Comments on the Discussion Document of 30 July 2013 on the OECD Guidelines (Chapter VI)

General introduction

The OECD released its latest draft of the proposed revision to Chapter VI of the Transfer Pricing Guidelines on Tuesday July 30 2013. Comments are invited by Tuesday October 1 2013. A public consultation at the Paris headquarters of OECD is planned to take place this November.

The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

Power and scope of intangibles

It is the case on nearly every recognised stock exchange that the combined market capitalisation of the exchange is heavily weighted in favour of intangible value. Put simply intangible assets account for the majority of the average company's value. This is a continuing and developing trend. Governments and tax administrations have generally not orientated their tax systems in a way which recognises this fact. As such there is a lot of uncertainty and confusion around the taxation of intangibles and this is especially the case in the field of transfer pricing. This discussion paper is a necessary next step in the process but perhaps governments would be better advised to consider fundamental revisions to tax legislation to ensure that intangibles are taxed in a coherent and consistent manner across all types of direct and indirect taxation.

Necessity to precisely define scope and depth of intangibles

We consider that it is vital for there to be a strong and clear definition of intellectual property ("IP") on the one hand and intangible assets ("intangibles") on the other. IP is of course a subset of intangibles. Transfer pricing rules should directly apply to intellectual property but not to intangibles generally. The guidelines should produce a clear and definitive list of IP that businesses and tax administrations can use to develop coherent rules (reference should made to definitions provided in US tax law). The discussion paper discusses the categorisation of certain common intangibles but falls short of providing specific and definitive guidance and fails to discuss the obviously difficult areas.

It is beneficial to keep the distinction between marketing and trading intangibles and to build on this in the paper and the numerous examples.

Location savings and other local market features.

It is helpful that the paper discusses these matters. However they appear out of place as the first section of the discussion paper. It would be better if these sections were incorporated into the main body of the paper in the next version. It should be noted that the discussion paper fails to state whether an assembled workforce is an intangible or not.

Economic ownership and cost sharing

In a number of places (e.g., paragraph 38) the paper describes the steps necessary as part of a functional analysis. One of these steps is to identify the <u>legal</u> owner of the intangible concerned and the contributions (presumably by the legal owner although this is unclear) to development etc. We do not however consider this to be sufficient. It is common for both third parties and related parties to work together to develop intangibles. The costs of development and the fruits of ownership are often shared under a cost sharing arrangement. It is common for one member of the cost sharing arrangement to legally register the intangible as a nominee. The cost sharers are entitled to an economic ownership interest in the underlying intangible often evidenced by a royalty free licence. We do not consider that the current discussion draft fully considers or studies the issue of economic ownership both within and outside of a cost sharing arrangement. There would also appear to an over reliance on the concept of legal ownership.

Arm's length standard and avoid re-characterisation

In a number of places the document states that the legal owner of the intangible should only be entitled to keep the profits if it has <u>itself</u> undertaken virtually all aspects of the value chain from development and funding through to licensing and protection. We can see this attempt to link taxation to value creation. However it ignores what happens at arm's length in the outside world, where it is very common for IP companies to outsource key parts of the IP development process. To deny this to related parties would put unbearable strain on the rules and amount to an unjustified re-characterisation of the transactions for tax purposes. It would instead be better to ensure that proper arm's compensation is paid to reflect the services provided under an internal outsourcing arrangement. At all stages every attempt should be made not to re-characterise the legal form of transactions between related parties.

TP methodologies and profit split

Returns on intangibles (other than own use) are mostly generated in one of two ways, firstly selling the intangible and secondly licensing the intangible. The first generally produces a one off capital gain whereas the second generally produces an on-going flow of income (royalties). In related party transactions it is necessary to "value" either the capital sum or the on-going royalty. Both are generally very tricky to value. It is also very common for the CUP method to be inappropriate for a wide variety of reasons. The paper recommends the use of the transactional profit split in certain circumstances but rejects the use of a "rule of thumb". We believe that this should not be so easily dismissed. Rules of thumb that are based on empirical evidence can create a very valuable starting point for a transfer pricing analysis and in some cases may be the only realistic starting point.

This is on the whole a very difficult and contentious area. Furthermore it is one where tax authorities generally enquire into the transactions several years after they have occurred. It is essential that the use of hindsight is removed from any subsequent discussion regarding appropriate pricing. The revised guidelines should make this clear.

IP valuation

IP valuation is a specialised practice in much the same way as the valuation of other valuable and specialised property. We believe that the sections in the discussion document that discuss valuation (discount rates, terminal values etc.) should be removed and valuation matters left to valuation experts and not transfer pricing practitioners. We should also like to make the point (in reference to the BEPS project) that all IP is, in practice, hard to value.

Link to BEPS

The political and media interest in the taxation of multinational business, referred to now as Base Erosion and Profit Shifting (BEPS), has brought intense pressure to bear on transfer pricing and especially on the transfer pricing of intangibles. In the light of such pressure it will take strong nerves to deliver a principled expansion of the existing transfer pricing guidance rather than to take a new line and potentially alter the concept of arm's length pricing.

There are compelling reasons why a careful expansion of existing guidelines is appropriate. These are:

- An expansion of existing guidelines is likely to apply to all existing transactions, not just to transactions executed after the date that changed guidelines are agreed and implemented. It will therefore be a faster process and more likely to succeed;
- The revised guidance will also apply to all current OECD-based treaties, and to the national legislation of all countries that follow the OECD Transfer Pricing Guidelines. This will reduce the risk of double taxation and the resulting burden for tax authorities and businesses. The potential for double taxation is accepted as a risk to slowing economic growth which, in the current global economic climate, should be unacceptable to everyone; and
- There is no need to abandon the arm's length principle because with careful thought and clear guidance in Chapter VI for the application of the principles contained in Chapters I to III of the Transfer Pricing Guidelines the result will be appropriate in the context of BEPS.

Conclusion

There remains a lot of effort to complete the re-drafting of Chapter VI of the OECD Transfer Pricing Guidelines but this paper takes things forward in a positive manner. Much of that effort will most probably be in re-ordering the material to make it easier to understand and apply, in amending the material to keep well within the arm's length principle, and removing material that really does not belong in the Transfer Pricing Guidelines (such as valuation matters).

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