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30. September 2013

Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Madam or Sir,

Please find enclosed our comments regarding the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

The Federal Chamber of Tax Advisers represents the interests of more than 91.000 tax advisers in Germany vis-à-vis the Bundestag, the Bundesrat, the federal ministries, the top echelons of the civil service, the courts and the institutions of the EU and OECD.

The main duties of the Federal Chamber of Tax Advisers are to represent the entire profession at national and international level, to participate in the drafting of the laws of the profession and in consultations on tax laws and laws in all other legislative areas of the profession.

Yours sincerely,

Jörg Schwenker
Geschäftsführer

<u>Encl.</u>

Enclosure

Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

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PROPOSED AMENDMENTS TO CHAPTERS I – III OF THE TRANSFER PRICING GUIDELINES

D.6. Location savings and other market features
D.6.1. Location savings

The section on location savings refers mainly to paragraphs 9.148 to 9.153 on business restructurings. The question arises whether these remarks would not be more appropriately placed altogether in chapter 1. However, it should be noted that 9.148 and subsequent paragraphs provide more of a discussion and illustrations on the basis of examples than a solution.

D.6.2. Other local market features

The revised discussion draft indicates possible differences in terms of the size or geographical location of a market, infrastructure, and access to resources and customers that should be taken into account where comparability needs to be achieved. If it is not possible to find comparable transactions, the draft recommends that adjustments are to be made; but there is no indication as to how such adjustments can or should be carried out.

D.7. Assembled workforce

The subject of this section is not entirely clear. On the one hand the draft goes into the importance of an assembled workforce for the value of an enterprise (as assets similar to goodwill) while on the other hand reference is made to an assembled workforce forming the object of a possible transaction (staff secondment). The conclusions drawn by the OECD (remuneration for a service, a possible transfer of know-how has to be compensated) find our acceptance. As far as the relevance of an assembled workforce for the comparability analysis is concerned, however, the draft remains rather vague.

Chapter VI SPECIAL CONSIDERATIONS FOR INTANGIBLES

<u>35. to 38.</u>
The scope of application of chapter 6 is very broad since intangibles play a role in practically all business transactions. This means that there is an overlap with chapters 1 to 3. The OECD could limit its special considerations for intangibles to business transactions relating to the transfer or use of intangibles and omit guidelines on transactions “involving” the use of intangibles (for example in connection with sales of goods or services).

A. Identifying Intangibles

A.1. In general

39. to 46.

The OECD’s concerns regarding a definition of intangibles that might be too narrow are understandable. But if the definition is not sufficiently clear cut, significant uncertainties and problems of application result for tax authorities and enterprises alike. The requirement that an intangible has to be “owned or controlled for use in commercial activities” is helpful as it rules out in particular market conditions and other comparability factors. However, it remains unclear what constitutes the necessary “specificity” (#46) and to what extent intangible assets would need to be classified individually. Would taxpayers have to produce and update corresponding lists of intangible assets? If so, who would audit such lists and confirm them?

A.3. Categories of intangibles

49 to 51.

The purpose of categorizing marketing and trade intangibles is not perfectly clear and moreover the draft uses a definition of “unique intangibles” that is somewhat ambiguous. Under what conditions does the use of an intangible lead to “greater future economic benefits”? The prerequisite “greater … than … expected” would already be fulfilled if the profit is increased by one euro. Irrespective of this, the definition of “unique intangibles” is not convincing insofar as both a tested party and their potential comparable may have specific technologies or particular trademarks at its disposal which in themselves are unique and expected to yield greater future economic benefits (# 61, 212).

A.4. Illustrations

52. to 64.

The illustrations are in principle very helpful, although they only deal with common examples representing typical objects of legal transactions that enjoy legal, contractual or other protection. However, it remains unclear what constitutes “goodwill” according to the revised discussion draft on “Transfer Pricing Aspects of Intangibles”. Looking at this phenomenon from different perspectives (accounting or business valuation perspective) is certainly worthwhile. But the revised draft still lacks a definition for transfer pricing purposes. Instead, it is only pointed out that the compensation for assets transferred may include a goodwill element, as may be the case when reputational value passes to an acquirer on transfer of a trademark.

In the context of the acquisition of an entire enterprise, goodwill denotes the part of the purchase price that is paid in excess of the market value of the individual business assets. It reflects the profit potential resulting from the combination of all individual business assets in light of the company's possibilities to make profits. Among the factors contributing to goodwill ("business assets that are not individually identified and separately recognized") that may justify a higher acquisition price are typically the company's reputation, a customer base or an assembled workforce.

These factors cannot be transferred individually, yet they represent expectations in terms of the company's competitive position, synergies or efficiency advantages, which promise additional yields. Although there are different concepts for explaining or calculating goodwill (e.g., the accounting concept or business valuation concept) they are all based on the fact that the sum is calculated differently from the parts. When determining the acquisition price or value of an ongoing concern (a company or a strategic business unit), the acquirer or appraiser takes the position that the financial returns will be reinvested (having the consequence that the corresponding returns have impact on the valuation object as a whole), whereas in the context of determining the value of its parts (the individual assets) typically no such follow-on effects are assumed (that would impact the value of the individual assets, i.e., the valuation object as a combination of parts). If the revised discussion draft on „Transfer Pricing Aspects of Intangibles" proposes that goodwill (including the value of customer relationships, a competitive position, or efficiency advantages) has to play a role in assessing the value of intangibles, it should be made clear that in this process the OECD is willing to shift the perspective from individual assets to business functions or activities, assuming follow on effects. This clarification would help to free the OECD from the misconception of treating "goodwill and ongoing concern value … as intangibles". The latter are not in themselves intangibles but may serve to enhance the value of such assets.

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

<u>65. to 90.</u>

In comparison with the first draft, this section has been substantially revised and changed insofar as the meaning of the legal ownership of intangibles is concerned. In this context, legal ownership is a reference point for identifying and analysing controlled transactions relating to the intangible, and for determining the appropriate remuneration to members of a controlled group with respect to those transactions.

It is certainly true that legal rights and contractual arrangements should form the starting point for any transfer pricing analysis of transactions involving intangibles. This includes that in most cases, the legal owner will accrue receipts from the exploitation of the intangible in the first instance and remits to other group members arm's length remunerations reflecting the anticipated value of their contributions (# 73).

The reference to good practice for associated enterprises to record in writing their decisions and intensions regarding the allocation of significant rights in intangibles appears to be unnecessary, however, especially since it remains open what consequences are to be drawn if written records of such decisions and intensions are not in place at or before the time that associated enterprises enter into transactions leading to the development, enhancement, maintenance, or protection of intangibles (# 67). In its judgment of October, 11, 2012 (I R 75/11) the German Federal Tax Court had to deal with the issue of hidden profits distributions in cases of profit adjustments which are based on purely formal criteria according to German domestic tax law.

The Court held that German tax authorities may not challenge the deductibility of business expenses (i.e., adjust income correspondingly) where these expenses are based on a contractual agreement that does not fulfil certain formal requirements (for example, is not made in written form and agreed upon in advance). The arm's length principle links a correction to conditions that are made or imposed between the two enterprises in their "commercial or financial relations" (i.e., arising from contractual agreements or corporate transactions). These conditions made or imposed between the two enterprises concern the appropriateness of the determined values (arm's length price). The arm's length principle, however, does not extend to the "reason" (habitualness, seriousness) for the terms offered. Exceptions may apply to artificial transactions taking the form of a contractual agreement.

C. Transactions involving the use or transfer of intangibles

<u>104. to 124.</u>

One can surely agree that it may be possible and useful for the purposes of transfer pricing to isolate assets or services on the one hand and intangibles on the other if the transaction in fact forms part of a bundle of transactions for which no comparable situation can be identified. But doubts arise whether it is necessary to discuss the use of intangibles for purposes of production of goods and services. The case of the car manufacturer making use of valuable patents (# 123) may serve as an example. This case falls under the category "provision of goods by a manufacturer" which is the subject of Chapter I to III of the OECD transfer pricing guidelines.

D. Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles

<u>125. to 132.</u>

The revised discussion draft makes the point that in the context of intangibles, a comparability analysis always has to consider action alternatives which are available to the transferor or transferee. It makes it clear that a potential transferor would not accept a price that is less advantageous than its other realistically available options if the transferee cannot offer a higher price. Similarly, a transferee cannot be expected to accept a price that would make it impossible to anticipate earning a profit. The conclusion is questionable, however, that a transaction should be disregarded if, from the perspective of the transferee, the possible minimum price is higher than that which the transferor is willing to pay under the given conditions. This situation can in principle show that the transaction is carried out in the interests of an associated enterprise or the group as a whole. Under the arm's length principle, the legal consequence would be a transfer pricing adjustment.

<u>133. to 145.</u>

Intangibles often feature special characteristics that influence their future value in highly differing manner. Similarly, rights to intangibles may be subject to important limitations which likewise factor into their price. Among these special characteristics that deserve particular attention in a comparability analysis are, according to the revised discussion draft, a given exclusivity, the extent and duration of legal protection, the geographic scope, the useful life, the stage of development, the rights to enhancements, revisions, and updates, and expectations of future benefit or risks associated with intangibles (development risks, risks of obsolescence, potential legal infringements and/or product liability risks). This list can be granted full approval. But the difficulties of determining the resulting transfer price lie in finding relevant comparable data, identifying the impact of the various comparability factors, and taking into consideration their influence on the market price. It would therefore be more important for the OECD to show how to account for these differences as listed.

<u>146. to 148.</u>

The same applies for the allocation of risks between the parties involved. It is certainly true that comparability can be placed in question where the amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible. However, it appears to be less convincing to question the suitability of publicly available data drawn from commercial databases as long as there is neither a clear understanding nor empirical evidence of how these comparability factors affect the price of an intangible.

154. to 162.

Relating to the use of another method to determine the price that uncontrolled parties would have agreed where information regarding reliable comparable uncontrolled transactions cannot be identified, the OECD refers to comparability factors and additional aspects such as the business reasons, the perspectives of and options realistically available to each party to the transaction, and the expected future economic benefit from the transaction. While it appears to be reasonable that the options realistically available and the expected future benefits may serve as useful guidance for the marginal price of an acquirer, the role of business reasons for engaging in the transactions is all but clear. Such reasons should have no bearing on the price that uncontrolled parties would have agreed under comparable circumstances. Moreover, although we support the OECD in their rejection of one-sided methods, cost-oriented methods and rules of thumb in principle, it may be appropriate in individual cases to apply one-sided methods (for example the resale price method in the business of distributing software) or to draw on past experience (“rules of thumb”) for purposes of testing the outcome of a transfer pricing analysis. Against this background reference to the guidance in the section on the most appropriate transfer pricing method in Chapter II seems helpful.

163. to 175.

The application of the profit split method to the sale of full right in intangibles (#167) that is deemed conceivable by the OECD is hardly justifiable in our view, since it is not apparent which profit achieved by the parties to the transaction using an intangible is to be the subject of the profit split. Further indications would be very helpful here.

176. to 198.

In principle, projections prepared for non-tax business planning purposes may be more reliable from the perspective of the tax authorities than projections prepared exclusively for tax purposes or for purposes of a transfer pricing analysis. This presumption should not result in a transfer pricing analysis being considered insufficiently reliable from the outset. Taking into account that projections for business decision making often relate to the group as a whole (setting aside the legal boundaries of the group entities), they cannot as a rule be used for tax purposes. Consequently the preference shown for non-tax business planning should not be taken too literally.

As far as the role of taxes is concerned when methods based on the discounted value of projected cash flows are applied, the revised discussion draft concludes that tax effects to be considered comprise (i) taxes projected to be imposed on future cash flows, (ii) tax amortization benefits, and (iii) taxes projected to be imposed on the transferor as a result of the transfer, if any. In this context, it should be noted that a discounted cash flow valuation is based on the comparison of the cash flows of the valuation object and the cash flows of an alternative investment (typically a financial asset) represented by the discount rate.

This comparison must be made on a post-tax basis in order to adjust for possible differences in the taxation of the valuation object and the alternative investment. Therefore the tax effects must include (iv) taxes projected to be imposed on the future cash flows of the comparison alternative (i.e., the discount rate).

199. to 206.

The draft rightly stresses that in pricing a transaction on the basis of anticipated benefits it can be difficult to establish what profits were reasonably foreseeable at the time that the transaction was entered into. In this respect, the future development may be underestimated or overestimated. We agree that in such cases consideration should be paid to whether the associated enterprises intended to and did make projections that independent enterprises would have considered adequate. In these projections at the outset of the transaction, however, only such developments that can be traced back to decisions by the associated enterprises pre-transaction can be taken into account.

If, for example, it turns out that the market price for a patented drug rises or falls unexpectedly, this may justify a retrospective adjustment of the transfer price applied to the patent concerned (subsequent event of retrospective relevance as of the transaction date). But if the consequential increase or decrease of the market price is due to a post-transaction decision made by the transferor or the transferee, e.g., because they were able to achieve authorization of the drug in additional countries or pursued an unsuccessful pricing policy, there is no room for any price adjustment (non-adjusting events). This difference needs to be pointed out.

208. to 213.

Reference has already been made to the less than convincing interpretation of the term “unique intangible” (# 212, 51).

214. to 223.

In the context of situations where reliable comparables exist, the OECD indicates the possible necessity of comparability adjustments for factors other than differences in the nature of the intangibles used. In particular, mention is made of matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. One can go along with these points mentioned. The question is only how to carry out such adjustments. The revised discussion draft lacks guidance on how to go about this taking a transfer pricing perspective.