October 2013

CBI COMMENTS ON THE OECD REVISED DISCUSSION DRAFT ON TRANSFER PRICING ASPECTS OF INTANGIBLES

1 The CBI welcomes the opportunity to comment on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (referred to as 'Revised Discussion Draft' or 'draft') issued on 30 July 2013.

2 As the UK's leading business organisation, the CBI speaks for some 240,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

GENERAL COMMENTS

3 The CBI welcomes the changes made in the Revised Discussion Draft, which have improved the previous draft. However, the CBI remains concerned that the concepts raised in the draft chapter will give rise to the unwelcome potential for multiple parts of a group to be considered as having an interest in intangibles, and this outcome is likely to increase complexity and the scope for disagreement between taxpayers and tax administrations and among tax administrations.

4 In particular, the issues of "important" functions and "control" are explained in a very simplistic manner, and fail to recognise how these concepts vary depending on the nature of the intangible and from MNE to MNE, or how they should be valued under the arm's length principle.

5 The CBI believes that legal ownership and funding remain substantive functions in relation to intangibles, acknowledged in arm's length arrangements, but the draft tends to subordinate these functions to vague and undeveloped concepts of control. These concepts should be related to arm's length conditions and could be better developed as a comparability factor rather than as a seemingly arbitrary test of entitlement.

6 The CBI considers that the greater complexity of analysis required by the approaches in this chapter in order to test and demonstrate substance should be targeted at arrangements which are perceived to be abusive, rather than putting all arrangements under a very intensive and unnecessary spotlight.

7 Finally, the CBI is aware of comments made by BIAC, which it endorses.

SPECIFIC COMMENTS

Proposed amendments to Chapters I-III

8 The treatment of group synergies is simplistic, and fails to link the discussion to the arm's length principle. The draft fails to appreciate the expertise and risk involved in many third-party procurement

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arrangements; such activities rarely simply depend on the consolidation of buying power as the draft suggests (21). The “passive” benefit in the guarantee example is open to challenge: 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 the explicit or implicit long term contractual arrangements for the group company (a long term supply arrangement or long term access to markets because of a network of established sales companies, for example). 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).

9 The Revised Discussion 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.

10 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 “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.

11 Paragraph 34 is apparently innocuous in that it brings valuation methods into the approved methods. However, the original meaning has 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.

Section A

12 **Losses**: there seems to be a frequent assumption throughout the Revised Discussion Draft, including the examples, that intangibles create profits, and that higher risk means higher profits. Some thought needs to be given as to what is the best simple phraseology or approach to capture that risk is a two-way uncertainty and that spending on intangibles does not equate to value to the business.

13 **Other taxes:** paragraph 47 goes too far in asserting that the concepts of intangibles for other tax and treaty purposes “do not need to be aligned” with the concepts in the draft chapter. The concepts in the draft are likely to increase the number of group companies with an interest in returns from intangibles, and whereas the applicable concepts to define royalties and determine rights to withholding tax may not always be identical, there should be some broad overlap or consistency between them. Otherwise there are more likely to be problems of international tax systems multiplying taxing rights over the same profits rather than allocating rights.

14 Paragraph 38: point (ii) should 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 be included in this primary section.

15 Paragraph 50: although it may be helpful for definitional purposes to categorise intangibles, the CBI considers that the categories are very often inter-related and the relationships between them should

be considered. For example, some trademarks may, on proper evaluation of the facts and circumstances, be underpinned by strong product innovation, and derive substantial value from those trade intangibles.

16 Paragraph 57: the CBI suggests an amendment to the description of what is a brand along the following lines (insertions underlined): 'A brand may, in fact, represent a coherent combination of intangibles including, among others, trademarks, trade names and customer relationships, as well as associated reputational characteristics (and designs, qualities and know-how necessary to consistently deliver those characteristics) and goodwill.'

17 Paragraph 61: goodwill and ongoing concern value has to be considered an intangible for transfer pricing purposes even though it cannot be transferred separately from other business assets. While the Revised Discussion Draft states that it is "…not necessary for the purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes…" (paragraph 61), the lack of reasonably precise boundaries distinguishing when goodwill and ongoing concern value is relevant for transfer pricing and when it is not will inevitably lead to substantial difference of opinion not just between taxpayers and tax authorities, but also among different tax authorities. Therefore guidance on boundaries/definitions is appropriate.

18 The CBI suggests the following rules would be consistent with the rest of the guidance in this chapter. To be compensable for transfer pricing purposes, goodwill and ongoing concern value must: (1) be controlled by a specific member of the MNE group, and (2) be transferred.

Section B

General comments on changes made to the previous version

19 Improvements have been made to acknowledge legal ownership and funding and the Revised Discussion 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.

20 **Important functions and control:** the current description of important functions and control needs to be reconsidered so that (1) it reflects observed arm's length behaviour rather than imposing a different standard, (2) it acknowledges that control is not a simple concept and will differ between industries and between MNEs, and (3) the concepts are modified to reflect the different and sometimes minimal functions depending on the intangible and the industry. In Example 14, an inappropriate comparable is being proposed and one solution would be to develop control 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.

21 **Legal ownership:** 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. However, those companies would not in the past have been allocated an appropriate share of development costs and there is therefore a significant complexity in matching future income and historic costs.

22 **Anticipated value:** the indiscriminate use of "anticipated value" causes confusion since it appears to imply that all functions associated with intangibles require evaluation of their contribution to anticipated value. The CBI hopes 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.

23 **Return to capital:** 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.

24 **Marketing intangibles:** 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

25 **Segregating and aggregating transactions**: 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 in paragraphs 117 and 121). This is further highlighted in section D4 (paragraphs 211 and 212). The CBI welcomes this addition as it gives taxpayer more clarity on when such activity can be undertaken. However, additional guidance by means of a list of situations when such exercise would/ought to be undertaken would be appreciated in order to avoid potential for double taxation where tax authorities take contrasting views.

26 **Identifying intangibles:** 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). The CBI 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 welcome as it would capture and recognise the issue of potentially inaccessible information acknowledged in section 1.13 of the Transfer Pricing Guidelines.

27 **Disregarding transactions and recharacterisation:** The CBI believes that the Revised Discussion Draft has not addressed the concerns raised in relation to disregarding transactions and recharacterisation and some of that language has been maintained (for example, paragraph 109). As before, the CBI believes 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.

28 **Goodwill:** several references to goodwill have been made throughout Section C and the associated examples (for example paragraph 113 and Example 16). Furthermore, in CBI'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" transfer pricing transactions by tax authorities that may not or could not have taken place at arm's length.

29 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 of 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.

30 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 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".

31 **Split ownership of intangibles:** the CBI notes that there is still an implication in some of the examples in Section C (as well as other sections of the Revised Discussion 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 to 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 transfer pricing purposes should be avoided as it is not in line with the

arm's length principle. The CBI is concerned that this could result in more uncertainty for business and potentially more double taxation and more disputes between different jurisdictions.

32 **Location savings and synergies:** the CBI 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, the CBI remains concerned that the wording suggests that these factors are promoted to a higher level of prominence than the CBI believes is warranted.

Section D

33 There seems to be very little linkage between the concepts in previous sections, in particular Section B, and how to determine arm's length conditions in Section D. For example, evaluation of those important functions which are key to determining entitlement is not covered.

34 It would help reduce perceptions that Section D favours profit splits if this section were re-ordered, so that the more standard concepts in D4 were brought to the start of the section.

35 The use of "options realistically available" (e.g. paragraph 131) is confusing, contradictory and tends to support recharacterisation. The CBI believes that options realistically available is a comparability factor. However, here it tends to question the viability of the transaction. The reference to a transferee lacking resources to exploit the rights and to not engaging in the transfer at all uses the concept to encourage recharacterisation. In the next paragraph, "realistically available options" is confused with "expected benefits."