BUSINESSEUROPE

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Contact : Mr. Krister Andersson, Chairman

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Dear Joe,

Comments on the OECD Discussion Draft entitled "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" 30 July 2013

BUSINESSEUROPE is pleased to provide comments on the OECD Discussion Draft entitled "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" 30 July 2013 (hereafter referred to as the "the Draft"). We welcome the new draft and look forward to the public consultation to be held in Paris on November 12-13.

General comments on the Draft

As stated in our previous comments, it is important that the revised chapter VI takes its outset in trying to resolve the typical transfer pricing issues related to intangibles rather than the atypical and extreme situations such as complex tax avoidance and tax evasion schemes. We acknowledge the fact that the BEPS action plan includes a specific action to develop rules to prevent BEPS by moving intangibles among members of an MNE group. However, as much as it is important and relevant to address BEPS activities related to intangibles we believe that the guidance should first and foremost be aimed at providing the general principles and guidance to be followed when dealing with intangibles from a transfer pricing perspective.

The concept of "return attributable to an intangible" is highly unclear and a thorough clarification is crucial in order to achieve predictability and to avoid divergent interpretation by different fiscal authorities with the risk of double taxation.

Notably, the concept fails to distinguish between, on the one hand, the income that a service provider receives at arm's length for its performance of certain functions (which may or may not contribute to the value enhancement of the IP) without being allocated any share or ownership in the IP as such and, on the other hand, the income that consists of the residual net profit (or loss) arising out of the commercialization of the actual IP in question. Furthermore, the concept "return attributable to an intangible" seems to cover both types of income, or at least it is not clear that it does not. We believe that the draft needs to be revised as to make a clearer conceptual difference between ensuring an arm's length compensation for a service provider who is not

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performing functions that would entitle it at arm's length to any right in the IP itself and the issue of identifying the ownership of IP for transfer pricing purposes and thus the right to the residual profit or loss arising out of that IP.

We question whether the approach using the concept "return attributable to an intangible" is the right one to capture the essence of "economic substance". If the concept is to be used the draft would, from a business perspective, benefit from clearly reserving the concept to the kind of return (or loss) that would be allocated to the party being identified as the owner of the IP for TP purposes based on an analysis of the functions performed, assets used and risks assumed.

The current drafting of the concept "return attributable to an intangible" (notably as summarized in para. 89) seems to result in shared ownership of IP for transfer pricing purposes in a large majority of situations. This would, in our view, be a significant shift in principle from how the current guidelines have generally been interpreted and implemented until now. This would be detrimental for business and counteract the very purpose of the guidelines as it would give rise to significant controversy and double taxation.

For the majority of MNEs which have been operating with centralized TP-models (with centrally held IP) for decades, a shift in principle towards a "shared IP-ownership" approach would also trigger significant transitional issues regarding how to treat historic costs, profits and losses related to the IP which has been assumed centrally by the Entrepreneur or principal. It would also require tax authorities to agree on how historic costs should be reallocated between them. Further complexity would arise if historic profits and losses, or loss carry forwards, needed to be reallocated. Such an approach would also give rise to unprecedented complexity in how to set up remuneration flows for the use of IP in MNEs operating globally.

For these reasons, we would prefer a "threshold approach" under which IP can be centralized provided that the principal IP-holder performs certain functions, assets and risks which can be expected by a third party taking title to any IP being developed or enhanced partly or entirely by another unrelated party. Further on, it is the responsibility of OECD to ensure, within the guidance now being developed, that the threshold where functions performed in fact could lead to an ownership interest in the IP is defined reasonably and with such clarity that business can avoid situations where multiple and joint ownership interests will be suggested by tax administrations. This is not to say that service providers performing important IP-related functions (such as contract R&D or Marketing activates) should not be properly compensated at arm's length for their activities. However, this is an issue of comparability and pricing rather than one of ownership of IP for TP-purposes. We believe that the Draft sets an unreasonably high functional threshold and a level of substance for allocating returns that goes beyond the current guidance in the TPG and deviates from the arm`s length principle.

Furthermore, we are concerned about the complexity and the various requirements for business to provide exact analyses based on information that in many cases simply is not available. Examples can be found in a number of paragraphs in the Draft, e.g. in para. 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 […]".*

It should be born in mind that an important reason why many MNEs have principal TP-models with centralized risk taking and IP-ownership is 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, particularly in relation to what can be expected from a taxpayer to, so as to better reflect these difficulties.

We believe that the distinction between allocation of ownership and the compensation for functions performed is of important in order not to dilute the IP ownership concept for transfer pricing purposes into something completely unpredictable. Furthermore, in our opinion it is of utmost importance that the guidelines avoid a situation where it in most cases will be possible to argue for some sort of joint or shared ownership based on notions of how "important" various functions are considered to be.

Proposed Amendments to Chapters I – III of the Transfer Pricing Guidelines

Although we have no objection to move the section on assembled workforce from Chapter VI to Chapter I, we still have concerns about the wording, particularly paragraph 17 which reads as follows:

17. It should be noted, however, that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how from one associated enterprise to another. Where such a transfer of know-how results from the transfer or secondment of employees, the resulting transfer of know-how should be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the transferred know-how. Moreover, it should also be noted that access to an assembled workforce with particular skills and experience may, in some circumstances, enhance the value of transferred intangibles or other assets, even where the employees making up the workforce are not transferred. Example 18 in the Annex to Chapter VI illustrates one fact pattern where the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.

Even though the discussion has been moved to Chapter I the argument in the first sentence of paragraph 17 still seems to suggest that an assembled workforce could sometimes constitute an intangible. Is this the intention, and if so, why move the section to Chapter I? Is it an intangible or is it not? It is absolutely essential that the wording is clear in this respect.

BUSINESSEUROPE strongly oppose having an assembled workforce be treated as an intangible. We find it difficult to see how any personnel can be owned, controlled or transferred. In addition, this appears to be in contradiction to the contractual relationships which exist in many OECD countries. With the possible exception for athletes, it is equally uncommon to see that a shift of personnel in isolation would be remunerated between unrelated parties. Naturally, and as for any service rendered, if a group of employees is providing services for another company appropriate compensation should be paid. Equally if a business is transferred between independent parties including workforce providing valuable services, this may give rise to a higher value of the business as such (i.e. the assembled workforce is a comparability factor that may or may not add a value). It should be pointed out, however, that an independent acquirer normally is careful to put a high value and/or applies a high risk premium to such a factor for the very reason that workforce cannot be owned or controlled.

In addition, the wording in paragraph 17 is very vague, theoretical and complex and provides little guidance.

If the intention is to suggest that an assembled workforce could sometimes represent a carrier of a separate IP such as “know-how” this first of all needs to be clarified. Further on, it seems questionable whether such a statement adds any value. It would be essential to avoid suggesting that there might be valuable IP existing which is only possible to define through vague references to some unique skills of an assembled workforce. Unless it is possible to clearly identify and define the IP in question without referring to the language found in the current paragraph 17 it is probably not a relevant IP in the first place.

Another concern is how business shall apply such a provision in practice and be able to identify and draw the line between when a workforce will create or suggest the existence of an intangible and when it will not. This wording provides no guidance and is likely to lead to numerous disputes with revenue authorities with double taxation as a consequence.

Chapter VI Special Consideration for Intangibles

A. Identifying Intangibles

General comments

In order to avoid inconsistent interpretation and application, BUSINESSEUROPE believes that finding a clear and well accepted definition of the term intangible is of utmost importance. Anything else is likely to result in numerous dispute and double taxation.

In our view, a definition of intangible assets that are to be recognized for TP-purposes ought to include three typical characteristics: *ownership*, *control*, and *transferability.* Although business attributes or notions such as goodwill, on-going concern value, synergies, location savings, workforce in place etc. may affect the valuation of a transaction and consequently affect the transfer price of an intangible asset, such attributes or notions are not themselves assets which can be owned, controlled or transferred. Consequently, they should not be included in the definition.

Thus, unless it is possible to identify a transfer of a tangible or intangible asset (either by way of a realization of such an asset or the right to use such an asset), location savings and similar value elements cannot trigger a taxable event by themselves.

<u>*Detailed comments*</u>

Paragraph 40

40. In these Guidelines, therefore, the word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

We think the revised wording better reflects the type of intangible assets which are expected to be compensated in transactions between independent parties. However, the definition is still not clear enough to provide sufficient legal certainty. We fully support that an intangible should be capable of being owned or controlled for use in commercial activities. However, the word "something" is too vague and not an acceptable concept to determine what should constitute an intangible. Consequently, and in line with our previous comments, BUSINESSEUROPE suggests that the word "something" be replaced with "an asset".

Furthermore, a key characteristic of an asset in dealings between independent persons is that it can be transferred from one party to the other, thus excluding various business notions such as e.g. on-going concern value etc. from the definition. We therefore suggest that the notion of transferability should be more clearly set out in para. 40. This would in our view better reflect the conclusions drawn in the draft that attributes or notions such as e.g. goodwill, on-going concern value, synergies, location savings etc. are not themselves intangibles in the meaning of the guidelines. This would also be in alignment with the last sentence in paragraph 42 (see below) which indicates that transferability, albeit not separate, is a condition for an item to be characterised as an intangible for transfer pricing purposes.

Paragraph 42

42. The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.

As a general comment, we note 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).

Paragraph 44

44. The identification of an item as an intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case. Depending on the industry sector and other facts specific to a particular case, exploitation of intangibles can account for either a large or small part of the MNE's value creation. It should be emphasized that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances. For example, consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non-unique know-how. See paragraph 1.39. See also paragraph [51] for a definition of "unique and valuable" intangibles.

Although we agree with the fact that no additional premium return should be paid in transfers of non-unique or routine IP, we believe that the paragraph suggests this is only the case in rare situations. In fact, non-unique and routine IP constantly forms 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.

Paragraph 54

(ii) Know-how and trade secrets

54. Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret. In certain industries the disclosure of information necessary to obtain patent protection could assist competitors in developing alternative solutions. Accordingly, an enterprise may, for sound business reasons, choose not to register patentable know-how, which may nonetheless contribute substantially to the success of the enterprise. The confidential nature of know-how and trade secrets may be protected to some degree (i) under unfair competition or similar laws, (ii) under employment contracts, and (iii) by economic and technological barriers to competition. Know-how and trade secrets are intangibles within the meaning of section A.1.

Although we agree with the general conclusions in this section, we would like the guidelines to recognise that know-how should typically be unique or non-routine to create a valuable intangible that need to be recognised for TP-purposes. Know-how that is common knowledge, trade practice, off-the-shelf solutions etc. should typically fall outside the scope of what is considered an intangible asset for the purpose of these guidelines. We suggest the last sentence to read as follows:

"Know-how and trade secrets could constitute intangible assets within the meaning of section A.1 provided that they are unique and of a non-routine character which allows for them to be characterized as assets that are possible to transfer and value."

Paragraph 58

(iv) Rights under contracts and government licenses

58. Rights and obligations under contracts and government licences and concessions may be important to a particular business. Such contract rights and licences can cover a wide range of business relationships. They may include, among others, contracts with suppliers and key customers, agreements to make available the services of one or more employees, or a government grant of rights to exploit specific natural resources or public goods (e.g. a licence of band width spectrum) to carry on a specific business activity. Rights and obligations under contracts and government licences and concessions are intangibles within the meaning of section A.1.

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 the paragraph is amended accordingly.

Paragraph 61

(v) Goodwill and ongoing concern value

61. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes. It is important to recognize, however, that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred may represent compensation for something referred to in one or another of the alternative descriptions of goodwill or ongoing concern value. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price for the transaction. Similarly, when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise in connection with a trademark or other intangible, that reputational value should be taken into account in determining appropriate compensation. To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as intangibles within the meaning of section A.1.

We find it inconsistent to say that a definition is not necessary and then in the next sentence proclaim that goodwill and ongoing concern value represent significant value when assets of an operating business are transferred. The very fact that goodwill and ongoing concern value do represent significant value should, in our opinion, be reason enough to have a clear definition. We further fail to see why this would necessarily mean that these concepts would need to be included in the definition of what constitutes a separate intangible. In addition, when assets of an operating business are transferred between related parties, the valuation of goodwill (or badwill) and ongoing concern should necessarily be tied to a functional analysis, which is an essential step of any comparability analysis.

From a business perspective it would seem perfectly sufficient to conclude that goodwill (or badwill) and ongoing concern value could represent significant value, but although it is important to take such values into account, they do NOT constitute intangibles within the meaning of section A.1. In our view such an approach would give the draft a more stringent, focused and consistent starting point in what would be a clearer and more accessible definition. Furthermore, we fail to see how this could have any significant negative on tax administrations possibilities to safeguard appropriate tax bases.

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

General comments

The concept of ownership should aim at determining the allocation of intangible assets together with its expenses and expected returns for TP-purposes between two or more related parties. The owner of an intangible should typically receive the economic benefits of the intangible assets as well as assume the risks related to the assets in question. As noted above we find that the current concept "return attributable to an intangible" is too vague and, if it is to be used at all, it needs further clarification in order to avoid divergent interpretation.

We believe that legal ownership in terms of the contractual arrangement between the parties, including allocation of rights and obligations, is a sound starting point for the ownership analysis as this represents the intention of the parties with respect to the ownership allocation.

Legal ownership should be respected unless it clearly deviates from the economic substance of a transaction and the conduct of the parties. In line with Chapter IX of the TPG, such action from administrations should be allowed only in exceptionally, in clear cut cases. It is essential that reasonable efforts to centralize IP-rights are not disregarded by administrations without there being substantial and significant factors to indicate that this is necessary to ensure a taxation which is compatible with how independent parties would allocate IP and the returns therefrom.

In cases where the intention of the parties cannot be determined and/or when the conduct of the parties clearly deviates from such an arrangement at arm's length, the objective should be to determine what would be a reasonable allocation of the IP-ownership between independent parties given the facts and circumstances of the case.

In our opinion, the revised Draft still places too much focus on the performance of the actual development, maintenance and protection of an intangible asset for the purpose of determining ownership. It is frequently observed between independent entities that some or even all of such activities are being outsourced or subcontracted with a clear agreement that any intangibles being developed as a cause of these activities are owned by the principal. Although efforts have been made in the Draft to clarify this issue, there are still inconsistencies in this respect between various paragraphs (e.g. between para 76 and para. 80).

In our view, the draft needs to make a clearer distinction between the allocation of ownership for TP-purposes and the compensation for activities performed which may (or may not) contribute to the value of such IP. In our view, the notion of "return attributable to an intangible" as currently drafted fails to do this.

We believe that the allocation of ownership would be clearer if based on a "threshold approach" under which the IP allocation should be respected provided that the IP-owner performs certain functions which can be expected from an IP-owner in a third party situation. These functions should be based on the principles already developed in Chapter IX of the TPG regarding the notions of risk, control and financial capacity. In a third party situation, it is indeed reasonable to assume that the party taking the risk for a R&D or marketing activity, performing the necessary control activities to assume this risk and providing the funding for the activity, will retain the ownership of the intangibles being developed. As noted above we believe that the current Draft extends beyond the fundamental principles in the existing guidance in the TPG.

In this context, it is important to distinguish between allocation of ownership and the compensation for functions performed which may (or may not) contribute to the development and enhancement of the IP. The compensation for functions performed will naturally vary depending on the facts and circumstances in each case but nothing under the "threshold approach" would prevent a highly qualified service provider performing important functions related to the development and/or enhancement of the IP from being entitled to a significant service fee, without acquiring any right or share in the potential IP resulting from his services. At arm's length, it is indeed reasonable to assume that a highly qualified service provider performing high value adding R&D or marketing functions should receive a higher compensation than a service provider only providing routine R&D or marketing activities. However, this does not mean that either of the service providers at arm's length is entitled to a share in the IP as such.

We believe that this distinction is important in order not to dilute the IP ownership concept for transfer pricing purposes into something completely unpredictable. For reasons mentioned above, we believe it is of utmost importance that the guidelines avoid a situation where it will in most cases be possible to argue for some sort of joint or shared ownership based on notions of how "important" various functions are considered to be. In relation to this, the "broad-based analysis" is an essential step of the comparability analysis that should be required in the assessment of the allocation of ownership for TP-purposes and the compensation for activities performed which may (or may not) contribute to the value of such IP. The broad based analysis has to focus on the characteristics of the industry, competition, economic and regulatory factors and other elements that affect the taxpayer and its environment, without looking at the specific transactions in question.

Caution should be taken when adopting the notion of control in relation to activities creating intangible assets. Outsourcing R&D activities (e.g. by way of contract R&D) between independent parties is sometimes done because the principal does not have the resources or competence to perform these functions. The principal might therefore not have the ability to control and/or manage the process in any detail but only in a high level management sense. Hence, the meaning of control is crucial. Any requirement in this context ought to be fully in line with the guidance currently found in Chapter IX, such as the right to “hire and fire”, participation in and ultimate authority over budgets, key strategic decisions etc. The fact that the contractor/service provider is using its particular competence to decide how to reach the objectives outlined, should not influence the allocation of the intangibles for TP-purposes and the attribution of intangible returns. Whilst such competence may be a comparability factor and affect the arm’s length remuneration by the IP owner to the contractor/service provider, it does not mean that the contractor is entitled to share in the ownership of the IP.

Furthermore, it should be recognised that the notion of control in a third party situation is not a static concept. Although it is reasonable to assume that the IP-owner at arm’s length would perform certain control functions to safeguard its investment, it is equally true that the level of trust as developed over time between unrelated parties would influence the type and level of control being performed. In a long standing and trustful relationship between independent parties, it is reasonable to assume that the level of control will be less stringent and more high-level than in a new relationship. Care should therefore be taken in prescribing what level of control could be expected at arm’s length. In this context it should be noted that the level of trust between dependent parties by nature is very high. We therefore believe that only high level strategic control functions can be expected to be performed by the party claiming entitlement to the IP ownership in a related situation.

Detailed comments

Paragraph 65

65. Both taxpayers and tax authorities have struggled with the question of how to correctly allocate what may be described generally as the return “attributable to an intangible” or an “intangible related return.” Although the legal owner of an intangible may initially be entitled to receive the proceeds from exploitation or transfer of the intangible, other members of the owner’s MNE group may have performed functions, used or contributed assets, or assumed risks that are anticipated to contribute to the value of the intangible and for which they must be compensated under the arm’s length principle. The right of other members of the MNE group to receive compensation for their functions performed, assets used or contributed, and risks assumed may be conceptually framed as an allocation to those other members of all or part of the return attributable to the intangible. The need to provide such compensation arises in the context of determining the appropriate returns to and payments for functions performed, assets used, and risks assumed in accordance with Chapters I-III. This Section B confirms that the ultimate allocation of the return attributable to the intangible is accomplished by compensating members of the MNE group for functions performed,

assets used or contributed, and risks assumed in the development, enhancement, maintenance, or protection of intangibles according to the principles described in Chapter I - III.

We find that the concept “return attributable to an intangible” is too vague and request that the OECD provides further clarification in order to avoid divergent interpretation. As noted above, it is of utmost importance that the chosen approach distinguishes the allocation of ownership for TP-purposes from the compensation for activities performed which may (or may not) contribute to the value of such IP. Consequently we do not agree that the right of other members of the MNE group to receive compensation for their functions performed, assets used or contributed, and risks assumed may be conceptually framed as suggested.

Paragraph 73

73. The question of legal ownership is separate from the question of remuneration under the arm’s length principle. It is important to note that, for transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain any return from exploiting the intangible that may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return ultimately retained by the legal owner depends upon the contributions it makes to the anticipated value of the intangibles through its functions performed, assets used, and risks assumed, and upon the contributions to the anticipated value of intangibles made by other MNE group members through their functions performed, assets used, and risks assumed. For example, where the legal owner makes no contributions that are anticipated to enhance the value of the intangible, the legal owner will not ultimately be entitled to retain any portion of the return attributable to the intangible. Legal ownership is simply a reference point for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions. In most cases, the legal owner will accrue receipts from the exploitation of the intangible in the first instance. It must remit to other MNE group members arm’s length remuneration reflecting the anticipated value of their contributions. Thus, identification of legal ownership, combined with the identification of relevant functions performed, assets used or contributed, and risks assumed by all contributing members, provides the analytical framework for identifying arm’s length prices and other conditions for transactions involving intangibles. As with any other type of transaction, the analysis must take into account all of the relevant facts and circumstances present in a particular case. The principles of this paragraph are illustrated by Examples 1 – 3 in the Chapter VI Annex.

We find it quite provocative to say that legal ownership simply is a <u>reference point</u> for identifying and analysing controlled transaction relating to the intangible etc. Too reiterate our general comment above it is important that the guidance is focused on resolving the typical rather than the atypical and extreme situations. Consequently, the guidance should first and foremost be aimed at providing the general principles and guidance to be followed when dealing with intangibles from a transfer pricing perspective. The Guidance should be based on principles of clarity and predictability, not underlying notions of anti-abuse. The legal ownership must be the <u>starting point</u> for the analysis, not only a reference point. In our view, the legal owner would then be entitled to the returns - if any - that comes from exploiting the IP that has been developed. After having provided arm’s length compensation to all those who have contributed to the development, maintenance or protection of the intangible there is of course not any guarantee that there will be a net profit remaining with the legal owner. In our view, this is compatible with the current drafting of paragraph 73 but could certainly be spelled out more clearly.

Paragraph 76

76. If the legal owner of intangibles is to be entitled ultimately to retain the returns attributable to the intangibles, it will either perform the functions related to development, enhancement, maintenance and protection of the intangibles, or arrange to have such functions performed under its control by independent enterprises or by associated enterprises. It is not essential that the legal owner physically perform all of the functions related to the development, enhancement, maintenance, and protection of an intangible through its own employees in order to be entitled ultimately to retain returns attributable to the intangibles. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. A member of an MNE group that is the legal owner of intangibles could similarly be expected to retain either independent enterprises or associated enterprises, transacting on an arm's length basis, to perform functions related to the development, enhancement, maintenance, and protection of intangibles. In such cases, however, the party performing the outsourced functions should operate under the control of the legal owner. In assessing what member of the MNE group in fact controls the performance of the relevant functions, principles analogous to those of paragraphs 9.23 through 9.28 apply.

This paragraph is of crucial importance since it forms the starting point for the discussion on outsourcing and the threshold for being considered the owner of the IP in question. It adequately addresses most of the issues that we have commented on above, and also includes a reference to "control" as well as a most welcome cross reference to Chapter IX of the TPG. We do, in general, agree with the thrust of this paragraph. The main problem however, lies with paragraphs (79-81 and 89) which do not seem to be fully aligned with paragraph 76.

Paragraph 79

79. In considering the prices to be paid for functional contributions and the allocation of returns attributable to intangibles among members of the MNE group, certain important functions will have special significance. Depending on the facts and circumstances, these more important functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

The meaning of the first sentence is unclear to us and we suggest that it is revised to make clear that the allocation of IP-ownership should always be respected when the owner of the IP performs such "important functions". This would make the paragraph better aligned with the principles laid out in para. 76.

As for the definition of these “important functions”, we believe that it should more stringently refer to the kind of strategic control functions mentioned in paras. 9.23-9.28. As it currently stands, we find the definition unclear and going beyond these generally accepted principles. E.g. the references to the “design” of research and marketing programs and the “management” over budgets is unclear and could be interpreted in a way that goes beyond the principles laid out in Chapter IX. If an exemplification of such “important functions” should remain, it should be by clear reference to paras. 9.23-9.28 and only include such strategic control functions that could be expected between third parties.

Paragraph 80

80. An entity claiming the right ultimately to retain all or material parts of the return attributable to a given intangible on the basis of legal ownership will generally perform, through its own employees, the more important functions related to the development, enhancement, maintenance and protection of that intangible that are described in paragraph [79]. Those important 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. Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions. Where the legal owner outsources most or all of such important functions to other group members, the entitlement of the legal owner to retain any material portion of the return attributable to the intangibles after compensating other group members for their functions is highly doubtful. In some such circumstances it may also be determined that the outsourcing of such important functions would not have been undertaken by independent enterprises behaving in a commercially rational manner and that the actual structure adopted impedes the determination of an appropriate transfer price, thereby necessitating the disregarding of the actual structure adopted in accordance with the principles described in paragraph 1.65. Examples 13 and 14 in the Chapter VI Annex illustrate the principles contained in this paragraph.

Paragraph 80 states that the party claiming entitlement to intangible related returns will generally perform through its own employees the important functions related to development, enhancement, maintenance and protection of the intangibles.

As noted above, we believe that the draft implies too much focus on the performance of the actual development, maintenance and protection of an intangible asset for the purpose of determining ownership. We do not believe this to be in line with the arm’s length principle as it does not reflect the behavior between independent parties. As it currently stands, paragraph 80 may in fact be seen as contradictory to the existing guidance found in Chapter IX of the TPG.

Furthermore, the conclusion that the legal owner should not retain any material portion of the return attributable to the intangibles when most of the important functions are outsourced seems to contradict what is said in paragraph 76. The paragraph seems to be drafted based on the assumption that there will always be a positive return attributable to the intangibles, and seems to disregard the fact that any sharing in potential profit arising from the IP would also require actual risk taking and financial capacity to assume that risk. A legal owner assuming this risk and having potentially absorbed several years of losses from unsuccessful contract research would not be likely to share any subsequent positive return from IP eventually developed based merely on the "importance" of the development function as such.

In addition to this, it is unclear how "own employees" shall be interpreted (e.g. by way of payroll or organizational reporting) considering the fact that control and decision bodies may be centralized, but include employees with employment with several legal entities. From a general tax perspective, a principle based on the employment contract with a legal entity rather than the operational belonging and place of decision making seems to be a strange way to allocate taxing rights. It could also open for undesired planning as it would be relatively easy to structure employment contracts in a way that does not reflect the actual functions performed within a legal entity.

The wording also seems to indicate that all these functions (development, enhancement, maintenance and protection of the intangibles) always are equally important for the entitlement to intangible related returns. Functions that potentially could be considered relevant and important in this context would probably not be the same for all types of intangibles and would certainly not be the same for development activities as for maintenance activities.

The assumption of risk together with the financial capacity to bear the risk is a key factor when determining entitlement to intangible related returns. This issue is adequately addressed in the TPG (9.10-9.46). Intangible related returns should naturally be allocated in accordance with the economic reality underlying the arrangement as addressed in the current Guidelines.

At best the paragraph is very unclear as to the intended message. Under all circumstances it needs significant redrafting to ensure alignment with paragraph 76 and chapter IX of the TPG.

Paragraph 89

(d) Summary

89. The legal owner of an intangible is entitled to all returns attributable to the intangible only if, in substance, it:

• Performs and controls all of the important functions described in paragraph [79] related to the development, enhancement, maintenance and protection of the intangibles;

• Controls other functions outsourced to independent enterprises or associated enterprises and compensates those functions on an arm's length basis;

• Provides all assets necessary to the development, enhancement, maintenance, and protection of the intangibles; and

• Bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible.

In our view, this paragraph does not represent a fair summary of the preceding section. Furthermore, the requirements for being considered the owner of IP for TP-purposes seems to extend beyond the accepted principles laid out in Chapter IX. The first bullet point in paragraph 89 states that a member of an MNE should perform all important functions to development, enhancement, maintenance and protection of the intangibles and control other related functions outsourced to other parties. The wording implies that performance cannot be outsourced without losing control and can be interpreted in a way that only few or minor functions (and not the important functions) can be outsourced without losing the ownership over the IP for TP-purposes. This would not be compatible with the current wording of Chapter IX, nor would it be reasonable from an arm's length perspective as it would not mirror third party behaviour.

As previously stated in our comments to paragraph 80 we believe that the relationship between risk, financial capacity to assume the risk and entitlement to the IP for TP-purposes is appropriately addressed in Chapter IX. The wording regarding functions in paragraph 89 is not only contradictory to for e.g. paragraphs 9.25-9.26 in Chapter IX, but also show a lack of understanding of how MNEs are organised and structured from a business point of view. In addition, the wording implies that the concept of significant people functions developed for attribution of profits to permanent establishment should also be applied between legal entities in an article 9 context. We find this highly inappropriate.

We think that the summary should be revised to make clear that the allocation of IP for TP-purposes shall be respected if it concurs with the clear principles laid down in Chapter IX regarding financial capacity and control. The current wording would, in our view, undoubtedly open the door for diverging interpretations regarding the allocation of IP for TP-purposes and give rise to an increased number of disputes and cases of double taxation.

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

Detailed comments

Paragraph 132

132. It will often be the case that a price for a transaction involving intangibles can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34 – 9.38 or 9.122 should be applied, or whether the conditions of the transaction should otherwise be adjusted. Similarly, if situations arise in which there are assertions that either the current use of an intangible, or a proposed realistically available option (i.e. an alternative use of the intangible), does not optimise resource allocations, it may be

necessary to consider whether such assertions are consistent with the true facts and circumstances of the case. This discussion highlights the importance of taking all relevant facts and circumstances into account in a comparability analysis involving intangibles.

The first sentence can no doubt be questioned. As for the second sentence and onwards, we fear that this will lead to tax authorities rejection transactions actually conducted based on the argument that independent parties would not have made such a transaction.

It needs to be acknowledged that there are probably transactions taking place within a group that one would rarely find between independent parties. This does not mean that these transactions cannot be priced in accordance with the arm's length principle. It does however mean that these transactions will be more difficult to analyze. Paragraph 1.69 of the TPG states "…The fact that independent enterprises do not structure their transactions in a particular fashion might be reason to examine the economic logic of the structure more closely, but it would not be determinative….". Consequently, tax administrations are advised to show great cautiousness in dealing with such transactions and to respect the transactions actually undertaken to the extent it is possible. Transactions should not be disregarded or substituted with other transactions simply because it is difficult to find comparable transactions between independent parties.

If there is an overlap of the range of acceptable prices for the seller and for the buyer and if the price falls within this range, the price should be accepted by the tax authorities. The tax authorities should not ask for the median or a specific point in the range. When looking at the realistically available options of a company, a company should not be compelled to elect for the most favorable one since it should take into account its belonging to a group and so the interest of other members. As indicated in paragraph 9.60 of the TPG, as long as the choice is not clearly less attractive than another one it should be accepted.

"9.60 ……………However,alternative structures realistically available are considered in evaluating whether the terms of the controlled transaction (particularly pricing) would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances. If a more profitable structure could have been adopted, but the economic substance of the taxpayer's structure does not differ from its form and the structure is not commercially irrational such that it would practically impede a tax administration from determining an appropriate transfer price, the transaction is not disregarded. However, the consideration in the controlled transaction may be adjusted by reference to the profits that could have been obtained in the alternative structure, since independent enterprises will only enter into a transaction if they see no alternative that is <u>clearly more</u> <u>attractive.</u> "

Paragraph 139

(d) Useful life

139. Many intangibles have a limited useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, as noted above. The useful life of some intangibles can also be affected by

the rate of technological change in an industry and by the development of new and potentially improved products. It may also be the case that the useful life of particular intangibles can be extended.

The useful lifetime of an intangible is an important factor in many valuations but there is great uncertainty and divergent opinions on how to determine it. In our opinion, the definition of useful life in paragraph 139 does not provide accurate or sufficient guidance. In particular, the paragraph should better reflect the fact that in today's fast changing environment, very few, (if any) intangibles will hold a value indefinitely unless supported. Thus the paragraph should in our view take the position that intangibles with indefinite lifetime only holds true in exceptional cases. BUSINESSEUROPE suggest the paragraph be worded as follows:

"Other than in exceptional cases, intangibles have a limited useful life. The useful life of an intangible is the time period over which the intangible, without additional support, can be expected to generate above-normal or above-routine returns. However, the useful life is not necessarily the time period over which the intangible can be used or continues to work. The market value of certain types of intangible tends to decline over time if the value is not enhanced through R&D investment. The rate at which the value declines depends on the speed of technological progress in the industry, the intensity of competition, and the role that intangible property plays in the overall production process."

Paragraph 151

151. 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. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

We find that the paragraph appears to place too much emphasis on the profit split method and does not seem to be in line with the principles in Chapter IX. If an IP-owner complies with the principles on risk-taking and funding as set out in Chapter IX, it is reasonable to conclude that the IP-owner also should have the residual profit (or loss), provided that an arm´s length compensation have been paid to the entities performing the outsourced functions.

Paragraph 182

182. In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by

management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

It is not our experience that projections prepared for non-tax purposes are likely to be more reliable than projections prepared exclusively for tax purposes. Business forecasts often tend to be overly optimistic, resulting in too high values. In addition, projections are made ahead of events, whereas a tax return analysis is made after the event and based on actual rather than expected outcome. Consequently, while projections are important they do need to be revised for reality.

Paragraph 194

194. In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an indeterminate useful life at the time of valuation, that fact does not imply that non-routine returns are attributable to such intangibles in perpetuity.

We do not agree with the last sentence in the paragraph. It should rather be stated that few if any intangibles have indefinite lifetime.

Paragraph 205

205. If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

Is it possible to determine if independent enterprises would have insisted on a price adjustment clause in comparable circumstances? Are there any typical situations where it clearly can be said that independent parties would have included such clauses? In our opinion it is virtually impossible to say what independent parties would have done in this respect. We are concerned that this will lead to numerous disputes and recommend that the paragraph is deleted. At the very least, it is crucial to recognize that there is no standard adjustment clause. Consequently, related parties should have enough flexibility to stick to their economic context.

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EU and other aspects

BUSINESSEUROPE would like to emphasize the importance of appropriately considering and analysing any EU-law implications within the project. Exit taxes, for one, are a concern and relevant since as many as 21 of the OECD members also are members of the EU. As concluded by the European Commission, although an unconditional deferral may resolve the immediate difference in tax treatment, double taxation or unintended taxation may still arise due to mismatches between different national rules. This can be the case e.g. where Member States apply different valuation methods.

A key objective of this project must be to eliminate international double taxation in a timely manner. Consequently, the need for consensus and equal application of transfer pricing rules in relation to intangible property in the Member States and beyond are of utmost importance. Given the severe budgetary situation in many countries, temptations to impose burdensome rules or interpretations of what constitutes appropriate prices for the transfer of intangible property must be resisted.

Furthermore, considering the complexity of this area, it is important to strike a balance between what can be perceived as a theoretically “correct” solution and what is a workable approach in practice. Again, the objective is to find a model which allocates profits and losses relating to intangible property in a reasonable way without leaving a large space for domestic interpretation, divergences and thus risk of double taxation.

BUSINESSEUROPE is happy to continue a constructive dialogue with the OECD on this topic.

On behalf of the BUSINESSEUROPE Tax Policy Group

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