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Comments by Copenhagen Economics

OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles
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We, Copenhagen Economics A/S, would like to provide the following comments for the public consultation held by the OECD on its Revised Discussion Draft on Transfer Pricing Aspects of Intangibles.

Generally, we are pleased with the progress the OECD has made in its revision of the first discussion draft released on June 6, 2012. However, the final/next version could benefit from modifications in some areas and from further guidance in other areas.

We will argue that the final version should be modified in the following areas:

- **Legal Ownership**: The notion of economic ownership reflecting anticipated economic benefits to indicate the basis for any intangible related remuneration should be adopted. The draft misleadingly stresses the importance of legal ownership.
- **Payment for the use of the company name**: Any compensation for expanding the use of the acquirer's company name is fundamentally wrong with any economics and business thinking.
- **Tax audit**: Tax administration's need to carefully evaluate taxpayer's assessment of the intangible value. Tax administration's should not be allowed to reassess any intangible value based inferior methods and information.

We think that the final version could benefit from further guidance in the following areas:

- **Control**: Further guidance is sought on which functions can be outsourced in third party relationships and only need to be controlled vs. which functions need to be performed by own employees.
- **Realistically available options**: Further guidance is sought on what constitutes realistically available options.

We discuss each of these aspects in detail below.

1 Legal Ownership

The discussion draft rightly acknowledges that "*The question of legal ownership is separate from the question of remuneration under the arm's length principle. […] [This] depends upon the contributions it makes to the anticipated value of the intangibles through its functions performed, assets used, and risks assumed […]*" [73.].

However, in our view the concept of legal ownership receives misguiding attention in the discussion draft. While the draft acknowledges that legal ownership and remuneration are separate [cf. 73.], it still places legal ownership at the central start of the analytical framework to identify arm's length prices [cf. 66f.] and even assigns legal ownership to entities [cf. 72.].

According to the discussion draft, "*Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles*" [67.] and, consequently, "*The Framework for analysing transactions involving intangibles requires the following steps: (i) identifying the legal owner of intangibles […]*" [66.].

The governing principle in the discussion draft is that "*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*" [73.].
We believe that remuneration should be based on the contributions each member of the MNE group makes to the value of the intangible. The value of and price for an intangible relates to the anticipated economic benefits an intangible can derive. We believe that a distinction needs to be drawn between *economic ownership* and *legal ownership*. The former, we suggest, is a means to define the contributions made which lead to economic benefits of the intangible. Legal protection, which may be the consequence of legal ownership, may be a means or "contribution" to be able to derive these economic benefits. At the same time, a plethora of further contributions can be made to derive these anticipated benefits.

For example, legal ownership in a patent may provide a time-constrained protection from competition and thereby potentially higher profits. At the same time, a legally protected, but outdated or inactive patent may not constitute a competitive advantage and may not by itself lead to economic benefits for the MNE group. In this case, the legal ownership may not be a contribution to the anticipated value of the intangible. The intangible, however, may still have a value as follow-on innovations based on and made possible by this intangible may generate substantial economic benefits. For this purpose, we suggest for the framework in para [66.] to rather start with the identification of the *economic ownership* (i.e. the actual contributions which lead to anticipated

economic benefits of the intangible) as this is the basis for any remuneration (see para. [73.]).

Finally, it is at odds and misleading in the same sense as outlined above that "*If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE group which, based on the facts and circumstances, controls decisions concerning the use and transfer of the intangibles and has the practical capacity to restrict others from using the intangible will be considered the legal owner.*" [72.]. First, assigning a legal right based on the control of the decision rather than a legal act is common legal practice. Second, it is unclear why such assignment is necessary as the remuneration is explicitly not based on the legal ownership (para. [73.]) and would only serve as a means to follow and implement the analytical framework based on the legal ownership paradigm as stipulated in para. [66.]. However, as indicated above, the analytical framework in para. [66.] should rather start with the identification of the economic ownership as this is the basis for any remuneration.

2 Payments for use of the company name

Paragraph [103.] outlines that consideration should be given to the case where an acquired company should be compensated for expanding the use of the acquirer's company name.

In our view, this idea is at odds with fundamental business thinking: Upon expanding business, firms generate a financial benefit in the form of additional revenue. This situation happens in everyday business life and not only occurs in cases of acquired businesses. An expanding firm generates additional revenue and, ultimately, aims for higher profit – this higher profit is ultimately the compensation for the expansion of its business. However, we do not see why the acquirer should reimburse or compensate the acquired company for expanding the use of the acquirer's company name.

At the same time, we acknowledge the fact that acquired businesses may have an existing business, from which they would also generate revenue without the use of the acquirer's company name. In this case, a "*financial benefit*" [102.] may not have been realised through the use of the acquirer's company name, for which reason, in this case, this generated revenue may not be eligible for a royalty for the use of the acquirer's company name.

3 Tax audit

According to paragraph [206.], "*a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the basis of the information that independent enterprises would have used in comparable circumstances to set the pricing*".

We agree that, as paragraph [206.] appears to intend, no ex-post data can be used by tax administration in deriving an adjustment ("*would have used*").

However, as the paragraph reads, tax administrations are allowed to make adjustments based on information "*reasonably available*" [204.] among independent enterprises. While we acknowledge that an informational bias may exist between taxpayers and tax administrations as pointed out in para. [204.], it should be stressed that information among related parties, however, might be *more* precise for deriving a price for the intangible than third party information. This may exemplarily relate to knowledge about the intangible, its development and characteristics, specific financial and technical data, assessments of future scenarios and sensitivities. Therefore, in our view, tax administrations need to evaluate the valuation and information presented by taxpayers thoroughly before making assessments based on information "*reasonably available*" among independent enterprises, where it is not clear what information would have been "*reasonably available*" between independent enterprises. Therefore and in order to establish "*conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances*"[1], it should be clarified on which ("*reasonably available*") informational basis tax administrations should make any assessment.

In this light, it has been observed that tax administrations ex-post re-assess the price of an intangible based on a comparison of profits prior and post the transfer or any other method, which does not establish the price of the intangible based on carefully evaluated anticipated economic benefits derived from all information available at the day of the transfer (i.e. the original valuation date). The taxpayer's informational advantage should stress the tax administrations' need for a thorough assessment of the taxpayer's valuation. In this case, it also needs to be clarified, what "*reasonably available information*" [204.] intends to include or refer to, when a tax administration intends to "*adjust the amount of consideration"* [206.].

4 Control

The discussion draft stipulates that "*It is not essential that the legal owner physically perform[s] 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*." [73.] and that "...certain" [73.] functions can be outsourced to other entities between third parties. At the same time, the discussion draft indicates that "*...to retain all or material part of the return attributable to a given intangible on the basis of legal ownership [the entity] will generally perform, through its own employees the more important functions related to the development, enhancement maintenance and protection [...]"* [80.].

[1] OECD Transfer Pricing Guidelines, para. 1.6

While we agree that not all functions need to be performed by the owner to receive remuneration and acknowledge the exemplary "important functions" listed in paragraph [79.], clearer guidance is sought on which functions only need to be *controlled* vs. which functions need to be *performed by own employees*. Specifically, it should be clarified which functions can be outsourced or performed by other parties in transactions among independent enterprises.

5 Realistically available option

According to paragraph [129.], "*transfer pricing analysis must consider the options realistically available to each of the parties to the transaction*". However, any guidance on what constitutes realistically available options is missing. Merely, paragraph [132.] outlines that "an alternative use of the intangible" may constitute a realistically available option.

Further guidance on what constitutes realistically available options is sought.