REPLY TO THE OECD'S REQUEST FOR COMMENTS ON THE *"REVISED DISCUSSION DRAFT ON THE TRANSFER PRICING ASPECTS OF INTANGIBLES - 30 JULY 2013"* FROM CMS

CMS is an organisation of 10 major independent European law firms:

CMS Adonnino Ascoli & Cavasola Scamoni (Italy)
CMS Albiñana & Suárez de Lezo (Spain)
CMS Bureau Francis Lefebvre (France)
CMS Cameron McKenna (UK)
CMS DeBacker (Belgium)
CMS Derks Star Busmann (The Netherlands)
CMS von Erlach Henrici (Switzerland)
CMS Hasche Sigle (Germany)
CMS Reich-Rohrwig Hainz TOV (Austria)
CMS Rui Pena & Arnaut (Portugal)

<u>Contacts for follow-up.</u> This contribution was prepared by the CMS Transfer Pricing Group and, in particular, by the following experts:

Name:	Bruno Gibert: Partner Arnaud Le Boulanger: Partner, Chief Economist Xavier Daluzeau: Tax Partner Stéphane Gelin: Tax Partner Nadia Sabin: Senior Economist Elfie Ossard-Quintaine: Economist
Organisation:	CMS Bureau Francis Lefebvre, 1-3 villa Emile-Bergerat, 92522 Neuilly-sur-Seine Cedex, France
Country	France
E-mail address:	bruno.gibert@cms-bfl.com arnaud.leboulanger@cms-bfl.com xavier.daluzeau@cms-bfl.com stephane.gelin@cms-bfl.com nadia.sabin@cms-bfl.com elfie.ossard-quintaine@cms-bfl.com
Telephone:	+33 (0)1 47 38 42 19
Fax:	+33 (0)1 47 45 86 75

Do you authorize the OECD to publish your contribution on the Internet site www.oecd.org/taxation?

■ Yes

Introduction

The *"Discussion Draft"*[1] (June 2012) called numerous replies and raised intense debates amongst businesses, practitioners and tax administrations worldwide. This illustrates the importance and the sensitivity of the subject for all parties involved in transfer pricing issues.

The ideas and arguments put forward during the Public Consultations (November 2012) confirmed this core interest and reaffirmed the complexity of transfer pricing issues regarding intangibles.

In this context, we welcome the fact that the OECD invited us to comment on its *"Revised Draft"*[2] of Chapter VI of the *"Guidelines"*[3] on the transfer pricing aspects of intangibles.

Further to providing our general comments on the Revised Draft, we will address issues that relate specifically to each one of the four sections of the draft document:

- Identifying Intangibles;
- Ownership of Intangibles and Transactions involving the Development, Enhancement, Maintenance and Protection of intangibles (previously titled *"Identification of Parties Entitled to Intangibles Related Returns");*
- Transactions involving the use or transfer of intangibles; and
- Supplemental guidance to determining Arm's Length Conditions in Cases Involving Intangibles (title to which the terms *"Supplemental guidance to"* were added).

Generally, the main trends observed in the Revised Draft are in the continuity of the ones observed in the Discussion Draft. These are the following:

- Focus on abusive behavior: one of our comments regarding the first Draft was that it seemed to be based on the assumption that all taxpayers behave fraudulently. Although we welcome the obvious efforts in the Revised Draft to reduce such assumption, it is still present throughout the document. However, most of the taxpayers are willing to set and apply transfer pricing policies in compliance with the OECD Guidelines, as well as regional and local legislations.

- Legal and tax uncertainty: as of today, the Revised Draft seems to leave a wide scope of interpretation in favor of tax administrations. The proposed new language still leaves room for diverse interpretations: certain concepts and definitions remain confusing, if not unclear, or some exceptions are brought up to the level of principles. This may generate legal and tax uncertainty and thus a significant level of risks for taxpayers.

- The Discussion Draft already seemed to have raised higher standards with regard to the qualitative analysis of facts and circumstances, especially regarding comparability analyses. It appears that the Revised Draft seems to set these standards at a higher level again. We thus reiterate our previous comment according to which the taxpayers' compliance burden could increase significantly.

[1] *"Discussion Draft – Revision if the Special Considerations for Intangibles in Chapter VI of the OECD TP Guidelines and related provisions"* – 6 June to September 2012
[2] *"Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles"* – 30 July 2013
[3] *"Transfer pricing guidelines for multinational enterprises and tax administrations"* – July 2010

I. Proposed amendments to Chapter I - III

We understand that three new paragraphs are to be added to *Chapter I – Section D – Guidance for applying the arm's length principle*. These paragraphs address respectively location savings, other local market features, assembled workforce and MNE Group Synergies and are destined to be inserted after §1.79 of the Guidelines.

- Prior to the comment of specific points of the proposed amendments, we would like to raise the question of the articulation between the proposed section *Location savings and Other local market features* and the existing section *D.1.2.4. Economic circumstances.* Indeed, certain concepts of these sections seem either complementary or redundant. For example, §1.55 to 1.57 already describe various types of local market features that may be considered in the framework of a comparability analysis. In particular, §1.55 quotes the *"costs of production, including the costs of land, labor and capital"*.

  Therefore, an adequate articulation between the existing sections *D.1.2.4. Economic circumstances* and the proposed one titled *Location savings and other local market features* would be welcome, instead of a simple insertion of the latter *as is* further to §1.79.

- The example given in §12 relating to "other local market features" is quite interesting. We understand this example as stressing the need to identify the value drivers for a given industry in a given market, and the concern that such value be associated to a certain intangible while the value is actually generated by a routine industry know-how which happens to generate a higher value in a specific geographical market. However, a benchmark study focusing on a given market or on a given industry would a priori include companies having the specific features of this market or industry described in this paragraph (e.g., each comparable would have the license necessary to perform its activity); consequently, absent these features, a company would not be retained in the benchmark study.

- As regard assembled workforce, we welcome the fact that the Draft does no longer recognize assembled workforce as an intangible. The proposed amendment is flexible enough to admit the possible existence of assembled workforce in some companies and their potential impact on arm's length prices. This leaves the possibility of a case by case analysis.

- As regard MNE Group Synergies:

  - It seems that the analysis under this title is an illustration of the question as to whether, within a group, a service has been rendered or not (see §7.6 and following of the Guidelines). A reference to Chapter VII of the Guidelines could then perhaps be added.

  - We understand that §23 explains how the profits derived from the group's synergy should be allocated in reference to the profit split method. In particular, the second sentence of §23 describe an example of its application. However, the emphasis placed on the profit split method was one of the major points extensively discussed further to the Discussion Draft and during the Public Consultation of November 2012. For example, as regards royalties, debates then highlighted the express preference of the

Draft for the Profit Split method to the detriment of the CUP method. Yet not only independent third parties are unlikely to rely on a Profit Split in the framework of their transaction, but also royalties are publicly available information as opposite to third party profits.

II. <u>Proposed language for Chapter VI – Special consideration for intangibles</u>

The proposed language of the four sections relating to Special considerations for intangibles has been either partly or completely amended.

As a general comment, we welcome the reminder of independent third parties' transactions as a reference in the framework of a comparability analysis (§37). We also welcome the fact that the new language focuses on presenting principles and recommendations with a more neutral tone, addressing both tax authorities and taxpayers willing to comply with the OECD Guidelines and the arm's length principle.

However, we note that most of the key questions raised by the previous Draft remain in its new version.

1. <u>Identifying intangibles</u>

- As regard the general aspects of intangibles' identification: the newly drafted §39 introduces this section by observing the difficulty of drafting a unique and common definition of intangibles. It recognizes the inconvenience of too broad or too narrow definitions. It thus seems to aim at simply stating these issues as facts and then at introducing the following paragraph. §40 then proposes a definition of intangibles that appears as being closer the economic reality of intangibles than the previous one.

  The currently proposed definition is in three parts, two of them being proposed in the previous Draft: *"not physical asset nor financial asset" (…) "capable of being owned or controlled for use of in commercial activities"* (§40); the third element newly introduced is the reference to the compensation that independent third parties would agree upon in the framework of transactions involving the use or transfer of intangibles. We welcome this third element as it anchors the definition of intangibles in the reality of the free market.

  We also welcome the reminder introduced by the newly drafted §44 stating that not all intangibles used in the context of products or services will require a compensation distinct from the latter products or services.

  However, we reiterate our request for clearer definitions of intangibles.

- We noticed that the following paragraphs remained mostly unchanged. Therefore most of our previously expressed comments could be repeated as of today.

  For example, the attempt to define together brand, trademark and trade name in §57 could generate a confusion. Regarding goodwill and ongoing concern (§§60-62), we also recommended separate and detailed definitions as both concepts reflect different realities. In particular, the new insertion to §62 regarding valorization is confusing by reason of its location in the text. In addition, this new assertion seems to refer to the works on Base Erosion and Profit Shifting ("BEPS") and we raise here the question of the relevance of such reference.

Therefore, for the above paragraphs at least, we reiterate our previous recommendations to provide separate and distinct definition in order to avoid further debates between tax authorities and taxpayers when applying the latter.

- Finally, the newly drafted §58 regarding *Rights under contracts and governments licenses* is in our view too general and includes examples of agreements (e.g., contracts with suppliers or agreements to make available the services of one or more employees) which clearly, in principle, do not characterize intangible assets. The fact that a contract be important for a specific business does not necessarily mean that such contract leads to the characterization of an intangible asset. A more detailed analysis, per type of agreement, should be contemplated.

2. <u>Ownership and Transactions</u>

We welcome both the renaming and the redrafting of this controversial section. The change in title, i.e., *"Ownership of Intangibles and Transactions involving the Development, Enhancement, Maintenance and Protection of intangibles"* replacing *"Identification of Parties Entitled to Intangibles Related Returns",* makes it clearer that the starting point of the determination of a party's entitlement to intangible returns lies in the analysis of the value chain and the location of the main valuable operations.

As a preliminary remark, we would like to underline though that the creation of intangibles is not a topic addressed in the present proposed amendments.

More generally, we noticed that, although entirely re-drafted, the proposed amendments vehicles the same principles as the former language of the Discussion Draft.

- As regard legal ownership, we note that it is still pointed out as a non-valuable characteristic. At this stage, we thus reiterate our prior comments according to which legal ownership held by independent third parties is valuable as it grants, for example, a protection to the owner of the intangible against abusive competition. Such right may be sufficient to significantly impact business value.

  Furthermore, the Revised Draft would still benefit clarification as regard the entitlement or non-entitlement of the legal owner to receive returns from the exploitation of its intangible. For example, §65 recognizes that a legal owner may be *"initially entitled"* to compensation whereas §73 distinguishes the legal ownership from compensation and insists on the fact that the first one does not induce a right to the second one. These two paragraphs may thus appear as contradictory.

  Besides, the wording of §73 leaves the impression that transfer pricing is being distinguished from its legal aspects. However, intercompany transfer pricing policies are required to reflect free market conditions and independent third parties consider legal aspects of intangibles in the framework of their transactions (e.g., identity of the legal owner of the intangible, type of "transfer" (sale or license) envisaged). We are concerned that the newly proposed language of the draft may initiate a gap between transfer pricing and the legal characteristics of the transactions and, consequently, a gap between transfer pricing and free market practices.

- Among the functions, assets and risks relating to intangibles, we would like to point out the association that seems to be made between the compensation of the *"development, enhancement, maintenance or protection"* functions on the one hand, and, on the other hand, the value of the intangibles as anticipated to be increased by the benefit of such services (§77 *"(…) the legal owner of the intangibles must compensate those members (…) for the intangible value anticipated to be created through such functions"*). However, the arm's length compensation of functions performed may be based solely on the costs incurred by their performer without consideration of the value of the intangible at stake, whether anticipated or existing. Therefore, such association may not be relevant depending on the situation examined. We thus believe that this paragraph would benefit clarification.

  We would also like to specifically address §84 that seems to adopt the principle of loan return in the event of funding *"without the assumption of any further risk"*. However, this would be relevant if it was clear that financing research and development involved the same level of risk than a bank loan. Thus at this stage of the draft, we believe that the proposed amendment actually generates a risk for the taxpayer as §84 introduces the possibility for tax administrations to challenge all MNEs' policies by reference to bank loan rates observed on the market. And consequently, a taxpayer compensated according to another rate may need to demonstrate that this chosen compensation is correct and methodologically determined in proportion with the risks identified as born by the lender.

- §§93-103 seem to try to give a value / price to each activity in relation to / use of an intangible assets. First, it should be recalled, as indicated in §44, that not all intangibles have a compensation separate from that of a product or services (§44). In particular in §96 regarding extensive distribution activities. The association of these paragraphs may generate confusion and a significant risk for the taxpayer: on the one hand, all intangibles are not necessarily compensated separately from the product or service but, on the other hand, certain activities may present the characteristics of intangibles and be re-qualified as such. We believe this paragraph leaves too many possibilities of interpretation. In particular, §96 could refer to the Guidelines (§§2.31- 2.32) where it is indicated that the margin earn by a distributor is in particular dependent on the extent of its functions.

  We understand also that this section (§§93-103) aims at describing the application of the OECD principles in commonly occurring fact patterns. However, we believe that reader should be aware of the detailed facts and circumstances of these examples in order to appreciate their scope and their relevance. For example, §102 read *as is* states that, in the event a company acquires another one, the use by the purchased company of the purchaser's brands induces *"no automatic assumption"* that such use should be compensated. Such statement actually challenges legal principles and should remain at the level of exception whereas it seems to be quoted as a principle.

  Consequently, these observations tend to maintain the anti-abuse trend of the Draft (although such trend is much more moderate in this second Draft).

3. <u>*Supplemental guidance to determining Arm's Length Conditions in Cases Involving Intangibles*</u>

As a preliminary remark, we note the change in the above title consisting in adding the words *"Supplemental guidance"*. Indeed, as the Draft is destined to replace Chapter VI within the Guidelines that already address the determination of arm's length conditions in its Chapter I, it appears useful to precise that the following section supplements the latter (e.g. §133).

Otherwise, this section calls for the following comments:

- It is not clear whether §§129-132 suggest that an analysis of the options realistically available ("ORA") to the taxpayers should be performed in all circumstances or whether a benchmark study (of course, performed in accordance with the principles described in the Guidelines) is sufficient to demonstrate the arm's length character of a given price. If such ORA analysis is necessary in all circumstances, it would clearly increase the compliance works of taxpayers and the uncertainty as regards the appropriateness of the transfer pricing policy applied. The position of the OECD in that regard should therefore be clarified.

- As mentioned previously, comparability analyses tend to be more and more complicated, see §§134-148. This increases in parallel the taxpayers' compliance burden. With this regard, we maintain our prior comment reminding the concept of reasonableness expressed in Chapter I of the Guidelines. We thus highlight the necessity to reach a point of balance between precise comparability analysis and reasonable burden for the taxpayers.

Then our main comments address valuation techniques addressed in §171 and following.

- Firstly, we welcome the step forward made by the Revised Draft as it much more clearly states that the *"income based method"* may be used (§172).

- However, we understand that §175 requires valuation to be made *"from the perspective of both parties"*. Although this, again, increases the taxpayer's burden in the event valuation should be made from both ends. As a matter of fact, it is not rare that independent third parties would each proceed with valuations in order to bring different arguments and scenarios in the negotiations; however, it could be recognized that one valuation made on the basis of standard valuation techniques and reasonable assumptions should be sufficient.

- As regard §176, we would like to highlight the fact that the language of this paragraph is not comprehensive and would benefit further clarification. For example, the statement according to which *"cash flow method can be volatile"* could be completed with recommendations to identify the level at which such volatility remains acceptable.

- We note that §§201-202 introduce a concept close to the US "commensurate with income" which, in our view, would significantly increase tax administrations scope of intervention within an MNE and, therefore, the legal and tax risk for the taxpayer.

  This, again, leaves the impression that the Revised Draft refers to the assumption that taxpayers generally do not comply with the Guidelines and the arm's length principle.

- Finally, although the reference to independent third parties' behavior is welcome, one should bear in mind that the information relating to such behavior should be publicly available. In particular, §205 opens the possibility for the tax administration to refer to what independent third parties would have considered in similar circumstances. However, third parties considerations are rarely publicly available. Most of the time, only the result of their negotiations are put in written and may thus be referenced in databases. Therefore, if such information is not publicly available, it would seem controversial to allow tax administrations to reassess taxpayers on such ground.

  Again and as mentioned above, this would participate in increasing the taxpayers' legal and tax uncertainty.

*

*   *

As of today, we are thus of the view that, although the Revised Draft represents a significant step forward, it still does not close discussions.

The launch of the works on BEPS and the express reference to the latter in the Revised Draft raises the following questions regarding the main aim of the Guidelines: to facilitate the understanding of intangibles (and of their appropriate pricing) in the context of trans-border intragroup transactions or to focus on potentially abusive behaviors or situations? Oppositely, the works on BEPS could represent the opportunity to distinguish these goals.