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By e-mail: TransferPricing@oecd.org

Rotterdam, 1 October 2013

Subject: OECD revised discussion draft on intangibles

Dear Mr. Saint-Amans,

EY is grateful to WP6 for the opportunity to submit comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. This letter presents the collective view of EY's global transfer pricing network. We agree to have our comments posted on the OECD website.

Our perspective is that the purpose of the OECD Guidelines on Transfer Pricing should be to assist taxpayers and tax administrations in determining transfer prices within the framework set by the arm's length principle, and to help prevent and settle instances of double taxation or double non-taxation. In approaching our work of reviewing this Revised Discussion Draft, we have tried to focus on the business and commercial impact of the draft guidance on multinational enterprises, drawing on our collective experience of typical business structures and the approaches being taken by tax administrators.

It is clear that the OECD work on intangibles has been strongly influenced by the work on Base Erosion and Profit Shifting ("BEPS"). The key theme of section B is the relationship between legal ownership of intangibles, economic activities that create value in intangibles, and the allocation of income derived from intangibles. This theme is aligned with one of the key objectives of the BEPS Action Plan, to "assure that transfer pricing outcomes are in line with value creation".

We appreciate the need for action to tackle abusive tax planning. However we believe WP6 should recognize that it must balance two apparently different objectives for this report: on the one hand, providing practical advice on applying the arm's length principle with the aim of avoiding instances of double taxation, and on the other hand, arming tax authorities with guidance that in many jurisdictions will become *de facto* anti-avoidance rules. These two objectives do not always sit comfortably together. In particular we suggest that WP6 reconsider certain emergent themes from section B: an increasing emphasis on finding comparable third party behavior in order for the actual transactions undertaken by a taxpayer to be respected; a reduced emphasis on legal and contractual rights; and the implication that in cases where the "important functions" are not all performed by the legal owner of an intangible, a profit split will be necessary to adequately remunerate other group entities. These themes appear to us to be directed at preventing BEPS through the migration of intangibles to group members without business purpose and relevant substance, but we see a risk that the guidance may have unintended consequences for many multinational groups that are not engaged in such intangible migration, which in practice seems likely to result in double or multiple taxation of the same income. We elaborate on these themes below.

Another point of attention in our view is the imprecision of the concepts introduced in section A around the definition of intangibles, and the acceptance in the Revised Discussion Draft that different concepts of intangibles and domestic rules relating to intangibles may in some cases result in double taxation, effectively disarming the effect of Article 9 in practice. This appears to us to subvert the purpose of the Model Tax Convention and of treaties based upon it. Therefore, we strongly recommend that WP6 revisit this issue.

In our written contribution on the initial Discussion Draft (July 2012), we provided detailed comments on key aspects of the draft. We are pleased that some of these points have been reflected in the Revised Discussion Draft. However, several of our earlier comments have not been addressed and we believe they are still valid. We have integrated those comments in this contribution.

Our comments on the Revised Discussion Draft are organized as follows:

1. A summary of our key comments and recommendations with respect to the Revised Discussion Draft.
2. A more detailed discussion of our comments.

If you have any comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

Thomas Borstell/Ronald van den Brekel

Key Comments and Recommendations

Our key comments with respect to the Revised Discussion Draft, as further elaborated upon in the Detailed Discussion Section of this letter, can be summarized as follows.

1. In a number of places the draft puts emphasis on the importance of evidence of third party transactions with comparable allocations of functions and risks to the transaction actually undertaken, with the suggestion that where this is not the case, the provisions of paragraph 1.65 may be on point (permitting re-characterization of the transaction). We recommend clarifying throughout the document that taxpayers should not be required to prove that independent parties are structuring their business transactions in a similar way in order to have these transactions respected for tax purposes, so long as the exceptional circumstances described in paragraph 1.65 do not apply.

2. Although the definition of intangibles has been slightly updated, we continue to believe there is a need
   a. to further to sharpen the definition,
   b. to keep it as lean as possible to avoid a blurred definition not in line with tax law requirements, and
   c. to recognize that there may be factors too ill-defined to be useful for transfer pricing analysis (e.g. "streamlined management").

3. We recommend avoiding general assertions about "goodwill" or "going concern value." Rather, significantly more effort should be put into identifying the various uses of the terms "goodwill" and "going concern value" and analyzing the extent to which these different uses might have significance in applying the arm's length standard.

4. More guidance is needed on remuneration of funding, including the concept of risk-adjusted returns, especially on the remuneration of financing functions and excess profits caused by market circumstances, synergies, etc. We believe that it is at arm's length – because it occurs in dealings between unrelated parties - and in line with the current guidance in the Transfer Pricing Guidelines that a party financing the development of an intangible is entitled to a portion of the "excess profits" in connection with the intangible if that party has the management and financial expertise to bear such risks, even without any control over the use of the contributed funds or the conduct of the parties funded activity.

5. With regard to assembled workforce, the guidance does not clearly demonstrate when transfer or secondment would lead to a compensable event, and when not.

6. The proposed guidance with regard to group synergies and the examples on procurement centers are not well balanced, and do not properly reflect the spectrum of functions performed in practice by procurement centers. We recommend that the guidance clarify that volume discounts should not automatically be spread over the group companies in all circumstances. Neither should the guidance imply that the dedicated group company's remuneration should be limited to a routine remuneration like a cost plus. Such implication, in our view, would be in stark contradiction with independent party reality.

7. Although subject to further work, we would like to point out that the language on pricing in case of highly uncertain situations does not shed any additional light on the circumstances in which one would observe a price renegotiation clause or a stepped royalty rate in an arm's length

agreement. It also does not provide any guidance on the nature of such clauses. In our view, this is likely to lead to adjustments based on hindsight. We believe that these kinds of adjustments should not be applied routinely. Much clearer guidance is needed on the circumstances in which such adjustments might justifiably be made, making it clear this is unlikely to be appropriate except in a very small minority of cases.

Detailed Discussion

We offer the following specific comments to the Discussion Draft.

General

Respecting the transactions undertaken by taxpayers

A key area of concern is that the draft in a number of places emphasizes the importance of evidence of third party transactions with comparable allocations of functions and risks to the transaction actually undertaken, with the suggestion that where this is not the case, the provisions of paragraph 1.65 may be in point (permitting re-characterization of the transaction). Although in some places the draft (paragraphs 126 and 158) confirms the current guidance of paragraph 1.67 of the transfer pricing guidelines that MNE taxpayers should retain the right to structure transactions to suit their commercial purposes in ways that might not be seen between independent parties, we recommend clarifying throughout the document that taxpayers engaged in transactions with associated enterprises should not have to prove that similar transactions also exist between unrelated parties, so long as the exceptional circumstances described in paragraph 1.65 do not apply. This would otherwise put enormous (and often impossible) burdens on taxpayers and would significantly and unnecessarily increase controversy. Some examples where the current draft seems to imply otherwise are paragraph 37 and paragraph 80.

- In paragraph 37, which comments on the functional analysis, a new sentence has been inserted into the Revised Discussion Draft stating that "*Where necessary, it should consider, within the analytical framework of paragraphs 1.42 through 1.69, <u>whether independent parties would have entered into the arrangement</u> and if so, the conditions that would have been agreed*". (Our emphasis added).

- Paragraph 80 is of particular concern, as the penultimate sentence ("*In some such circumstances it may also be determined that the outsourcing of such important functions would not have been undertaken by independent enterprises … thereby necessitating the disregarding of the actual structure adopted in accordance with the principles described in paragraph 1.65*") may be read as a deeming provision allowing tax authorities to determine that the special circumstances of paragraph 1.65 have been met if some of the "important functions" have been outsourced, without either of the circumstances described in paragraph 1.65 necessarily being tested.

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

Assembled Workforce and Secondments

We welcome the additional guidance around comparability factors in general, and "assembled workforce" in particular. Analogous to our comments provided in 2012, we would like to point out that practically, however, it would be very difficult to take factors like a "unique assembled workforce" into consideration. The imprecision of such concepts would be a certain source of significant dispute. Consequently, we suggest taking such factors into consideration only if they are reliably determinable and measurable. The range concept deals with other situations. A thorough description of how to practically deal with assembled workforce as comparability factors would be very much welcomed.

In our view the guidance on arm's length compensation when employees are seconded, and when this is likely to give rise to a separately compensable event (e.g. from a transfer of know-how) is insufficiently clear. Paragraph 16 states that "*Where employees are seconded… in many cases the appropriate arm's length compensation <u>for the services</u> of the seconded employees in question will be the only payment required*." (Our emphasis). We welcome the comment that transfers or secondments of individual employees should not, perhaps except for some unique and well defined cases, necessitate a compensation separate from the remuneration of the employee, as these arrangements are common and in the vast majority of cases do not result in the transfer of unique or valuable intellectual property. Paragraph 17, however, comments that "*in some situations the transfer or secondment of one or more employees may … result in the transfer of valuable know-how from one associated enterprise to another*." This has the potential of opening a lot of discussions. The guidance does not clearly demonstrate when transfer or secondment would lead to a compensable event, and when not. In order to avoid disputes and the need for extensive documentation every time a single employee transfers from one part of a group to another, we suggest that the guidance should be expanded to provide details of the factors to be examined that might indicate a transfer of know-how was taking place that would require separate compensation.

On a separate note, the sentence in paragraph 16 quoted above could imply that the secondment of employees from one entity to another is equivalent to the provision of services by those employees to the recipient entity, but this is not always the case. The different possibilities may be illustrated by an example:

Consider a situation where company A in country S has a business of providing services to customers, consisting of designing specialist equipment, assisting in its construction, and operating the equipment. Company B is a sister company in country T. Company B provides similar services to customers in country T to operate equipment for its customers, but does not generally offer the service of designing or assisting in the construction of this equipment. In a particular year, company A provides a team of 12 engineers on secondment to company B for nine months, to assist company B in providing services to a new customer (X) that has requested equipment design services.

Depending on the facts and circumstances, the transaction between A and B could represent (i) the provision of engineering design services from company A to company B, for resale to customer X; (ii) the provision of engineering design and/or training services from company A to company B; (iii) the provision of payroll and HR services by company A to company B (company B being treated as *de facto* employer of the 12 engineers).

A full transfer pricing analysis of a secondment arrangement such as this needs to consider fully the details of the arrangement, including how the contract with customer X was won; the management reporting lines for the seconded employees, both before their secondment and whilst on secondment; arrangements between A and B in relation to holiday, sick pay and health and safety matters for the seconded employees; and the duration and extension possibilities of the arrangement. In our experience secondment arrangements can lead to extensive enquiries and discussions and we therefore suggest including further guidance on these factors.

MNE Group Synergies

We have fundamental concerns at the new guidance which is proposed be added to Chapter I on group synergies. The new draft guidance introduces a new concept of "deliberate concerted group actions" giving rise to synergistic benefits and a principle that the associated benefits should be shared in proportion to the contribution to the creation of the synergy.

We view this proposed principle as formulary rather than arm's length in nature. Indeed, the notion of a "concerted group action" seems at odds with Article 9 (e.g. paragraph 1.6 of the Guidelines).

To illustrate that this is more than a theoretical point using one of the activities considered, if 50% of a group's purchasing volume as accounted for by one entity with the remaining 50% widely spread, it seems quite likely that, if unrelated, only the larger purchaser would be able to gain any volume discounts. Yet, the proposed principle would allocate half of the group's discounts between the smaller purchasers. Furthermore, in practice the bundling is not simply a concerted group action, but the realization of the volume discounts is often due to deliberate actions by one dedicated group company. One common example is the situation that a group with skilled personnel performs coordination functions that effectively lead to standardization within the group. This complex set of functions effectively opens the opportunity to gain further volume discounts. The guidance should at least clarify that in such situations the volume discounts should not automatically be spread over the group companies. Neither should the guidance imply that the dedicated group company's remuneration should be limited to a routine remuneration like a cost plus.

Although the guidance is meant to illustrate the treatment of group synergies, the examples on central purchasing implicitly contain other guidance with regard to the remuneration of procurement centers. In our view, the examples don't fully illustrate the wide range of functions performed by procurement centers. The guidance focuses exclusively on cost savings achieved simply by aggregating volume and pays no attention to other functions performed, other benefits realized and others sources of cost savings by procurement centers. This is a too narrow view on the role and benefits of procurements centers because long term sustainable savings from volume aggregation are only available in markets/industries characterized by significant scale economies which are being captured by suppliers. In other circumstances the fundamental source of savings is different. For example, for traded commodities (e.g. coffee, sugar, aluminum) purchase price is not determined by purchase order volume, but on market supply and demand. In this case, the value procurement centers bring is not how much they buy, but when they buy. Another example is that of "one-off purchases" (e.g. capital equipment or infrastructure projects). In such cases, aggregation of buying volume is irrelevant as it concerns the purchase of one item. The benefits achieved by procurement centers may arise managing total costs, mitigating execution risks and structuring long-term, favorable commercial agreements.

Third party examples show independent sourcing companies generating profits that, or charging fees charging fees by which they capture part of the benefits of consolidating the requirements of some of their customers. They have developed different ways of remuneration for their services: risk/contingency based, purchase order transaction based, fixed fees, contract value based and a mix of these models. It is a serious misconception to view the sole or most important source of benefits from centralized purchasing as deriving from the mere aggregation of volume to increase negotiating leverage. The benefits MNEs seek are varied and flow from their own market circumstances and strategies. But they may include:

1. **Risk mitigation**: e.g., reduce price volatility through hedging, forward buying, price index tracking, macro-economic scenario planning etc.

2. **Innovation / product development**: creating access to new technologies, materials, knowledge from suppliers – feeding the organization with the capability to differentiate in the marketplace.
3. **Life cycle cost control**: identifying and selecting suppliers that contribute to cost control through the life-cycle of a product – this requires technical, financial, commercial and managerial skills from procurement professionals.
4. **Cash flow and working capital optimization**: through negotiating favorable payment terms and conditions with suppliers.
5. **Standardization / harmonization of buying requirements**: reducing complexity of specifications is often a more effective way to reduce purchasing costs as it pushes the entire cost curve down, rather than moving the dot down on the cost curve.
6. **Budget transparency and compliance:** by institutionalizing robust purchasing procedures, clear definition and enforcement of buying policies, the quality of budget reporting/management will improve and cost of non-compliance will be reduced. Creating awareness of current buying behavior and understanding the consequences of non-compliance to purchasing policies is often the best way to sustainably reduce costs – and procurement is the function that is tasked with this role.
7. **Sustainability**: Procurement is the gate to the supply market and in that position is the main advocate to drive corporate social responsibility towards 3rd party vendors.

A further concern is that the guidance appears to create a need to distinguish the cost savings which could (hypothetically) be achieved by mere coordination, and other cost savings.

Based on this, we would either suggest the examples be deleted, or, at the very least, other examples should be added indicating that methods other than cost plus may be appropriate, such as the CUP or profit split methods, in line with the current guidance of Chapter IX.

Section A: Identifying intangibles

Clear Definition of Intangibles

In our view, vague definition and unclear concepts give room for different interpretation by taxpayers on the one hand and tax administration on the other hand. In this respect, we obviously welcome the clear statement in paragraph 43 that features of a local market may affect the determination of an arm's length price for a particular transaction, but that they are not intangibles for purposes of Chapter VI. In addition, we believe that the new sections D.6 through D.8 in general contain helpful guidance for both taxpayers and tax administrations.

Despite this helpful additional guidance, we continue to believe that an even clearer definition of “intangibles” is needed for a number of reasons. As pointed out in response to the initial Discussion Draft, one of the reasons is that in many countries a definition that is not sufficiently concrete could be contrary to domestic law, including constitutional law, that prohibits overly vague concepts. In this respect, we are concerned about the statement in paragraph 48 that the guidance in Chapter VI is also not relevant to recognition of income, capitalization of intangible development costs, amortization, or similar matters and that, for example, a country may choose not to impose tax on the transfer of particular types of intangibles under specified circumstances. Similarly, a country may not allow for amortization of the cost of certain acquired items that would be considered intangibles under the definitions in this Chapter and whose transfer may be subjected to tax at the time of the transfer in the transferor's country. It is recognized that inconsistencies between individual country laws regarding such matters can sometimes give rise to either double taxation or double non-taxation. We are in particular concerned about this statement in light of the OECD's overall goal of avoiding double taxation since such inconsistencies effectively will lead to double taxation.

Group synergies and market specific factors
We welcome the explicit clarification that group synergies and market specific characteristics are not intangibles for the purposes of a transfer pricing analysis, but rather are comparability factors. We agree with this and we believe that this clarification will help to focus the transfer pricing analysis on the correct issues, in particular in situations where taxpayers are entering or expanding their operations in new jurisdictions. Even though we welcome this clear statement, we recommend adding additional wording to further clarify that local market features should also not be considered to be "unique contributions" that as such would justify the application of the profit split method.

Goodwill and ongoing concern value
Goodwill and ongoing concern value are still classified in the Revised Discussion Draft as intangibles. In response to the initial Discussion Draft, we expressed our concerns with respect to the statement that it is not necessary for purposes of Chapter VI to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes because the definition of goodwill and ongoing concern is uncertain and may vary depending on the context. We expressed our believe that accepting uncertainty in this respect is not appropriate since it will simply create abundant opportunity for conflict between and among taxpayers and different tax authorities. We reiterate the importance of a clear definition of intangibles. We can't see how it is possible to conduct a proper transfer pricing analysis on an intangible asset without a clear understanding of what the asset is and how it contributes to value. As the Revised Discussion Draft states at paragraph 46, *"In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity … it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions."* We are particularly concerned about the inclusion of "goodwill" as an intangible asset where there is no precision about what is meant (indeed, the language of paragraph 61 appears to suggest that it doesn't really matter what goodwill is) - such a vague definition invites dispute.

It is hard to reconcile the inclusion of goodwill and ongoing concern value with the definition of intangibles at section A.1. In particular, ongoing concern value is not in our view "capable of being owned and controlled for use in commercial activities", and there are many ways in which this concept can relate to factors that are explicitly defined as not intangibles in other parts of the Revised Discussion Draft (for instance, the value of a business over and above separately identifiable assets could derive from market-specific characteristics or group synergies). As regards goodwill, the Revised Discussion Draft offers three different possible definitions (of which one is equivalent to ongoing concern value, whilst the others represent quite different concepts) and states at paragraph 61, "[i]t is not necessary for purposes of this chapter to establish a precise definition of goodwill …".

At the same time we understand the importance of ongoing concern value (or "goodwill" in the sense of value in excess of the identifiable assets of a business) in testing whether business restructuring transactions provide adequate compensation for these factors.

We therefore suggest instead that goodwill and ongoing concern value be treated as comparability factors to be addressed in a transfer pricing analysis. In the context of business restructurings, paragraphs 9.93-9.95 already adequately deal with the point. In the other senses in which it is used, "goodwill" again seems to be a comparability factor. For instance, "goodwill" is used to explain the fact that a trademark may have significant value in one jurisdiction through the positive associations that customers have of products sold under that trademark (and therefore, the expectation of future economic benefit from the trademark) whilst another trademark may have little or no value because there is no equivalent goodwill. "Goodwill" here therefore seems simply to be a factor that explains the difference in value between intangible assets that are otherwise similar. As the Revised Discussion Draft points out in paragraph 60, it is generally not possible to transfer goodwill separately from other assets, so treating "goodwill" as a comparability factor rather than as a separate intangible asset is aligned with this commercial reality.

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

Remunerating MNE group members for their contributions to intangibles should not default to a profit split or formulary apportionment of intangible-related profits

Paragraph 65 says 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 an allocation to those other members of all or part of the return attributable to the intangible."* (Our emphasis added).

If the point here is that all members of the MNE group that perform functions, use assets or bear risks related to the development, enhancement, maintenance, protection or exploitation of an intangible should receive an arm's length return for that activity, then we agree. However, if that is what is meant, it is worded in a way that invites misunderstanding and dispute. It is the "framing" as an "allocation of all or part of the return attributable to the intangible" that is wrong since in some cases the performance of functions and the use of assets may correctly be characterized as the provision of a service to the owner or user of an intangible. If that is the case, then the arm's length return for the service is independent of the return attributable to the intangible in question, and is not properly part of the return to the intangible. "Framing" it as an "allocation" of the return attributable to the intangible invites taxpayers or tax authorities to claim that the transfer price should be determined with reference to the return earned from the intangible, effectively ending up in a profit split with an apportionment based on headcount, operating expense or some other formula. This is not how third parties deal at arm's length, and should not be the case in controlled transactions.

The same issue arises in paragraphs including 73, 77, 86, 90, 93 and 101 in the discussion on how group members should be remunerated for their activities: e.g.

> "*It* [the legal owner] *must remit to other MNE group members arm's length remuneration reflecting the anticipated value of their contributions*" (paragraph 73); "*the legal owner … must compensate those members performing such outsourced functions on an arm's length basis for the intangible value anticipated to be created through such functions*" (paragraph 77).

The repeated references to "value" are misleading. At arm's length, entities that perform outsourced functions earn arm's length remunerations: in some cases, this arm's length remuneration is related to the intangible value created, whilst in other cases, it is independent of the intangible value created. We recommend rephrasing these sections to clarify that arm's length remuneration means exactly that - i.e., whatever is arm's length in the circumstances of the case – and does not necessarily imply that the return to the intangible should be split.

The importance of "important functions"

One of our concerns with the initial Discussion Draft was the hypothesis about arm's length behavior in terms of who would be required to perform the "important functions" with respect to the development, enhancement maintenance and protection of intangibles. In general, we consider the structural changes to section B and the introduction of the analytical framework in paragraph 66 to be a significant improvement compared to the initial Discussion Draft. In our view, the theoretical framework for dealing with "intangible related return" is now more in line with the general principles of Chapters I – III of the OECD Guidelines since it no longer is a prerequisite to identify the party that is entitled to the intangible related return. With respect to the performance of "important functions" and the entitlement to intangible related returns, we welcome the explicit reference to the principles of paragraphs 9.23 through 9.28 of the OECD Guidelines, instead of the presumption that an independent party would physically perform such activities itself (through its own employees).

However, one of our overarching concerns with the Revised Discussion Daft is that it places great weight on the performance of "important functions" in determining the right to retain some of the returns attributable to the intangibles. Intangible value is generally created not only by workers performing functions, but also by owning and using assets, and bearing risks. We are concerned that tax administrations will discover "important functions" in almost any entity within a multinational group that touches in some way the valuable intangibles owned by the group, with a consequent degradation of the arm's length standard to a default application of the profit split method based on headcount, operating costs or sales – which is formulary apportionment in disguise.

Paragraph 80 illustrates this point most clearly, suggesting that in situations where the "important functions" are outsourced, it may be difficult to find comparable transactions involving the outsourcing of such functions, therefore dictating the use of transfer pricing methods not directly based on comparables such as profit split methods and valuation techniques. There appears to be a logical disconnection here: just because a comparable third party transaction involving the outsourcing of a specific function cannot be identified, this should not automatically mean adoption of the profit split method.

In MNE groups, it is not uncommon for some of the important functions associated with intangibles to be distributed between different group members. Furthermore, there are levels at which each of the "important functions" may be performed, which may result in multiple entities claiming to perform these important functions. Consider, for example, the case where the legal owner of a patent decides to invest in a research programme to develop new uses for the invention. The objectives of the research programme and the budget are communicated to a related party which is tasked with performing the research. That related party is then responsible for managing the budget it has been allocated and performing the research within the budget, and for managing the quality of its own work. The local tax authority might then claim, under the guidance of paragraph 79, that it is performing the "important functions" of managing the research budget and quality control. Following the guidance of paragraphs 80 and 81, this could result in selection of the profit split method as "the most reliable method".

We are concerned that the guidance here will, in practice, result in a default to the profit split method in many cases where it is not appropriate. We believe that in situations where an entity is the legal owner of an intangible asset that it developed or acquired by itself, and then outsources some of the "important" functions (per paragraph 79), this should not mean an automatic default to the profit split method. Furthermore we believe that if that entity ceases to perform most of the "important" functions, this should not mean that its right to retain a material portion of the return attributable to the intangibles is *"highly doubtful"* (per paragraph 80).

We are also concerned that the guidance does not address temporal issues with respect to performance of the "important functions". For instance, some intangible assets may arise from research carried out by an entity, with commercialization happening only several years later. At that stage, the 'important function' of managing the research is no longer being carried out. We do not think it is appropriate (or necessarily intended) that the legal owner of an intangible should be denied the right to retain a material portion of the return attributable to the intangible if it ceases to carry out "important functions"; however we can see the guidance being interpreted in this way.

The Role of Legal Ownership

Section B.1 suffers from a seemingly ambivalent attitude towards legal ownership. On the one hand, there are a variety of places where the discussion suggests that legal ownership is a crucial factor. Thus, the term "ownership" figures prominently in the title of section B.1 ("Intangible ownership and contractual terms related to ownership"). The very first sentence in Section B.1 states that "*[l]egal rights [which surely must include ownership] and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles.*" (emphasis added).

On the other hand, paragraph 73 states that "*[t]he question of legal ownership is separate from the question of remuneration under the arm's length principle.*" But, of course it is precisely the issue of "remuneration under the arm's length principle" that the Guidelines are addressing. So if the issue of legal ownership is separate from this issue, how important can legal ownership be? The answer seems to be - not all that important. Rather, paragraph 73 states that "*[l]egal ownership is simply a reference point for identifying and analyzing controlled transactions relating to the intangible and determining the appropriate remuneration …* "

We are concerned that this seemingly contradictory position creates the potential for significant uncertainty and confusion. Clarification is necessary.

We think the point being made here is methodological. Any analysis should take into account the legally cognizable rights of the parties in order to determine the arm's length result since the availability of a legal remedy may have a significant impact on the value of a party's rights in an intangible asset. However, the existence of such legal rights is not the end of the analysis. There are a variety of reasons why legally cognizable rights might not translate (directly or at all) into market value. For example, the underlying intangible asset may have little commercial value. Performance of various functions associated with the commercial exploitation of the asset may leave little return available to the legal owner of the intangible asset. Legal rights can be subdivided and assigned or transferred in numerous ways with the result that the titular "legal owner" may retain few rights of great value. Sometimes, the legal rights may have little value even if the intangible asset is of value; the legal rights may be simply too difficult to protect or enforce.

One specific point of attention with regard to this ambiguity with respect to legal ownership is the potential inconsistency between profit allocations and the transfer of intangibles. If based on the above guidance little income is attributable to legal ownership, then little value should be attributed in case the intellectual property is being transferred. In practice we experience that countries in case of the transfer of the legal ownership of an intellectual property claim compensation based on the ownership, despite the fact that based on the above guidance little income should be attributable to the legal ownership. This creates double taxation and is the source for numerous disputes.

Anticipated return versus actual return

The guidance presented in section B.2. could in our view create confusion with respect to the treatment of risk for transfer pricing purposes. We believe that the current guidance does not properly address the importance of making the distinction between anticipated return (when dealing with associated enterprises) and the actual return. Such a distinction in general should be made, but also in case of transactions involving intangibles (e.g. when applying valuation methods that rely on projections of future events to perform a transfer pricing analysis). The arm's length nature of the allocation of risk should not be challenged merely because the actual return – due to the materialization of risks – is not in line with the anticipated return.

Allocation or risks
As pointed out, taxpayers engaged in transactions with associated enterprises should not have to prove that similar transactions also exist between unrelated parties, so long as the exceptional circumstances described in paragraph 1.65 do not apply. The same should apply for the allocation of risks between related parties: the fact that a certain allocation of risks between related parties is not observed in a similar manner between unrelated parties should in itself not be a reason to challenge the allocation of risks as agreed upon between the related parties.

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

Options realistically available should consider all relevant circumstances
Paragraphs 131-132 and example 24 focus on the analysis of options realistically available ("ORA"). The guidance here suggests that an analysis of ORA should consider, almost exclusively, the immediate financial consequences of different options on the after-tax profits derived from the use to which an intangible asset is put. For example, if entity A transfers rights in an intangible to related entity B, and the present value of after-tax profits are no greater or decline as a result, then the guidance suggests the pricing of the transaction may be questioned, and consideration given to re-characterizing or disregarding the transaction altogether.

We are concerned that this guidance places too little weight on the wider circumstances that may surround a transaction involving intangibles, and the bargaining factors that might influence the price at which entities are willing to transact. In the example above, the transaction could provide many benefits to entity A that are not readily quantifiable as part of the NPV assessment, such as: better alignment of activity with management resources; freeing resources to exploit short term opportunities; or preparation for divestment of a part of the business.

Contract R&D arrangements
Paragraph 97 discusses contract R&D arrangements and discusses the need to consider all factors, including whether the research team *"possesses unique skills and experience relevant to the research"* and noting that cost-plus compensation may not be appropriate in all cases. We feel this guidance may be misleading, as contract research teams will necessarily develop unique experience of performing research related to a particular field merely by virtue of being engaged to perform such research. We are concerned that tax authorities in territories where contract R&D is being performed will use this guidance to discover, in every case, the existence of unique skills and experience related to the research being carried out, therefore indicating that a profit split is the only appropriate form of arm's length remuneration.

Cost based methods
Paragraph 160 states that transfer pricing methods based on the cost of intangible development should usually be avoided. We think that this is a generalization that in many instances will not be appropriate. Most businesses generate intangible assets such as handbooks, policy manuals, customer lists, internal use software, forms, etc., and in many cases a cost-based valuation method appears entirely appropriate for valuing such assets.

Highly Uncertain Value

In response to the initial Discussion Draft, we made a number of comments with respect to the pricing in case of highly uncertain transactions. We have taken notice of the remarks in the Revised Discussion Draft that one area of future BEPS related work involves the transfer pricing treatment of hard to value intangibles, and that it is anticipated that substantial work will be focused on this topic in coming months. In light of that work, we would like to reiterate our comments with respect to pricing of highly uncertain situations.

We pointed out that the language in the initial Discussion Draft on pricing in case of highly uncertain situations did not shed any additional light on the circumstances in which one would observe a price renegotiation clause or a stepped royalty rate in an arm's length agreement, or on the nature of such clauses. In our view, this is likely to lead to adjustments based on hindsight. We believe that these kinds of adjustments should not be applied routinely. Much clearer guidance is needed on the circumstances in which such adjustments might justifiably be made, making it clear this is unlikely to be appropriate except in a very small minority of cases. In addition, we are concerned about the wording in paragraph 204 which indicates that certain cases might prompt a tax administration to inquire what a third party would have done. To deviate from contractual allocations, the tax authorities should be required to prove that a third party in similar circumstances would have included some kind of protection against uncertainty. The fact that a tax administration may inquire about this should not imply that a taxpayer should be required to prove that a third party would not have included such protections against uncertainty.