The Chemical Company

Taxes and Duties

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Dear Sir/Madam,

We appreciate the opportunity to provide the OECD with comments to the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles published on 30 July 2013.

BASF is a multinational group operating in more than 80 countries with business activities comprising 14 operating divisions and almost 400 production sites and with high volumes of complex transaction flows within the group. Research and development is conducted in numerous research hubs located primarily in Germany, USA, China and India. In 2012, 1120 patents were registered. We therefore welcome the OECD initiative to provide more detailed guidance on transfer pricing in order to achieve a better common understanding between countries and therefore reduce the risk of double taxation.

With regard to this Discussion Draft, we would like to highlight below the substantial difficulties which we would face in the practical application of the principles set out herein which - in many cases - lead to more uncertainty and risk compared to the previous guidance in chapter 6 of the OECD Transfer Pricing Guidelines. These practical constraints arise to a great extent from the difficulties in identifying “control” over functions within multinational groups due to the structure of decision-making processes. These items are detailed below.

In addition, we understand that in the light of the current discussion around BEPS the focus of the OCEDs work in the area of transfer pricing is becoming more focused on ensuring that abusive structures are properly addressed by appropriate guidance. However, it is important to bear in mind that transactions which involve intangibles are often not at all tax-motivated but driven by a large number of business factors and e.g. involve intangible transactions between high-tax jurisdictions. By introducing guidance which is motivated by the existence of tax-haven structures and the presumption of tax-motivated transactions and applying such guidance to all situations, the OECD is creating huge complexity which is not appropriate to non-tax motivated transactions. We will illustrate this in the sections below.

Our specific comments are as follows:

1. Control over functions

The Discussion Draft introduces the concept of “intangible related return” (IRR) and concludes that the party controlling the important functions related to the development, enhancement, maintenance, or protection of intangibles shall be entitled to the IRR.

The Discussion Draft relies on the explanations contained in Chapter 9 (business restructurings) regarding the definition and application of the concept of control. Para 9.23 states that control over risk means “the capacity to make decisions to take on the risk… and decisions on whether and how to manage the risk, internally or using an external provider”. The Discussion Draft states that these principles apply to control over functions analogously.

The allocation of return based on a concept of control assumes that it is easily possible to identify persons who unambiguously exercise control and therefore also possible to allocate control to a specific party. This is also clear from the examples given in para. 9.25 and 9.26 which describe the situation in relation to a fund management service and to a contract manufacturing arrangement respectively. However, the reality in the majority of multinationals is very different. Quality management and controls relating to the risks, functions and assets employed are to a wide extent part of corporate procedures which are generally valid group-wide and are fully integrated in the business processes. The research and development process is managed by electronic systems which track the allocation of projects to specific research centres, the adherence to budgets, the sign-off processes and the registration of IP rights. “Control” is therefore to a large extent built in to group-wide guidelines and operating systems, and can therefore be performed anywhere as such systems enable a decentralised, collaborative organisation.

As far as control can be linked to decision-making capacity, the question arises how it shall be determined. In multinational groups there are always numerous persons and units who play a role, e.g. the Board of Directors, the operating business unit, the research department etc. Operational decisions are made in consensus between these units and in strict adherence with policies provided by management. For example in our research projects, a number of gatekeepers are identified who in turn perform various “control” activities – e.g. check the scope of the project, release the budget, define the research targets, define stop/go criteria, brief the management, check and control the budget, review the business case at regular intervals, decide on further project scope, control the timelines and track the progress. All these activities together comprise the *operational* decision making in regard to research projects.

It should be noted that *strategic* decision-making is generally performed by divisional management of global business units, without a view to legal entity structures. Such divisional management may be regional or global, and is responsible for the decisions made across the whole division with the region or on a global basis. The persons involved in such decision-making are often spread over many different countries and legal entities. They are usually acting in teams (responsible for different aspects of the business) and may travel frequently and be seconded from country to country over a period of several years, retaining their divisional responsibilities. Would the IRR concept mean that the IRR must be allocated to the different countries and legal entities?

Generally, quality management and risk management as well as control over these occurs through systems as well as through management personnel on a group-wide basis, business-driven, irrespective if a group company is acting as a contract R&D entity or a fully-fledged R&D entity. Therefore it is not necessary, and often not possible, that the principal of an R&D contract researcher (as legal entity) “controls” the activity or risks of the researching entity.

Conclusion:

It is often difficult or impossible to identify who “controls” a function in a multinational company. This criterion should therefore not be the main criterion in determining the allocation of the IRR, but can be used to provide guidance in specific cases.

Due to complex decision-making processes in multinational groups, the decision-making capacity is multi-layered and can often not be clearly identified. This should therefore not be a decisive factor for the allocation of the IRR.

2. Mobility of employees

Even if it were possible to allocate control to specific entities based on persons with specific decision-making capabilities, global mobility within multi-national groups mean that people may be delegated to other legal entities whilst retaining their responsibilities within a business division as stated above. Would the consequence be that the IRR would need to follow these people as they transfer from one company to another? Would the transfer of these people be regarded as a “business restructuring”?

Conclusion:

By allocating the IRR based on individual persons decision-making competencies, global mobility within multinationals would lead to significant and numerous transfers of IRR between group companies. Therefore this should not be a decisive factor for the allocation of the IRR. More guidance is required to address this aspect.

3. Cost-bearing and IRR

Based on the above, it is in our view often impossible to identify a specific legal entity as performing “control” over specific functions or risks. In our view it is also not necessary because the IRR should accrue to the party which bears the costs and incurs the risks. To segregate cost and risk from reward would result in an asymmetric taxation with losses borne by one entity in the development phase and profits by another when the intangible is developed.

The treatment of losses is generally not addressed in the Discussion Draft. The party which bears the costs of developing an intangible should according to the Discussion Draft be entitled to a “risk-adjusted rate of return” but “not more”. How is the rate of return to be determined? Some research projects carry substantial risk and may require years of investment before ending, some of them, if not even the majority in failure. If the IRR is deemed to be due to the party exercising control over the important functions, which party should bear losses related to such failed investments in research projects? Should the losses be transferred to the party exercising control, leaving the funding entity with a (somehow determined) rate of return? This issue is not addressed in the Discussion Draft but fundamental to the issue of ensuring symmetry between taxing of profits and losses. As an example, if an investor buys shares on the stock exchange, bearing the cost of the investment completely, should the investor not be entitled to any profit, and indeed, be required to bear any losses?

Conclusion:

Allocation of IRR to any party other than the bearer of costs leads to significant complexity and uncertainty. The IRR must accrue to the party which bears the costs and incurs the risks. To segregate cost and risk from reward would result in an asymmetric taxation with losses borne by one entity in the development phase and profits by another when the intangible is developed. This should be the key criteria for the allocation of IRR. Deviations should only apply in exceptional cases, e.g. if IP ownership is attributed to a low tax jurisdiction .

4. Acquisition and integration of companies

Practical issues also arise when companies or groups of companies are acquired and integrated into an existing group. Such integration usually leads to a shift in decision-making capacities and therefore lead in a shift of “control over functions and risks” in relation to intangible assets of such acquired companies. Under the principles of the Discussion Draft such situations would lead to a forced transfer of IRR, regardless of existing contracts and legal ownership structures.

For example, company A which has developed its own IP has license income from third parties as well as from related parties and is acquired by company B. After the acquisition, A’s license department and control over the function is completely centralized in B. Who is entitled to receive A’s license income - A or B? A has borne all costs related to the development of the IP and had – up to the point of being acquired by B – control over the related risks and functions. Is A entitled to some form of return, if so, how is such payment to be qualified?

Conclusion:

Acquisitions result in “forced” changes in management structures in corporate groups. The question as to at what point in time “control” needs to be performed by the party entitled to the IRR becomes particularly significant in such cases. If control should be a criterion for the allocation of the IRR, such timing issues must be addressed. The tax treatment of the payment of an IRR between group companies must be addressed.

5. Coherence with CCA rules

The reliance on control is in strong contradiction to existing rules on cost contribution arrangements. Under the CCA rules (Chapter 8 of the OECD Guidelines) each participant’s contribution is proportionate to the share in the expected benefits to be received under the arrangement. Under a CCA, pool members may share costs related to management activities in the area of research and development.

Such management activities are allocated proportionally to the pool members as if they were their own activities. There is currently no requirement for pool members to control any functions funded under the CCA in order to participate in the funding and therefore in the future benefits.

Conclusion:

There is therefore a need to align the principles laid out in the OECD Discussion Draft with the CAA rules.

6. Coherence with AOA approach

The concept of the IRR deviates from the Authorized OECD Approach (AOA) according to which the significant people functions are allocated to a permanent establishment. The concept of control over the important functions appears to differ from the "significant people" function concept, which prescribes an attribution of profit based on significant people assuming or managing risk or relevant to the economic ownership of assets as a first step in the attribution of profits to a permanent establishment. The OECD should harmonize these concepts in order to ensure a consistent application of the tax rules.

Conclusion:

There is therefore a need to align the principles laid out in the OECD Discussion Draft with the AOA rules.

7. Coherence with taxation of royalties

It is stated that it is not intended that this chapter should have any relevance for other tax purposes e.g. art 12 (royalties). Nevertheless it must be recognized that this chapter will have significant consequences on these other aspects which will need to be addressed to avoid double taxation.

The transfer of an IRR from one party to another as prescribed by this Discussion Draft can cause significant double taxation issues. Take as an example a legal owner of intangibles who is legally entitled to a royalty, but is not considered to be entitled to the IRR under the principles of the Discussion Draft. In such case the IRR would need to be transferred to the party entitled to the IRR. What is the nature of the payment which would then need to be made? Is this a royalty and is it subject to withholding tax? Is it tax deductible in the country of payment or is it an intangible asset? Is it considered a sale of intangibles or consideration for a right to use intangibles?

Conclusion:

There is a lack of guidance on the practical aspects of implementing the Discussion Draft in regard to the tax treatment of the IRR which is likely to be interpreted differently by different tax authorities leading to complexity and the risk of double taxation. More guidance is required in this regard.

We would welcome the opportunity to discuss the above-mentioned points in more detail and to describe the research and development procedures in our organisation in more detail to give you a better understanding of the issues involved.

We hope that our comments are useful. Please feel free to contact us with any questions you may have on the above.

Yours sincerely,

BASF SE

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