhere within the range of both (transferors and transferees) present values after taking into account taxes required to be paid with respect of the transaction" needs to be specified. Often there is a large gap between the value of the transferee and the transferor and the decision where within the range the relevant price falls will be decisive for a transfer pricing analysis. In practice, finding the relevant transfer price within the range of transferors and transferees present values cannot be solved without some bargaining concept and we propose to include a statement where within this range the relevant transfer price should lie.

- Sec. 167 should be revised in a way that a terminal value should only to be taken into account in very exceptional cases.

- We do not agree to the concept of highly uncertain valuations (sec. 171 et seq.). First of all any valuation has to live with the fact that the future is uncertain. The concept of a “high” uncertainty will lead to unnecessary discussion, since nobody can judge when a valuation will handle “highly” uncertain future cash flows or only “averagely” uncertain future cash flows. We believe that independent third parties will react to uncertain cash flows with an appropriately higher discount on the transactional volume compared to the same expected but less risky cash flows. Those higher risks are best reflected by a risk adjusted higher discount rate. We therefore propose the use of a strict ex ante approach when using NPV valuation techniques. Accordingly, we do not agree to the concept of price adjustments (e.g. sec 173) which are not very common in third party transactions. The implementation of price adjustment clauses will finally implement an ex post approach which is not used between independent third parties in transactions. What is commonly seen in third party (e.g. in M&A) contracts are some kind of warranties which are often referred to as price adjustment clauses.

Those warranties are contingent to a given specified risk (e.g. potential additional taxes in a future tax audit) and can impact the transactional value in an M&A transaction. Most likely the buyer will pay a higher price due to lower tax risks, when those potential additional taxes have to be paid by the seller. The later payment of the seller for additional taxes could then be seen as an ex post price adjustments but should be economically qualified as the payment for an ex ante warranty. Conclusively, we only accept price adjustment clauses as warranties when they are re-

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2 This should not prevent the inclusion of side effects as tax shields in the valuation etc.
lated to specific and identifiable risks under an *ex ante* approach. We do not accept any price adjustment contingent on a lower/higher than expected cash flow. This would be an application of hindsight and contradictory to the arm's length principle.

However the outcome of the discussion about the OECD draft on timing issues might provide further guidance on this issue.

### 4.5 Comments on example 19

Example 19 should be revised. It does not really fit to the findings of chapter D.4 of the IP Draft. Since it is the only example referring to the implementation of the concept of a two sided valuation approach it should be far more elaborated. Please find in the following our comments to example 19.

- First of all example 19 does not use cash flows but entity specific income after tax as basis for discounting. An adjustment to the income after tax to take care of non cash effective income (e.g. for depreciation contained in the COGS) does not take place.

- Example 19 states that the transferred intangibles constitute of patents and trademarks, without specifying this. One of the value drivers in the transaction is the reduction of the COGS at company S. The COGS reduction is most likely not related to the transferred intangibles but to a cheaper workforce. The COGS reduction should therefore not impact the value of the transferred intangibles.

- The difference (23) between income after tax and the residual value in table 1 is not explained. The routine (operating?) profit for Pervichnyi manufacturing activities would be \(600 \times 5\% = 30\) (21 after tax), which should then be the difference between the value of the intangible (7a) and income after tax (7) in table 1.

- Although it is theoretically valid to take into account the contract manufacturing option of table 3, this setting is purely hypothetical. It will not be possible in practice to elaborate on a potential contract manufacturing scenario.

- In sec. 258 there is a reference missing how the transactional value within the bargaining range (941 – 735) could be derived. Without such a concept a two sided approach will be misguiding.

In case of any questions please do not hesitate to contacts us.

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