The Voice of OECD Business

BIAC Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

September 30, 2013

BIAC is pleased to respond to the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, published on 30 July 2013 (hereafter referred to as "Draft"). BIAC appreciates the work of OECD Working Party No. 6 ("WP6") and the many improvements that have been made to the Draft.

BIAC made substantial comments on the previous draft guidance (issued in June 2012) and we have reconsidered those comments in-light of the revised Draft. To make this response as useful as possible to the OECD, we have set out or comments in the following sections:

1. Introduction
2. Key comments
3. Additional specific comments
4. Examples

Please note that the information set out in section 4 (Examples) does not represent a BIAC consensus.

We welcome the proposed consultation with business in November 2013 as a means of further improving the draft guidance, and will be pleased to discuss any questions you may have regarding the BIAC comments.

1. Introduction

1. BIAC believes that the current Draft addresses some significant concerns previously expressed by the business community and, in particular, we welcome new wording in Section B. BIAC is convinced that these improvements will help all parties, including non-OECD members, to better understand the complex issues surrounding the management of intangibles and the associated transfer pricing issues.

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2. We understand that it is difficult to reach consensus in this area. We think that in trying to reach such a consensus, some of the core concepts, which have proven to contribute to growth in cross border trade and investment over the past 20 years or so, may now be weakened in the Draft, which may lead to uncertainty and ultimately, double taxation.

3. However, where we have the opportunity to have an open dialogue with the OECD, we feel that both BIAC and the OECD are actually aligned in striving to protect and improve these core principles.

4. BIAC would therefore welcome an express statement from the OECD (in a format of its choosing) confirming its agreement with the following three points:

    - The arm's length principle remains the best and the only principle to define how MNEs price intangibles transfers and flows;
    - Ownership (based on legal protection), control and separate transferability are the three key criteria that should be considered when identifying and defining an intangible, and
    - Some degree of flexibility should be permitted when identifying comparables to use in the pricing of intangibles transactions, recognising that perfect comparables may not exist and that the residual profit split method should not be preferred method (or be used as a "sanity check" in all instances).

5. We strongly believe that formal alignment between BIAC and the OECD on such principles would accelerate business endorsement and answer many concerns our members expressed on some key paragraphs of the Draft. It would also prevent some of the misunderstandings that we anticipate in future day-to-day relationships, not only between taxpayers and the tax authorities, but also between member states. We see such an alignment as a key priority and we are at the OECD's disposal to further discuss and facilitate this.

2. Key comments

Section A: Identifying Intangibles

Definition

6. We recognize that intangibles are complex to tackle for both the tax authority and the taxpayer and we also recognize that some significant improvement has been made in the definition of intangibles in the revised Draft.

7. We agree that having a too narrow or too broad definition of what an intangible is can be detrimental to both the taxpayer and the tax authorities. We strongly believe that in order to meet requirements stated in the BEPS action plan (i.e.: "*adopting a broad and clearly delineated definition of intangibles*") and to reflect the way intangibles are identified between independent parties as prescribed under the arm's length principle, the OECD should move away from defining an intangible as a "something" and instead use the following clear language: "an **asset** of being capable of being owned, controlled and transferable". This

would be consistent with the wording of the comments of the OCDE Transfer Pricing Guidelines ("TPG") which mainly refer to an "intangible **asset**".

8. Certain tax authorities may be concerned that such a definition would be too narrow, however, it will bring much needed certainty for both parties. This is especially the case for transactions involving intangibles as valuation is already such a subjective exercise in many cases and is a fundamental issue dealt with by the revised Draft. The interested parties should at least start with a solid definition of what they will further value.

9. We also believe that if such a clear definition did not capture all intended transactions, tax authorities would benefit from the language of paragraph 36, which states that "*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 an arm's length price and other conditions for controlled transactions*". However, we would only expect this to be applicable in very limited instances.

10. If the OECD intends to maintain the current definition and still believes that a "something" is a valid concept that member states will use in implementing their own legislation, then BIAC strongly insist that:

    - the following three characteristics should be included in the definition: ownership, control, and separate transferability, so that the uncertainty around the word "something" is balanced by very clearly articulated and well understood concepts, (this is very close to the current wording within paragraph 40), **and**
    - legal and accounting concepts and contractual arrangements should be relied upon in view of what could have been agreed upon between independent parties for a comparable transaction.

11. The combination of "something" and the by-pass of legal and accounting definitions creates a grey area that will ultimately result in additional uncertainty and disagreement, notably when transactions involve certain non-OECD countries that take a very broad view on what an intangible that may see the current drafting as OECD affirmation of their approach.

12. We also note that the definition is somewhat weakened by the fact that the term "*transferability*" has been deleted in other provisions since the previous draft. In line with our comments above, we recommend that transferability be reinserted into the relevant paragraphs of the revised Draft (e.g. in paragraph 43).

Protection and transferability

13. BIAC believes that paragraph 42 is very difficult to understand as it seems to contradict concepts that are emphasized in other parts of the Draft. This is particularly true in relation to two concepts: protection and transferability.

Protection

14. Paragraph 41 rightly states (as paragraph 40 does) that an intangible must be "*capable of being owned or controlled*". However, paragraph 42 seems to state that where legal protection impacts the value of an item, the existence of such protection is not necessary for it to be considered an intangible. We would like to understand how a "something" can be "owned" (which is one of its three core characteristics) if it does not benefit from legal or other protection against those who might claim "ownership" of the same "something".

15. In the same spirit that we believe certainty and clarity is of the interest of all parties, we believe that emphasising legal protection as the main criteria to define an intangible will avoid endless discussions about what are in fact intangibles and those items that do not qualify as intangibles (but may play a role in the valuation of an intangible). In addition, in most if not all situations, third parties will always seek to legally protect their intangibles through appropriate contractual terms or other measures.

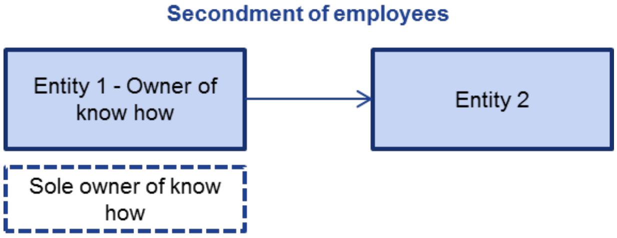
16. Similarly, moving away from the concept of legal protection may trigger significant uncertainties around the concept of "*know-how*" when not legally protected. This would especially be the case with respect to the notion of "*assembled workforce*" which has rightfully been removed from the Draft. BIAC is concerned that this notion may reemerge if protection is not appropriately covered by the Draft.

17. Assembled workforce and its related concept of "*implicit know-how*" should not be viewed as intangibles. It is difficult to see how any personnel can be owned, controlled or transferred. Equally, if a business is transferred between independent parties, including a workforce providing valuable services, this may give rise to a higher value of the business (i.e. the assembled workforce is a comparability factor that may or may not add a value). However, an independent acquirer normally is careful to apply a high risk premium (and therefore a discount) to such a factor for the very reason that a workforce cannot be owned or controlled.

18. Another concern is how business should apply such a provision in practice and be able to identify and draw the line between when a workforce creates an intangible and when it does not. Paragraph 17 provides no guidance in this regard and is likely to lead to numerous disputes with tax authorities with double taxation as a consequence and may lead no non-arm's length conclusions.

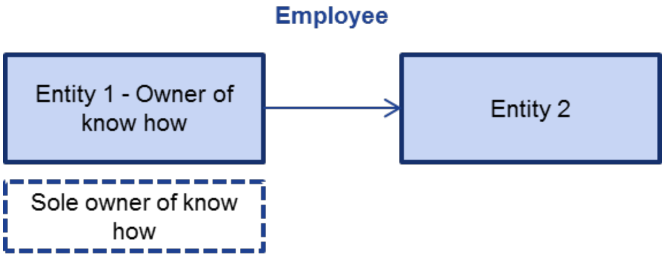
<u>*Example 1*</u>

19. Entity 1 and Entity 2 are part of the same group. Entity 2 benefits from the know-how of one senior employee who has significant knowledge of the business and the market and who was seconded by Entity 1. BIAC questions whether there is there an "implicit intangible" transferred with the employee? Should Entity 2 compensate Entity 1 for the intangible transferred with the employee from Entity 1?



Example 2

20. Entity 1 and Entity 2 are third parties competitors. Entity 2 benefits from the know-how of one senior employee who has significant knowledge of the business and the market. This employee was hired by Entity 2 after he resigned from Entity 1. BIAC questions whether there is an "implicit intangible" transferred with the employee? Would Entity 2 ever compensate its competitor (Entity 1) for any intangible transferred with the employee?



21. Naturally, and as for any service rendered, if a group of employees provide services to another company, appropriate compensation should be paid. However, the payments for such services are not made in return for the transfer of an intangible.

Transferability

22. BIAC insists on the fact that if certain intangibles may be transferred in combination with other intangibles, such an intangible would not exist if the asset does not have legal protection and/or where the asset cannot be separately transferred.

23. As a result, were some business attributes such as goodwill, on-going concern value, synergies etc., … may affect the valuation of a transaction and consequently affect the transfer price of an intangible asset, such attributes or notions are not themselves intangibles, which can be owned, controlled or separately transferred. Consequently, they should not be included in the definition.

24. For example, under some circumstances and certain specific local legislation, 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. This is why BIAC has concerns about recognising a "something" as an intangible for TP purposes that is not capable

of being separately transferred (or with goodwill) and that does not enjoy some level of legal protection.

Residual asset splits

25. We 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 (as we believe is the intention of paragraph 44). However, paragraph 17 (in section D7) on assembled workforces again raises some uncertainties in this regard, although a consistent approach should be followed, as shown in examples provided in the ‘additional specific comments’ section on Paragraph 44.

26. Lastly, we agree with the fact that no additional premium return should be paid in transfers of non-unique or routine intangibles, we believe that paragraph 44 suggests this is only the case in rare situations. In fact, non-unique and routine intangibles constantly form part of dealings between unrelated parties without any premium compensation. We suggest that the paragraph is revised to better reflect this. As a minimum, we recommend to delete the words “*in all circumstances*” in the third sentence of the paragraph.

Know-how and trade secrets

27. We agree with the general conclusions in this section, but we would welcome some wording in the Draft that clearly recognises that know-how should typically be unique or non-routine and legally protected to create a valuable intangible that should to be recognised for TP purposes. Know-how that represents common knowledge, standard trade practices or off-the-shelf solutions etc. should typically fall outside the scope of what is considered an intangible asset for the purpose of the Draft. We suggest the last sentence of paragraph 54 should 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 non-routine in character which allows for them to be characterized as assets that are capable of being separately transferred and valued”*

28. Also see our comments on assembled workforce.

Section B: Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles

29. BIAC is pleased that improvements have been made to acknowledge legal ownership and funding, and that the revised Draft examines 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 return with respect to the intangibles.

Important functions and control

30. The current description of important functions and control needs to be reconsidered so that:

    a) it reflects observed arm's length behaviour rather than imposing a different standard;
    b) it acknowledges that control is not a simple concept and will differ between industries and between MNEs; and
    c) the concepts are modified to reflect the different, and sometimes minimal, functions depending on the intangible and the industry.

31. BIAC understands the issues behind Example 14 where an inappropriate comparable is being proposed, and asks whether control could be further developed as a specific comparability factor rather than making control an entitlement factor. Such an approach would require an evaluation of control by reference to third-party arrangements.

Legal ownership

32. Although it is welcomed that legal ownership is now recognised, the Draft tends to imply that legal ownership is not important in determining compensation at arm's length. There is concern that the concepts in the chapter could be applied to attribute greater returns to more companies within the MNE group than has been the case before.

33. Those companies would not, in the past, have been allocated an appropriate share of development costs, and so there is significant complexity in matching future income and historic costs. Rather than requiring the legal owner to perform all functions, the Draft should consider a "*threshold approach*" under which intangibles can be centralized provided that the principal intangible-holder performs certain functions, assets and risks which can be expected by a third party taking title to any intangible being developed or enhanced partly or entirely by another unrelated party.

Anticipated value

34. The indiscriminate use of "*anticipated value*" causes confusion since it seems to imply that all functions associated with intangibles require evaluation of their contribution to anticipated value. We hope that this is a drafting issue rather than a substantive point. The issue may stem from the difficulty in distinguishing between functions which should receive a routine return and those functions which may, at arm's length, command a return linked to the potential intangible value. Drafters may find the concepts relating to determining an interest in intangibles in the 2010 Report on the *Attribution of Profits to Permanent Establishments* worth reconsidering (particularly paragraphs 81 and 94) in trying to formulate a distinction between routine activities and those which may, at arm's length, command an interest in the intangible value.

Return to capital

35. It is welcome that the Draft now recognises a return to capital, but it seems doubtful that the funding risk can be separated from other risks, and the Draft is unclear about how the funding return would be determined.

Marketing intangibles

36. The discussion of marketing intangibles continues to be unsatisfactory in that there is tension between a criterion based on level of costs and a criterion based on control functions. In addition, there should be recognition that marketing intangibles may rely to varying extents on other intangibles; the market for some products, for example, is driven by the product intangibles.

Section C: Transactions involving the use or transfer of intangibles

37. BIAC welcomes the various improvements that have been made to the revised Draft in this section. Specifically, we are pleased with the addition of more cross references in the Draft to relevant examples which help in illustrating the points being made (examples are found in revised paragraphs 109, 113, 114 and 116), as well as the simplification and rewording of some of the examples. However, BIAC would still prefer the revised Draft to have incorporated more examples and narrative covering licensing arrangements. We would also encourage the 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 returns attributable to intangibles.

38. BIAC also acknowledges the changes made to section C to reflect more references to the use of the actual arrangements and conduct of the parties as a starting point in the TP analysis for intangibles. This will be helpful for analysing the nature and value of assets that have been transferred as well as to assess the need to aggregate or segregate intangibles for specific transactions (examples found in paragraphs 108 and 115). We agree with the addition of such comments as they relate to showing the taxpayer's intent for such transactions and give further consistency with paragraph 1.52 of the TPG.

Segregating and aggregating transactions

39. Further to the above, several references to availability of reliable third party data as a factor to consider when segregating or aggregating transactions have been added to the revised section C (examples as per paragraph 117 and 121). This is further highlighted in section D4, paragraphs 211 and 212. Although BIAC welcomes this addition, as it gives the taxpayer more clarity on when such an activity can be undertaken, we note that additional guidance by means of a list of situations when such an exercise would/ought to be undertaken would be appreciated in order to avoid potential for double taxation where tax authorities take contrasting views.

Identifying intangibles

40. Section C's reference to the identification "with specificity" of the intangibles and the nature of rights to intangibles that are being transferred remains prevalent (examples of such language are found in paragraphs 107 and 113). BIAC believes the reference to be quite comprehensive and thus could potentially significantly increase the compliance burden on a taxpayer. A more narrow definition of the identification requirement or the rewording of the sentence as follows *" …it is essential to identify, within reason, the nature of the intangibles and rights in intangibles…"* would be welcomed as it would capture and recognise the issue of potentially inaccessible information acknowledged in section 1.13 of the TPG.

Disregarding transactions and recharacterisation

41. We believe that the revised Draft has not addressed the concerns raised in relation to disregarding transactions and recharacterisation, and some of that language has been maintained (example paragraph 109). As before, we believe that recharacterisation should be undertaken in extreme circumstances only as per Chapter I paragraph 1.64. This is also true of newly added paragraph 121, which is discussed in more detail below.

Goodwill

42. Several references to goodwill have been made throughout Section C and the associated examples (for example paragraph 113 and Example 16). Furthermore, in BIAC's view, statements like "…*reputational value sometimes referred to as goodwill…*" are confusing. Reputational value is not the same as goodwill. Goodwill is an accounting term and by nature is difficult to measure, observe and value. The implication of including such items as intangibles is that it can lead to the creation of "hypothetical" TP transactions by tax authorities that may not or could not have taken place at arm's length.

43. Furthermore, from an accounting perspective, goodwill is merely a balancing figure and the items that make up that figure are almost impossible to observe. The accounting definition for goodwill is the purchase price over and above net asset position of the acquired company (which is composed of tangible assets, intangible assets and liabilities). In many cases goodwill will contain a subjective estimation of future value hoped-for synergies by the acquirer and, possibly, management enticement figures for acquisition purposes.

44. Moreover, when an acquisition takes place under IFRS accounting rules, companies can opt to use the fair value method (vs. the book value method) for valuation. Under the fair value method, it is assumed that parties will assign a market value for the various intangibles instead of book value, and that the assigned value ought to be derived from data and specialist valuations. As such, it would be more difficult to consider goodwill as containing intangibles of value, and moreover, by classifying goodwill as an intangible, there may be a risk of attributing value to a non-existent "intangible".

Split ownership of intangibles

45. BIAC notes that there is still an implication in some of the examples in section C (as well as other sections of the revised Draft), that the returns attributable to intangibles 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. As mentioned before, the temptation to allow everyone to claim a 'slice of the pie' for TP purposes should be avoided as it is not in line with the arm's length principle. BIAC is concerned that this could result in more uncertainty for business, and potentially more double taxation and more disputes between territories.

Location savings and synergies

46. BIAC strongly welcomes the move of the discussion on location saving and group synergies to Chapters I-III, as well as the clarification that these items are not intangibles and should be treated as comparability factors. However, we remain concerned that the wording seems to suggest that these factors are promoted to a higher level of prominence than BIAC believes is warranted.

Section D: Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles

47. BIAC acknowledges the efforts made to reorganise the material of section D and welcomes the improved clarity in the general guidance and in the separate sections related to transfers of intangibles or rights in intangibles, and to transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

48. However, BIAC still finds that there are significant concerns in relation to all the key issues highlighted in its comments to the previous discussion draft published in June 2012. These relate to:

    - Simpler rules for simpler cases and further refinement of the principles applying to complex cases;
    - Guidance on the selection of method;
    - Services using intangibles;
    - Administrative burden; and
    - Example 19 (now Example 24).

Simpler rules for simpler cases and further refinement of the principles applying to complex cases

49. BIAC welcomes the edits made to section D.4. of the guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services. We recommend that similar guidance should apply to all transactions involving intangibles.

50. BIAC also recommends further work to create simple and practical guidance, supplemented, where necessary, with additional detailed direction (and, if

possible, practical examples) for complex cases. BIAC also requests clarification with respect to how to characterise transactions (simple vs. complex etc.).

Guidance on the selection of method

51. Some edits made within section D.2. (Supplemental guidance regarding transfers of intangibles or rights in intangibles) appear to be prescriptive in discouraging the use of methods based on comparability. BIAC strongly believes that the "*best method*" approach should be maintained and recommends a rethinking of the prescriptive statements in paragraphs 156 and 164:

> *"However, it will often be the case in matters involving transfers of intangibles or rights in intangibles 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 and other conditions. (…)"* (Paragraph 156)
>
> *"(…) It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible."* (Paragraph 164)

52. In addition, the revised Draft guidance may be interpreted as prescribing the Profit Split method. Immediately after the above paragraphs, paragraph 166 states:

> *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. (…)".* (Paragraph 166).

53. Although explicitly referring to the section of Chapter II dedicated to the transactional Profit Split method (2.108 through 2.145), there seems to be some disconnection between the draft wording of Chapter VI and Chapter II. In fact, paragraph 2.109 describes the transactional Profit Split as appropriate for:

    - highly integrated operations for which a one-sided method would not be appropriate; and
    - cases where both parties to a transaction make unique and valuable contributions.

54. In chapter II, comparables appear to be an element of the Profit Split analysis (where possible), rather than an alternative. This is particularly the case when the specific methodology applied is the Residual Profit Split. In this respect we note that where Profit Split methodologies are used, the Residual Profit Split method is much more common in practice.

55. Section 2.121 refers to the Residual Profit Split and states that such an analysis "*divides the combined profits from the controlled transactions under examination in two stages. In the first stage, each participant is allocated an arm's length remuneration for its non-unique contributions in relation to the controlled transactions in which it is engaged*" (ordinarily through the application of one of the other OECD transfer pricing methods and then "*any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances*".

56. BIAC believes that the Residual Profit Split approach is more likely than the Contribution Analysis to provide results that reflect what would have been achieved between unrelated parties in relation to transactions involving intangibles.

57. BIAC is concerned that the revised Draft could be seen as supporting a new definition of the Profit Split which moves it closer to a formulary type approach. If this is the intention, much more detailed guidance about the application of this method would be required. If this is not the case, BIAC recommends the review of the wording that could lead to the interpretation that Profit Split is the recommended approach in all cases where comparables cannot be found or are considered not reliable. BIAC strongly opposes the use of formulary apportionment type methods and supports the continuing use of the arm's length principle as the foundation of the TPG.

58. Similar concerns can be expressed about section D.4. (Supplemental guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services): that the revised Draft states that:

> *"It will often be the case that, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or provision of services, reliable comparables can be identified. (…)"* (paragraph 215),

59. But then goes on to state at paragraph 220 that:

> *"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 the sale of goods or the provision of 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."*

60. While the case of unique and valuable contributions is clear, it would be important to understand whether the sentence "*where reliable uncontrolled transactions cannot be identified*" leads to the same type of issues highlighted above for the section on transfers of intangibles or rights in intangibles.

61. BIAC welcomes the following new wording in paragraph 166:

> *"In evaluating the reliability of Profit Split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered. See paragraph 2.114."*

62. However, some additional wording would be helpful to expand upon implementation difficulties often associated with Profit Split methods (as highlighted in section 2.114 of the TPG) that, combined with the issues highlighted in the wording of paragraph 166, may lead to extreme difficulties in the administrability and auditability of Profit Split methods in certain cases. In fact, after having solved all the issues highlighted in paragraph 2.114 and determined the division of profits that independent enterprises would have expected to realise, a taxpayer (or a tax authority) will still have to solve the issues of developing algorithms to calculate the appropriate transfer prices and to administer them.

63. BIAC also observes that the inevitable complexities of Profit Split as outlined above may make it a very costly and difficult method for small and medium enterprises to implement and for emerging countries to audit.

Services using intangibles

64. This is a significant area of concern for business. Extracting and analysing the potential intangible component of every provision of related party services would place an unmanageable burden on the taxpayer and introduce significant complexity and potential for dispute.

65. BIAC observes that no changes have been made to the Draft on this subject and confirms the position expressed in its 2012 comments, recommending the development of practical and administrable guidance on this subject.

Administrative burden

66. Business has significant concerns about applying the revised Draft guidance in practice.

67. The requirements of paragraph 151 (formerly 108) have not significantly changed and those of paragraph 157 (formerly 126) have become even more burdensome.

68. BIAC reconfirms the comment made in relation to the 2012 draft on this subject and recommends that, in addition to establishing a conceptual framework, that the OECD also analyses the issues of manageability and the encouragement of a balanced approach based on the quantum of the transaction(s), size of the multinational group, availability of information and complexity.

69. Materiality thresholds could also be considered in order to prevent excessive resources to be dedicated to relatively minor transactions.

Example 19 (now Example 24)

70. BIAC acknowledges and appreciates the statement that analysis set out in the Example is greatly oversimplified by comparison to the analysis that would be required in an actual transaction. However, in practice, business has already experienced cases of tax adjustments based on oversimplified models, similar to the one illustrated by Example 24. BIAC would therefore recommend either the deletion of the Example or the inclusion of additional wording about minimal requirements of analyses based on valuation techniques.

Other general comments

71. BIAC suggests that section D should provide detailed guidance on the issues that have been discussed in the previous chapters of the revised Draft(for example, particularly focusing on sharing compensation for split ownership of intangibles and pricing the provision of contract R&D) and what business should look for in comparable uncontrolled transactions (including necessary adjustments). Such guidance would help business to determine when the CUP method and Profit Split are appropriate.

72. BIAC also acknowledges the fact that the wording of section D.3. has been left unchanged, pending the development of BEPS related work on the TP treatment of hard to value intangibles. BIAC considers this area particularly important because of the potential for significant uncertainties. We would welcome a full public consultation as soon as a new draft section D.3. is available.

3. Additional specific comments

Section A: Identifying Intangibles

Paragraph 38

73. Paragraph 38 (ii) should probably be extended slightly to say *'and available legal and practical frameworks to provide protection*'. The issue is touched on elsewhere (e.g.: paragraphs 42 and 54) but is so fundamental that it should probably go in this primary section.

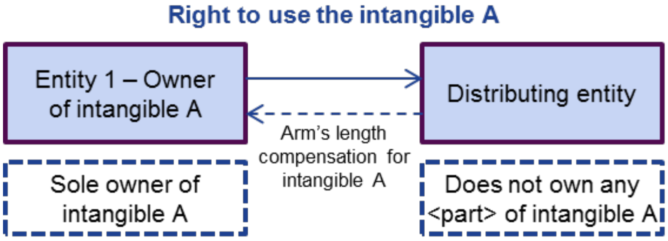
Paragraph 44

74. As noted in our section 2 of this document (key comments), paragraph 17 (in section D7) on assembled workforces raises some uncertainties with respect to the use of a “residual asset split approach”. We note in this regard that a consistent approach should be followed, as shown in examples provided below.

<u>*Example 3*</u>

75. A distributing entity, that 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 intangibles.

76. Appropriate approach:



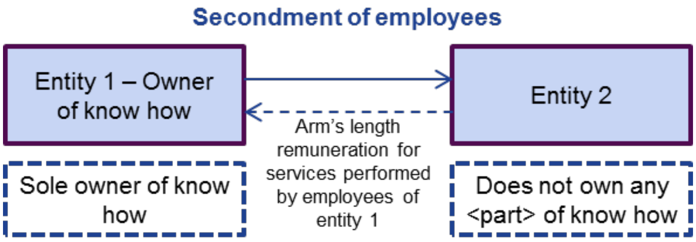
77. Legal and accounting principles and contractual arrangements should be used in order to assess whether or not intangible asset A exists;

   a. Determine if Entity 1 owns an intangible for TP purposes. Entity 1 should simultaneously (1) own legal protection of the intangible A (2) perform functions in relation to the ownership, the maintenance or the management of the intangible A and (3) incur costs in relation to the intangible A.
   b. Determine if Entity 2 owns an intangible for TP purposes. If Entity 2 does not simultaneously (1) own legal protection of the intangible A (2) perform functions in relation to the ownership, the maintenance or the management of the intangible A and (3) incur costs in relation to the intangible A, then it only has the right to use intangible A but does not own intangible A.
   c. Determine if compensation received by Entity 1 from Entity 2 for transferring the right to use intangible A is arm's length according to the TPG.
   d. Determine if entity 2 owns its own its own developed "distribution" intangible B.

__Example 4__

78. Entity 2 benefits from the know-how of some employees seconded by Entity 1. Such a secondment should not be seen as a transfer of an intangible, but Entity 1 may well be entitled to a certain level of income if its employees perform training activities to the benefit of Entity 2. Whether or not a business is simultaneously transferred by Entity 1 to Entity 2 is irrelevant and should be analysed separately.

79. Appropriate approach



80. Steps for analysis:

- Determine if compensation received by Entity 1 from Entity 2 for seconding the employees is arm's length in accordance with the TPG.

Paragraphs 49-51

81. We would welcome clarification on the definition of a "marketing intangible" which is stated as being customer facing but also seems to include customers lists, data and relationships.

82. More importantly**,** whereas a discussion on the role of advertising and marketing in creating or enhancing brand intangibles is useful, care needs to be taken that the grouping of various items within the definition of 'marketing intangibles' is used in a way that provides greater clarity. This approach should not place too much emphasis on one class of functions which may contribute to maintaining or enhancing brand value, or lead to the setting of a low bar for recharacterising legal arrangements where brands are concerned.

Example 5

83. If a jacket is manufactured, marketed and distributed in China but bears a trademark legally owned, maintained and protected in Germany, would the combination of the manufacturing/distribution skills, the market knowledge and any customer lists qualify as a "marketing intangible" that should be owned by the Chinese entity, which would thereby "co-own" an intangible with its German parent?

84. This example illustrates another reason BIAC believes that separate transferability and legal protection are crucial characteristics of intangibles. We also reiterate our view that for such those reasons, a brand should not be considered to be an intangible in paragraph 57.

Paragraph 58

85. We agree that rights under contracts and government licenses are intangible if the right in question can be transferred. Consequently, we propose that the last sentence in paragraph 58 is amended accordingly.

Paragraph 59

86. Although rightly pointed out that under a license agreement, "limited rights" are at stake; paragraph 59 seems to state that all licenses are intangible, where it is not the case as pointed out in our comments on the previous draft guidance. Although a license can create a value for the licensee, it is a right to use an intangible asset owned by the licensor, rather than to exploit the intangible itself. Notably, a short term license is not an intangible asset in and of itself. This does not prevent tax authorities and the taxpayer from including such licenses in a TP 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 distinguish 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 60

87. Paragraph 60 still needs to be drafted in more precise terms as it affects a very significant concept (goodwill and ongoing concern). BIAC considers that goodwill and ongoing concern are not intangibles due to their non-transferable nature. However, we recognize that, in combination with an intangible, these concepts do have to be taken into account as part of a TP analysis in the case of a transfer of the underlying intangible. Suchs analysis is already appropriately handled under Chapter IX of the TPG.

88. 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 value attributable to an intangible and will bring more uncertainty than clarification to the current guidelines. It should be very clearly stated that, as opposed to what paragraph 60 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 its own right. This paragraph should refer to the elements that need to be considered in order to value an intangible rather than suggesting that those factors are intangibles themselves. If a reference to the role that reputation and goodwill play is still relevant, they should be quoted in another section to avoid confusion.

Paragraph 61

89. BIAC continues to disagree with the conclusion of paragraph 61, which treats goodwill and ongoing concern value as intangibles. We note that these items are not capable of being separately transferred.

90. No precise definition of goodwill or going concern value is provided, yet paragraph 60 states that goodwill may consist of the difference between the aggregate value of an operating business and the sum of the value of all separately identifiable tangible and intangible assets. Similarly, ongoing concern value is said to be 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.

91. The problem with treating goodwill and ongoing concern value as intangibles based on those concepts is that it will lead to double counting of the same items of value and consequent overvaluation of related party transactions. Paragraph 153 already requires that when intangibles are transferred in combination with other intangibles, or with tangible assets or services, that those transactions should be evaluated in the aggregate where that will lead to more reliable pricing. We believe that the tax authorities are appropriately protected by the guidelines around the valuation of intangibles.

Paragraphs 47-48

92. BIAC questions whether (in paragraph 47) it is right to explicitly state that the contents of the intangibles TP guidance is not relevant for other purposes (e.g. Article 12). Although the applicable concepts may not always be identical, there should be some broad overlap or consistency. Otherwise, there will be an increased potential for multiple jurisdictions attempting to apply taxing rights over the same profits rather than allocating rights appropriately.

93. An explicit disclaimer such as that in paragraph 47 is liable to be interpreted as suggesting that the TP concepts are irrelevant for other purposes, whereas more appropriate guidance would be to state that TP principles may be informative but not conclusive. We note in this respect that TPG acknowledge that accounting valuation data may be informative where its principles and objectives overlap with those required for TP purposes, but that those principles and objectives often may not overlap.

94. We would recommend that the Draft stay silent on the issues of relevance for other tax purposes (perhaps deleting paragraph 47).

Paragraph 46

95. We understand the need to perform analysis in order for the tax authorities to have a better understanding of the complex transactions that may surround the ownership, the transfer and the use of intangibles. We agree with paragraph 46 which states that *"[i]n a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value, the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value […]".*

96. We however would welcome wording from the OECD that would permit the use of "non-perfect" comparables in certain situations where the number of transactions or the value of the transactions are not significant. It should be born in mind that an important reason for many MNEs to have principal TP-models with centralized risk taking and intangible-ownership it that it is very difficult to identify and value these factors with great specificity. We thus believe that the Draft needs to be more balanced in relation to what can be reasonably expected from a taxpayer to better reflect these difficulties.

Section B: Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles

Paragraph 73

97. This paragraph starts to examine whether parties other than the legal owner may have an economic interest in an intangible. Although in concept the points are valid, the drafting needs tightening in several areas.

98. The second sentence asserts that legal ownership by itself does not confer any right to retain any return. This seems to go too far as a general proposition, and tends to contradict the helpful comment in paragraph 72 that marketing activities undertaken by a licensee may affect the value of the underlying intangible legally owned by another party. If the drafters are referring to the concept of caretaker ownership, as illustrated in Examples 1-3, where a party assumes legal ownership on behalf of the "*real*" owner, then the drafting needs to distinguish the general proposition from the narrow example. As a general proposition, legal ownership is often linked to the prices received and income earned by parties operating at arm's length. For example, the value of mineral rights is strongly associated with legal ownership rather than active management and control, and the value of those rights may be affected by developments made by others (changes in the market price of the mineral or developments in extractive technologies).

99. The third and fourth sentences introduce the concept of "*anticipated value.*" Although anticipated value is acknowledged to be relevant when considering the arm's length pricing for transactions involving intangibles, the wide use of "*anticipated value*" lacks discrimination in the Draft and causes confusion. For example, later in this paragraph the Draft states that the legal owner remits to other group companies remuneration reflecting the "*anticipated value*" of their contributions; this is unlikely to be the case if those contributions are routine. The third sentence would be easier to understand if it stated that the return ultimately retained by the legal owner depends upon the contributions it makes to the development, enhancement, maintenance, and protection of intangibles, with the same amendment made in relation to the contributions to the development, enhancement, and maintenance and protection of intangibles of other group companies.

100. The example in the next sentence seems to be contradicted by the guidance in paragraph 72 that the legal owner could end up with an enhanced intangible even though all of the enhancement is done by a licensee. The watch examples also seem to contradict this statement, since they are based on the share in the enhancement to value between the legal owner and the licensee.

101. This paragraph introduces Examples 1-3. Example 3 is particularly problematic if it were taken to suggest that the legal owner, as a general concept, should not have any interest in the increase in value in its intangibles. It would be helpful in Examples 2 and 3, where Company S enters into licensing arrangements, to emphasise that Company S is performing a caretaker role and acts on behalf of Premiere.

Paragraph 79

102. This paragraph describes important functions. Paragraph 76 invites the reader to interpret control by reference to the principles of sections 9.23-28 of the TPG. Those paragraphs examine the decision to hire, the type of research and objectives assigned to it, and determining the budget. Paragraph 79 goes further than this; for example "*design and control of research and marketing programmes.*" Under sections 9.23-28 of the TPG, the design and control of

the programmes in order to fulfil the objectives of the research would not be regarded as a control function.

103. A control function to determine what needs to be targeted in a marketing initiative, and how much to spend on such an initiative, is not the same as designing how those objectives would be achieved. In some industries, a research programme is designed by the outsourced provider in order to provide independent validation. Perhaps instead of "*design and control of research and marketing programmes*" the Draft should refer to "*setting strategic objectives for research and marketing activities*."

104. Another example is management of budgets. Management of budgets seems to be a different matter to the setting and control of budgets. Reference to "*ongoing quality control*" is very vague, and the phrase can be associated with fairly routine checking. Perhaps something like "*assessing outcomes at appropriate stages*" may be more helpful.

105. The key points are: the current description of important functions needs to be tightened, and the guidance needs to be consistent with observed arm's length behaviour and should be adjusted depending on the intangible and the industry. There is a particular difficulty in some industries with the concept of control in relation to the development of intangibles: control can be seen as limiting, and there have been efforts to free research efforts from control in order to encourage innovation. In addition, MNEs may not be hierarchical, and key people may move around an organisation. Control functions, where they can be identified, may be highly mobile. Although the *2010 Report on the Attribution of Profits to Permanent Establishments* is not perfect in the drafting of determining which part of the enterprise has an interest in an intangible, it is worth reflecting on the possibility that the two reports are not consistent in discussing the issues which may indicate an economic interest in the value of an intangible.

Paragraph 80

106. BIAC remains concerned that standards of behaviour are outlined without clear reference to arm's length behaviour. The first sentence of this paragraph implies that a party will perform the more important functions through its own employees. BIAC believes that the analysis should be rooted in arm's length behaviour and should compare the behaviour of the associated parties with observations of the behaviour of unconnected parties in similar situations. We suggest that guidance is provided so that tax authorities are encouraged, when evaluating the level and nature of important control functions, to take into account prevalent practices in the industry sector and the level and nature of important control functions observed in similar uncontrolled arrangements.

107. We suggest that the first sentence of paragraph 80 is deleted. The paragraph could begin: "*Important control functions usually make a significant contribution to intangible value, and if those important functions are outsourced in transactions between associated enterprises, they should be compensated accordingly. Comparable transactions may be available in order to apply arm's*

length pricing. Where comparable transactions are difficult to find, or cannot be adjusted reliably, it may be necessary to utilise transfer pricing methods not directly based on comparables . . ." The statement that no material portion of the return would be attributed to the legal owner where most functions are outsourced is difficult to reconcile with the treatment of the provision of capital and risk: capital is discussed in the section headed "*assets*," but the provision of capital and assumption of risk could also be regarded as a function, yet the Draft seems to downplay the importance of funding.

108. Examples 13 and 14 are associated with this paragraph. Example 13 makes it clear that investment in an intangible will give rise to a return, even when no other control functions are performed. Example 14 is less clear but does state that the legal owner and capital provider should not be entitled to all of the returns, which implies that some return is allocated to the capital provider even though it performs no other functions.

Paragraphs 82-84

109. These paragraphs are helpful in the acknowledgement that funding should create entitlement to a return. But it is not clear how to measure that return. Third-parties do lend to high-growth companies, often involved in the development of intangibles, and the lending does not transfer control of the development activity to the capital provider. There may be a relatively high interest rate and options over shares to allow upside participation. It may be that the drafters envisage that such third-party arrangements seen in the open market are not regarded as comparable to a group situation, but it is unclear why. BIAC would be pleased to provide examples of the return to funding seen in the open market. Paragraph 84 attempts to separate funding risk from "*the assumption of any further risk*." However, this is conceptually very difficult to do: funding the development of an intangible seems to be inextricably linked with that development risks since the capital provider risks no return if the development is unsuccessful.

Paragraph 88 and Example 4

110. The paragraph makes the point that costs associated with risks materialising should be aligned with the contractual allocation of risk. However, Example 4 is unhelpful in reaching two difference conclusions: one conclusion is that the product liability costs should be borne by the parent and not the limited risk distributor; the other conclusion is that the distributor was incorrectly determined as limited risk and an increase in prior distribution margins should be made. The potential for tax authorities to reach two different conclusions is not helpful. The Example seems to suggest that control of risk and capacity to bear risk are significant criteria, and it would seem that the Example could be used to reach one conclusion.

Paragraphs 89-90

111. The way in which paragraph 89 is phrased is highly restrictive in that it requires the legal owner to perform all the important functions, provide all assets, and bear and control all risks, if it is entitled to all returns. We note that this does

not reflect arm's length behaviour and does not appear to provide an accurate summary of the intentions of the preceding paragraphs. The way in which paragraph 66 is phrased suggests that the legal owner retains all returns after paying arm's length compensation for contributions made by other parties, and this approach is confirmed by paragraph 90. It would be more appropriate to phrase paragraph 89 in this way.

Paragraph 96

112. This paragraph continues to present difficulties since it seems both circular and potentially inconsistent with other discussions.

113. It seems circular because it appears to say that, in determining the right price for a distribution function, it is fine for a distributor to bear marketing costs if the price is right. The concepts of the Draft call for a different approach: the paragraph should take on the final comment in paragraph 95 and state that in determining whether a distributor should bear the cost and risks of marketing activities, the analysis should focus on the extent to which the distributor controls the risks associated with those activities and performs the important control functions.

114. It seems potentially inconsistent because the distributor is effectively providing capital; it is performing a routine function of distribution but also spending money on investing in an intangible. In this paragraph, the investment calls for an additional return based on value creation. Earlier in the Draft an investment return is treated more cautiously.

115. In the first sentence, it would be helpful to rephrase the point about arrangements for the legal owner to reimburse marketing expenditures. In many instances there may be no direct reimbursement, but the appropriate use of a resale price margin or net margin method effectively means that the cost and risk of marketing activities is indirectly reimbursed. This point reinforces the main point that the emphasis should not be initially on the costs, but on which party controls the activities and risks.

116. At the end of the paragraph, it is not clear what is meant by "*a share of the profits associated with the enhanced value of the trademark*." What and whose profits are meant here? The Draft should also be even-handed and include the risk of loss of value.

Examples 5-10.

117. Example 5 seems to be consistent with the comments above, rather than with the formulation of paragraph 96. This Example seems to illustrate the point that Primair controls the marketing activity performed as a service by Company S, and therefore, that Primair should bear the marketing costs and retain the intangible income.

118. Example 6 seems partially consistent with the comments above, in that it concentrates on the control functions performed by Company S in determining

its marketing plan. Given the opportunity in the long-term contract for Company S to benefit from assuming these risks, no additional compensation is required. However, the Example starts to require comparison of the marketing activities with those of independent parties, despite the fact that Company S is acknowledged to have high operating expenditures and slim margins. It is very difficult to compare marketing activities between companies. In this Example, there are apparently no significant differences between Company S and comparable marketing companies.

119. Example 7 continues this point. Now there are significant differences in the level of costs incurred by Company S and comparable companies. As a result, it seems that Primair has to assume a payment to Company S even though it is acknowledge that Primair does not control the marketing activities performed by Company S. Such an outcome seems inconsistent with the principles of section B.

120. The options to remedy the perceived issue in paragraph 250 of Example 7 are very odd. The first option is to find comparable distributors, but the Example hypothesises that there are no comparable companies, so this is not an option. The third option is for Primair to pay for the marketing activities conducted by Company S, but this is contrary to the guidance developed in section B which directs that the party controlling the important functions should have the interest in the intangible return. The second option is to perform a Profit Split, but this option would, it seems, support the status quo; in other words it would endorse the result that was deemed to need remedying. If one gave a routine return to Company S and to Primair in relation to Country Y market, there would be no routine return to Primair. If one then split the residual loss based on contributions, then there is no contribution made by Primair. So the Profit Split would endorse the position of Company S that it sought to remedy. The most important point seems to be made right at the end in paragraph 251. This paragraph seems to suggest looking at the expected returns from the important functions performed by Company S, rather than basing the analysis on some measure of excessive marketing expenditure. In other words, Company S manages and controls the risk arising from its marketing investment since it has long term rights.

121. Example 8 tests this conclusion since Company S now has only short-term rights. The Example is still phrased in terms of excessive expenditure, but it would be more in keeping with the concepts of section B to frame the issue in terms of control of risks. Company S cannot control the risk that its investment will create value.

122. Example 10 reaches the same conclusions as Example 7, which seems a flawed conclusion.

123. Paragraph 97 focuses on contract R&D; we are concerned that reimbursement seems to require reflection of the anticipated value of any resulting intangible. This is not typical of third-party contract R&D arrangements. The Examples focus on control functions in accordance with section 9.26 of the TPG, whereas

this paragraph discusses a much wider range of factors which may be appropriate for comparability purposes but are not appropriate for establishing whether the party has any interest in the intangible.

Examples 11-14.

124. Example 11 exemplifies the control requirement found in section 9.26 of the TPG. However, paragraph 265 then phrases the return to the service provider as reflecting the anticipated contribution to intangible value. It is not clear why this is correct in principle since it is not typical of arm's length arrangements, or how this reflection can be implemented.

125. Examples 12 and 13 illustrate the concept of control of risks, and Example 13 recognises that the transactions are respected, and that there is a return to capital without further functions.

126. Example 14 seems to present a comparability issue rather than a point of principle; in the Example Company A is not performing in a way comparable to CROs. In both Examples 13 and 14, it seems that the application of Profit Splits or other methods would appropriately arrive at an acceptable answer without recourse to recharacterisation.

127. The discussion in paragraphs 99-103 of the use of the company name reaches unclear conclusions. What seems to be lacking is reference to deliberate action to use the group name to create branding, and creating the distinction between incidental benefit and concerted action found in the discussion of group synergies. Paragraph 100 is particularly unclear since it suggests that a payment for the group name would be appropriate where there is a financial benefit. However, that financial benefit may result from passive association rather than any active attempts to promote a brand associated with the company name. It would be difficult to apply the guidance at the end of paragraph 101 since it is unlikely that the company name would be licensed to third parties.

Section C: Transactions involving the use or transfer of intangibles

Paragraph 107

128. Paragraph 107 uses an example to illustrate how and why the limitation of rights to an intangible need to be identified. The current wording of the example implies that if a taxpayer wanted to transfer the exclusive rights for a patent in Country X, it can either sell all of the Country X patent rights or provide a license of a portion of the worldwide rights to the patent:

> *"For example, in the case of a transfer of the exclusive right to exploit a patent in Country X, the taxpayer's decision to characterise the transaction either as a sale of all of the Country X patent rights, or as a license of a portion of the worldwide patent rights, does not affect the determination of the arm's length price if, in either case, the transaction being priced is a transfer of exclusive rights to exploit the patent in Country X. Thus, the*

functional analysis should identify the nature of the transferred rights in intangibles with specificity."

129. We believe that the wording renders the example inaccurate as a licence of a portion of the worldwide rights is not the same as a sale. We suggest that the example be removed or at least reworded as follows *"… or as a perpetual exclusive licence of a portion of the worldwide patent rights,…"*

Paragraph 112

130. Paragraph 112 uses the example of a pharmaceutical company to illustrate that certain intangibles would be more valuable in combination. We believe that the example used is potentially misleading as it could be read to suggest that these various intangibles are equal. For the pharmaceutical industry the intangibles related to patent, trademarks and regulatory approval do not carry equal value; often the patent for the active pharmaceutical ingredient would be the item with the most inherent value as without it, there would be no product. Furthermore, we find the last two sentences of this revised paragraph quite ambiguous and possibly would benefit from some rewording as it is unclear what is meant by "*securing*" or "*value creation*" and this might imply some hypothetical assessment of the future is required.

Paragraphs 113-114

131. BIAC believes the example used in revised paragraph 113 to illustrate the need to identify all intangibles involved in a transfer, to be misleading and confusing. As currently worded, it is unclear if the paragraph is inferring that every trademark transfer should be associated with a payment for "*goodwill*". If so, how can we value such goodwill and how can we observe if it does require a separate compensation or if the value associated with the trademark will be sufficient? When considering third party arrangements, such analysis and separation of goodwill value would be very difficult to undertake and in most cases unobservable. Furthermore, we note that Example 16 does not properly illustrate the point being made in paragraph 113 and we would recommend that is significantly reworded. Please refer to our comments on revised Example 16 below.

132. Similarly, revised paragraph 114 references revised Example 17. We do not believe that Example 17 illustrates the points made in this paragraph.

133. Furthermore, paragraphs 113 and 114 appear to provide contradicting advice. One recommends the identification of goodwill separate from trademarks and the other refers to how such a separation can be viewed in disagreement with the arm's length principle as one would not observe third parties separating such intangibles.

Paragraphs 118-119

134. Clearer guidance on when the aggregation and separation of intangibles is necessary or desirable is still lacking. We are still unsure whether the examples in paragraphs 118 and 119 are implying that in the case of a franchise

agreement it is "*necessary to segregate*" and in the case of software maintenance it is "*necessary to combine/aggregate*" the intangibles from/with other transactions. More clarity would be helpful. In addition, in relation to revised paragraph 118, there may equally be no reliable comparables for the disaggregated amounts and thus we would need to assess the arm's length nature of the franchise package. Finally, we still recommend the removal of the qualifier "*so-called*" in relation to business franchises from paragraph 118. There are many third party examples of franchise agreements across a variety of industries.

Paragraph 121

135. Alhough the addition of paragraph 121 is welcomed (as it refers to the actual arrangements and conduct of the parties as starting point in analysis), it also goes on to explain that the decision whether to aggregate or separate such transactions should be done for purposes of determining the most appropriate method and should not be treated as restructuring per section 1.64 and 1.69 of the TPG. As currently worded, the last two sentences still appear to allow for recharacterisation. We believe that these sentences need to be reworded to explicitly indicate that recharacterisation should be done in extreme cases only.

Example 15

136. BIAC welcomes the changes made through the rewording of this Example in order to reduce the potential of inferring that a recharacterisation of the transaction would be needed.

Example 16

137. BIAC finds the Example confusing, especially whether the "*goodwill*" belongs to Ilcha or company S. Specifically, the sentence [*"In conducting a transfer pricing analysis related to the amount to be paid by Companies T and U to Company S for the manufacturing and marketing assets, and to Ilcha for the licensed right to use the intangibles in countries C and D, the value of the business transferred to Companies T and U that would be reflected as goodwill for accounting purposes in a comparable transaction with an independent enterprise should be taken into account."*] appears to BIAC to be an incorrect analysis. Why should companies T and U pay for goodwill when they are merely licensing the intangibles from Ilcha, and why should Ilcha be paid additionally for a grant of license if the subsequent royalty will be (as it should be) set on an arm's length basis?

138. Furthermore, as per our comments above, BIAC believes that goodwill should not be treated as an intangible as a third party would not be able to license rights in goodwill nor would they be willing to pay for such rights. It would seem highly unlikely that Ilcha would charge a third party licensee an amount for goodwill. Finally, we believe that issues such as the ones described in this

Example would be captured and are better dealt with under Chapter IX of the TPG.

Example 17

139. We appreciate the clarification provided through the addition of *"It performs no functions, bears and controls no risk, and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles."* However we believe that this Example could be removed, and if necessary would be better dealt with as part of BEPS.

Example 18

140. BIAC believes the analysis in this Example to be flawed and assumes that the price paid for the shares would be reflective of the value of the business when in fact asset and share acquisitions are quite different. It is our experience that share acquisitions tend to be priced differently to reflect a certain risk element or contingent liabilities not present through the acquisition of assets. For example, many developing countries have restrictions such as exchange controls or high withholding tax, and we have recent experience of a case where the vendor wishes to sell shares in an entity because it has trapped cash in the company. For the same reason, the purchaser wants to acquire the assets. The final price agreed is likely to depend partly on which route is followed.

141. Moreover, the Example makes the further leap that because there is a change in activity after the takeover to a contract R&D provider, T should be compensated either immediately or in the future for this bundle of " intangibles". BIAC suggests this Example should also be removed.

Section D: Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles

Paragraph 132

142. It should be acknowledged that certain transactions within a group may rarely take place between independent parties. This does, however, not necessarily mean that such transactions cannot be priced in accordance with the arm's length principle. 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 authorities 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.

Paragraph 139

143. The guidance on the useful life of an intangible should better reflect the fact that in today's fast changing environment, very few, (if any) intangibles will hold their value indefinitely unless supported through continuous investment.

Paragraph 151

144. Paragraph 151 states that "*this Chapter makes it clear that in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles*". This generalised comment appears contradictory to third party behaviour. At arm's length, the party owning and funding the IP will assume both the potential profit but also assume the risk of failure. The analysis required by taxpayers should be founded in the behaviour of unrelated parties where possible.

Paragraph 154

145. This paragraph explicitly supports the use of the most appropriate OECD (or other) method. BIAC suggests that this language should be promoted to a more prominent position in the Draft, for example, included within section DI.

Paragraph 156

146. This paragraph states "*it will often be the case in matters involving transfers of intangibles or rights in intangibles 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 and other conditions*."

147. BIAC would support more balanced language on the use of comparables and suggests the following edits:

> *"However, it ~~will often~~ **may** be the case in matters involving transfers of intangibles or rights in intangibles 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 and other conditions. This can occur if the intangibles in question have unique characteristics, or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes. Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm's length price and other conditions for the controlled transaction, except in circumstances where paragraph 1.65 applies.*

148. We also note that the above would be true for transactions not involving intangibles and we question the need for this guidance to be explicitly stated in this chapter.

Paragraph 160

149. This paragraph strongly discourages the use of cost based methods. In practice, cost based methods may be a useful tool in certain circumstances for business related. Methods should not be rejected out of hand if they represent how unrelated parties would approach the valuation of a transaction involving intangibles.

Paragraph 173

150. This paragraph suggests that certain valuation techniques that are readily used in transactions between independent parties may not be appropriate for TP purposes. If it can be shown that a particular valuation method is well recognised by unrelated parties, the guidance should support the use of such a method.

Paragraph 182

151. BIAC strongly disagrees that projections prepared for non-tax purposes are likely to be more reliable than projections prepared exclusively for tax purposes. Business forecasts may be overly optimistic, resulting in valuations that are too high. If business projections are to be used, historic accuracy should be used to confirm the quality of future forecasting. The last sentence of paragraph 182 should be deleted.

4. Examples

152. BIAC understands that the members of WP6 would appreciate some practical examples of how the Draft. We have asked BIAC members for input in this respect and have included the responses in this section. We note that the time-frame to provide such examples has been short and the number of examples presented is therefore not extensive. We would be happy to meet with members of WP6 and government representatives to discuss these and other examples if that would be helpful. Please note that the examples have been provided on an anonymous basis by specific BIAC members and do not represent a consensus view.

Example 1

153. Company A (located in Country A) is the legal owner of product specification technology developed within an MNE (which it recently acquired from a third party at fair market value).

154. Company A has entered into an outsourcing contract with Company B (located in Country B) to develop and enhance new and existing technology with respect to product specifications owned by Company A. Company A will licence this technology to group companies across the global operations of the MNE.

155. The legal contract between Companies A & B for this arrangement clearly states the following:

- Company A will maintain all rights and associated risks with respect to the specifications produced by Company B;
    - Should the technology fail, or the value of the specifications decrease due to competitor developments etc. Company A will bear the losses attributable to the associated reduced royalty receipts;
- Company A is fully responsible for the Global strategy of the business including the selection and development of its product portfolio.
- Company A provides Company B specific guidelines on what is required from the product specifications it is to develop in order to meet the global MNE strategy. Company A holds Company B accountable to contract performance targets and budget for delivery of the product specifications;
- Company A remunerates Company B for the services it provides based on a comparability search for similar contract R&D service providers. The search takes into account the accountability of the employees within Company B, the limited risk profile of Company B and the fact that company B does not legally own or utilise the specifications it produces;

156. The service fee paid to Company B by Company A is the subject of an audit by the Country B tax authorities.

157. By looking at Chapter VI, paragraphs 73 to 80 of the Draft, the tax authority concludes that Company B is responsible for and has ultimate control of the following functions:

- The “***control of budgets”*** utilised in company B (albeit that these budgets are constrained to the ultimate annual budget set by Company A);
- The “***design”*** of the specifications and “***the control over strategic decisions regarding the development”*** of the specifications (albeit that Company B must act in accordance with the strict guidelines and requirements set by Company A in line with the global business strategy);
- The “***defence and protection”*** of the specifications to ensure that Company B conducts itself in a manner that maintains confidentiality of the specifications produced (Albeit that this is a common requirement replicated by Company A for all other group companies under licence for the specifications);
- The “***quality control over functions performed”*** and of that of any of Company B’s outsourced service providers (albeit that Company A sets strict performance targets for Company B and holds it accountable thereto);

158. Country B tax authority determines that:

- Company B performs the ***“more important functions”*** (noted at Chapter VI, paragraph 79); and therefore
- Although Company A is the legal owner of the specifications produced by Company B, Company B is in fact the beneficial owner of the intangibles and will retain all of the royalty return attributable to the specifications as assessable income in Country B:

Response from Tax Authority in Country A:

159. Due to the ambiguity created from Chapter VI, (paragraphs 73 to 80) that has enabled the tax authority in country B to arrive at their position, Company A & B seek to avoid double taxation by initiating Mutual Agreement Procedures (MAP) proceeding between Country A and B tax authorities.

160. The Country A tax authority assesses the transaction and concludes that Company A is entitled to a portion of the intangible return. This is decided due to the fact that the Country B tax authority failed to recognise the value of the legal rights held by Company A with respect to the specification intangible and the contribution by Company A to the value creation of the specification intangible including:

- Identification and selection of the MNE global product portfolio in line with the Global strategy of the business; and
- Development and management of contract performance targets for Company B including budget restrictions for contract delivery.

Example 2

161. The facts are the same as example 1; however, due to the findings of the Country B tax authority, Company A & B agree to allocate reward to Company B via the use of the Profit Split TP method.

162. The tax authority in Country B contests the outcome of the applied Profit Split TP methodology on the basis that Company B is performing the "*more important functions*" (as per its analysis in Example 1). The Country B tax authority, subsequently issues an adjustment to the Company B tax return.

163. Companies A & B decide to move to MAP proceedings between the two Country tax authorities.

164. Further ambiguity frustrates the ability to arrive at a commonly accepted outcome between the two tax authorities under the MAP proceedings, due to the fact that it is found to be difficult to arrive at a method of value allocation between the two parties without using a biased subjective analysis.

165. For example Country B tax authority argued for the use of costs incurred as a method of value allocation, however, Country A tax authority argued that this is not accepted as reliable due to the differences in capital and labour prices between the two countries.

166. Country A argued that the development of the Global strategic plan by Company A contributed significantly greater value than that of R&D based activity of Company B, whereas Country B argued that this process does not contribute to the intangible itself.

167. To be able to apply a Profit Split approach, clear guidance should be provided on how to value the parts of the transaction to avoid subjectivity and to come to common approach on assessing value contributions to intangibles. With the lack of routine contributions, such a Profit Split approach becomes a subjective exercise that would be open to challenges in all cases, not allowing for certainty to tax authorities or for tax payers.

Example 3

168. Company A and Company B both independently wish to acquire the Q business of Company T. Company T is a cake decoration company active only in Country C, where it is the undisputed market leader due to an innovative cake decoration Q made according to a secret process developed by Company T. The Q business includes a state of the art manufacturing plant, which is operated by a skilled and specialized workforce. Company B is part of an MNE which designs, manufactures, and sells cake decorations around the world. It wants to acquire the Q business from Company T to improve B's market position in Country C, and to use T's state of the art manufacturing plant in Country C to manufacture its own products. Company A is another cake decoration company active only in Country C, and wants to acquire the Q business to become the biggest player in the Country C market. It does not need the manufacturing plant as it has sufficient capacity of its own, but it does intend to license the patents and trademark for Q to third parties in other countries.

169. Company A will make a DCF projection of its acquisition of Company T by estimating its incremental sales in Country C and its royalty income from

licensing the Q patents and trademark. It takes into account that it will be difficult to sell the manufacturing plant which has a book value of 20 in Company T's books and that there will be costs associated with reducing the workforce. It also makes an estimate of what it thinks Company B might offer and adjusts its offer price accordingly, reaching a price of 100 consisting of 5 for tangible property, 85 for patents and trademark, and 20 for other local goodwill.

170. Company B will value Company T by making a DCF projection of its own increased sales and the synergies of being able to use the manufacturing plant in Country C and closing down two of its own manufacturing plants, transferring some of the workforce from those plants to the new plant, as they are familiar with the company B products. Company B therefore also takes into account the cost of reduction of the T workforce. It also makes an estimate of what it thinks Company A might offer and it adjusts its offer price accordingly, reaching a price of 100 consisting of 25 for tangible property, 30 for patents and trademark (to compensate company T's foregone licensing income), and 45 for other local goodwill.

171. Neither Company A nor Company B has priced the presence of the skilled and specialized workforce, as they either do not need it, or will replace with a workforce skilled and specialized at producing other products. If internationally accepted TP rules had required the T workforce to be recognized as an intangible, a value would have had to be attributed to their transfer. However, both Company A and Company B would have had to write off this allocated value immediately, meaning that their basis in the other intangibles (local goodwill) would have been reduced without reason. Depending on how intangibles and their amortization are taxed in Country C, this could impact either Company A or B, or the C tax authorities.

The Voice of OECD Business

October 8, 2013

BIAC Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Chapters I-III)

BIAC is pleased to respond to the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, published on 30 July 2013 (hereafter referred to as "Draft"). This document contains BIAC's comments on the proposed edits to Chapters I-III of the OECD Transfer Pricing Guidelines ("TPG") in the revised Draft. This supplements comments submitted separately on proposed changes to Chapter VI of the TPG (sections A-D of the Draft).

Proposed amendments to Chapters I-III

1. We welcome the inclusion of the Location Saving, Assembled Workforce, and Group Synergies discussion in Chapter I rather than in the Intangibles Chapter, as well as the clarification that these items should be treated as comparability factors. We agree with the statement that such items are not intangibles (as per paragraphs 11 and 64). However, there are improvements that should be made to provide consistency and clarity, particularly in relation to the discussion on group synergies.

Location savings

2. We broadly agree with the proposed analytical approach to location savings in paragraphs 1-4, and the cross-referencing to chapter 9 is helpful. The confirmation and emphasis on the use of comparable transactions in the local market, with the use of reliable comparability adjustments where needed, is welcomed in principle. However, paragraph 5 lacks detail to allow for consistent interpretation. It can be read to imply that location savings, undetectable through comparability searches, should somehow be addressed. BIAC believes that the OECD should provide more complete guidance on how location savings can be properly determined and allocated. Location savings may typically be "*competed away*" by rival firms and passed on to customers, and so a theoretical discussion of the situations in which one might expect an enterprise to be able to retain the advantages of location savings would be helpful. Since we are dealing with a situation where comparables are hard to find, discussion of the types of evidence and transfer pricing methods that could be reliably applied would also be necessary.

Assembled workforce

3. For consistency with earlier paragraphs, it would be helpful if assembled workforce, noted as "*ordinarily*" a transfer pricing comparability matter in paragraph 14, is specifically stated as not being an intangible in its own right. 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. Furthermore, the drafting of paragraph 15 remarks that the transfer of an assembled workforce as part of a business restructuring may require comparability adjustments to the arm's length price with respect to the transferred assets. It should be clarified that the

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assembled workforce does not typically have a separate value, nor is it an intangible in its own right when transferred, as employees are by definition mobile and can join and leave employers at will. Paragraph 16 goes some way to addressing this, but not fully, when it says that the need for separate compensation for the transfer of individual employees as a general matter, is not the intention of the foregoing paragraph (15). We believe that these paragraphs allow for ambiguity, and thus clarification and consistency would be welcomed.

4. Furthermore, the suggestion in paragraph 17 that there can be situations when a temporary relocation of a single individual will give rise to a transfer of a valuable intangible (i.e., know-how) does not reflect arm's length behaviour. We believe that the knowledge and experience of employees is not owned by their employer, nor is it fully under the control of the company. As rightly pointed out, the knowledge and experience of an employee can constitute a comparability factor that requires a certain level of compensation. However, we believe that the temporary transfer of an individual (and even more than a single individual) does not give rise to a transfer of intangibles. It follows that we believe that the analysis in Example 18 is incorrect. Practically, employees add value by transferring knowledge all the time, and through many ways not limited to physical transfer or secondment; singling out secondments does not seem helpful, and doing so risks that transfers and secondments will always be suspect in the eyes of tax authorities. What is needed for a transfer pricing analysis is to determine whether know-how has been provided, not the medium.

Group synergies

5. The treatment of group synergies is overly-simplistic, and fails to link the discussion to the arm's length principle. In seeking to find examples of synergies which may or may not require consideration, the draft creates confusion. Group synergies are difficult to consider under the arm's length principle, since comparable companies are not groups. Therefore, the focus should be on whether there are economic factors within the group that are potentially analogous to third-party situations (for example, co-operative activities, or long term contracts), and whether there are economic factors which depend purely on shareholding.

6. The draft fails to appreciate the expertise and risk involved in many third-party procurement arrangements; such activities rarely simply depend on the consolidation of buying power as the draft suggests (in paragraph 21). Additionally, although examples 3 and 4 are similar, 'buy-sell' is not the same as facilitation, and the examples should perhaps acknowledge that there may be some difference in the compensation due to the procurement entity.

7. The "*passive*" benefit in the guarantee example is open to debate: it is far from clear that a preferential interest rate results from a shareholding connection to a wider group alone, or whether it results from recognition of qualitative factors loosely associated with shareholding but derived from the explicit or implicit long term contractual arrangements for the group company (for example, a long term supply arrangement or long term access to markets because of a network of established sales companies). In an arm's length situation, the stability and financial viability represented by such contractual arrangements is likely to influence the lending decision and the terms of that lending, and it should be challenged whether such a preferential rate is "*attributable to the group synergy derived purely from passive association in the group*" (27). We believe that the guarantee example does not help in determining synergies deriving purely from shareholding without further study; that study may be more appropriate to guidance on financial transactions and associated issues.

8. The Draft notes that negative group synergies may exist (paragraph 18) but provides no discussion on how to address them. In addition, the paragraph conflates a competitive inefficiency affecting the entire group (e.g., an inefficiency caused by group scale) with an

inefficiency suffered by a single member created by its forced conformity with the rest of the group (e.g., a group member is forced to adopt a computer or communications system that is not the most efficient for it on a standalone basis, although that system is optimal from the group's perspective). These two situations should be distinguished and addressed separately by reference to arm's length conditions.

9. The distinction between passive "*scale*" synergies and synergies which are an effect of "*deliberated concentrated group actions*" could be a matter of disagreement. It is unclear how the principles of the section would be applied to the following scenario. Assume that a Parent Company prepares product specifications and seeks and maintains relations with third-party producers; those producers have minimum order quantities of 50,000 units. The Parent Company regularly makes orders for 100,000 units. Assume that group Company A has requirements for 5,000 units. Company A has insufficient volumes to meet the minimum order quantities and has no capability to develop product specifications or seek and maintain relations with producers. The Parent Company "*allows*" Company A to add its requirements to its orders. Under the arm's length principle, it would appear that a valuable service has been provided to Company A, but the wording of the section could give the impression that Company A is simply benefiting from group membership and that there are no deliberate concerted group actions involved.

Modification to Chapter II

10. We welcome that Paragraph 34 brings valuation methods into the approved methods. However, the original meaning appears to have changed. The original meaning of the paragraph at 2.9 was that taxpayers could set prices without reference to the OECD-recognised methods, so long as those OECD-recognised methods are used to demonstrate that the prices set in a different way meet the arm's length principle. However, now the first sentence states that both taxpayers and tax administrations can use any method, not just OECD-recognised methods, both to set prices and also to demonstrate compliance with the arm's length principle. This seems to weaken the adherence to the OECD-recognised methods. In addition, it is unclear why tax administrations would need to set prices, as implied by the sentence. We would welcome a discussion on the drivers behind these changes and additional clarifications on the OECD's intentions.