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Dear Joe

OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Grant Thornton UK LLP (hereafter referred to as "we" or "Grant Thornton UK") welcomes the opportunity to comment on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles ("revised Draft") issued on 30th of July 2013. We appreciate the significant work of the Working Party No 6 on this difficult but important matter and the fact that the revised Draft has aimed to capture some of the suggestions made to the original Draft.

We would like to thank the various Grant Thornton International Limited member firms for their input and help on this letter, and in specific we would like to acknowledge Grant Thornton Canada and Grant Thornton Sweden for their valuable contributions.

The sections below set out our comments in regards to the revised Draft.

In general

We understand this version to be a work in progress and to which changes are likely to be made post the BEPS action plan discussions. We believe that the revised Draft has improved on the earlier version and has taken into account some of the various comments provided, but we feel that more changes are required if this document is to serve as the go to information resource for the taxpayer and tax authorities on the issues relating to transfer pricing aspects of intangibles.

We note below some of the positive changes:

- We strongly agree with the sections that are now Chapter I-III, as clearly location specific factors and workforce are not intangibles and do not belong in Chapter VI.
- The revised Draft makes more reference to legal owner and legal ownership in its various sections (mainly section B). We welcome this change as we believe that legal ownership should be at the heart of any intangible analysis. (However, we would have preferred to see this legal requirement and definition carried through consistently into the various sections where the notion of legal ownership appears to remain quite low in prominence and in some cases the wording appears to suggest that legal ownership does not imply the right to intangible returns. We disagree with this interpretation and will pick up on this

issue as part of our comments on Section A below.)

- We welcome the inclusion of statements highlighting the use of actual arrangements undertaken by the group and comparable third party arrangements as starting points in the transfer pricing analysis related to intangibles. We believe this to be an important change as it helps bridge the gap between the revised Draft and the arm's length principle. Such statements also provide more clarity on the aggregation and segregation of intangibles and/or intangibles from transactions, although we would prefer to see more guidance on this point.
- We believe that the changes to and reorganisation of Section D has helped in streamlining the comparability analysis, and though we believe that more work may be needed (as per our comments below on section D), we believe that it is a move in the right direction.
- The cross reference in the text to the examples found in the Annex is a welcomed, addition as is the simplification and rewording of some of the examples.

Notwithstanding the above we note below a summary of our main concerns:

- The revised Draft's definition of Intangibles does not appear to have addressed fully the concerns raised on the first draft. The definition of "intangible" remains quite vague and shies away from incorporating consistent aspects of legal ownership. We believe that this level of ambiguity also applies to the definition used for "goodwill and on-going concern".
- Our unease regarding the latter issue is only amplified through the revised Draft's statements regarding the need for specificity in intangible analysis which may be understood to imply a requisite to exhaust all resources when undertaking analyses. We are concerned that this unclarity coupled with the focus on the specificity requirement may lead to unreasonable compliance thresholds or the creation of "fictitious" and "hypothetical" comparables that cannot/do not exist from a legal perspective.
- We believe that the definition referencing "something" is too vague and that the use of the term (separately transferable) asset in the intangible definition, would be preferable.
- Our view is that the draft has not dealt sufficiently with issues relating to simple licensing of an intangible already owned and developed by the licensor (where the licensee does not add any further unique contribution). We would have preferred to see some more examples regarding this issue as it is encountered quite frequently in the framework of intangibles.
- We consider that the revised Draft seems to place higher prominence on the profit split than on the remainder of the transfer pricing methods, and if the revised Draft were to be left unchanged there will be an implication that all intangible related transactions ought to use a profit split method for determination of intangible related returns (see for example paragraphs 80, 81, 130, 147, 156, 159). As profit splits are highly subjective and difficult to apply, this will be significantly burdensome on taxpayers and is likely to increase transfer pricing disputes and issues of double taxation.
- We believe that the discussion in section D2 part (vi) (b) of the use of profit split may be insufficient in the unfortunate event that profit split becomes the default method for intangible issues. We would prefer to have seen a more detailed analysis on how to apply such a complicated method to such a complex issue and believe that the inclusion of a typical case analysis of an intangible transfer may prove helpful in illustrating the concepts of this method and its application.
- We disagree with the revised Draft's definition of "goodwill" as an intangible, and we are similarly concerned with the examples used to highlight the goodwill aspects. Goodwill by nature is difficult to measure, observe and value. Furthermore, when considering third party arrangements, such analysis related to separation of goodwill value may prove quite

difficult and in most cases would be unobservable. We will pick up on the issue of goodwill in our notes on section A below and our comments on examples 16 and 18, which we believe strongly to be flawed examples.

- We believe that the revised Draft has not addressed the concerns raised in relation to disregarding transactions and recharacterisation, and some of that language has been maintained in the revised Draft (for example paragraph 132, footnotes to examples 13 and 14). As per our comments on the earlier draft, we believe that <u>recharacterisation should be undertaken in extreme circumstances only</u> as per Chapter I paragraph 1.64.
- We consider that the revised Draft remains focused on functions undertaken by the parties as the main deciding factor in the attribution of intangible returns. While we believe that people functions are important, we are concerned with the revised Draft's reduced focus on intangible ownership, and, financial investment and risk as important factors in intangible returns. This issue is further highlighted through the revised Draft's implication that the outsourcing of certain functions (even if these functions were still controlled by the legal owner of the intangible), could lead to the outsourcing provider being entitled to intangible returns (for example paragraph 77). We consider that decisions to outsource or insource are commercial decisions and in third party situations outsourcing providers do not usually get compensation for potential future intangible value (if this is what is intended by the ambiguous phrase "anticipated to be created").
- Finally, we found the examples to be in some cases too simplistic and in others not following the arm's length principle. We would prefer if the revised Draft would have made an explicit statement to the effect of: The examples below are intended solely for illustrative purposes and should not be used as a means to categorise taxpayers transactions. Each situation should be assessed based on its own specific circumstances and facts.

The problem with intangibles is that they are nebulous and often uncertain in value. Valuable technology can be superseded in an instant and precious brands can be brought low by adverse publicity or just because fickle consumers find something else "cool" tomorrow. The draft is rather optimistic about the likelihood of super profits, but does not emphasize enough the real risk of losses. The treatment of losses should mirror the treatment of profit. Our challenge to the drafters is to make sure that half the examples deal with loss situations, to emphasize this very real issue. If some tax administrations think profits should be shared more widely, this must be consistently applied to losses.

We provide more specific comments below in relation to each of the sections.

Specific Comments

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

As mentioned above, we welcome the inclusion of the Location Saving, Assembled Workforce, and Group Synergies discussion in Chapter I, as well as the clarification that these items should be treated as comparability factors. We agree with the statement that such items are not intangibles (as per paragraphs 11 and 64).

We broadly agree with the proposed paragraphs on location savings. Whilst there is no specific guidance on how any location savings should be shared, the cross reference to paragraphs 9.148 through 9.153 should suffice. Furthermore, the confirmation and emphasis on the use of comparable transactions in the local market, with the use of reliable comparability adjustments where needed, is welcomed.

For consistency with earlier paragraphs, it would be helpful if assembled workforce, noted as "ordinarily" a transfer pricing comparability matter in paragraph 14, is specifically stated as not an intangible in its own right. Furthermore, the drafting of paragraph 15 remarks that the transfer of an assembled workforce as part of a business restructuring may require comparability adjustments to the arm's length price with respect to the transferred assets. It should be clarified that the assembled workforce does not typically have a separate value nor is it an intangible in its own right when transferred, as workforces are by definition mobile and can join and leave employers at will. Paragraph 16 goes some way to addressing this, but not fully, when it says that the need for separate compensation for the transfer of individual employees as a general matter is not the intention of the foregoing paragraph (15). We believe that these paragraphs allow for ambiguity, and thus clarification and consistency would be welcomed.

Furthermore, we find paragraph 17 unhelpful as it seems to suggest that given a workforce can enhance knowhow, some sort of compensation may be needed. It would be impractical to try and measure knowledge transfer via intranets, shared training, etc. Please also see our comments on Example 18, which we believe to be flawed.

In relation to MNE Group Synergies, the revised Draft suggests a distinction between the synergies achieved only through group affiliation and those from "specific concerted group actions". The revised Draft indicates that the former effect would not warrant a separate compensation while the benefits from the latter type of synergy should be shared among the MNE members. The revised Draft states that compensation should be given to the coordinator of the activity and the residual (remaining) synergy should be divided by the parties in respect to the influence they had on the effect. We believe that the revised draft does not provide sufficient clarity on how such compensation can be shared or should be calculated.

In addition, we believe that dividing synergies between passive "scale" synergies and synergies which are an effect of "deliberated concentrated group actions" could be a matter of conflict between different tax authorities who will battle each other on these definitions and ultimately put the taxpayer in a precarious situation. Moreover, we believe that comparability adjustments for synergies will prove quite hard to undertake, since the third party comparables most commonly derived in such searches by default do not include any synergies (since they don’t belong to a group). Questions on synergy adjustments will follow, and tax authorities might argue that a previously done comparative analysis is obsolete due to the lack of such adjustments.

Finally, the revised Draft recognises that negative group synergies (burdens) may exist but provides little guidance on how these should be addressed. We are aware of examples of arguments both from local company managers and tax authorities (on audit) that costs arising from negative group synergies should not be shared by group companies. We consider that section D8 should include further guidance here or provide greater clarity that burdens should be addressed in the same way as benefits.

Examples
We suggest examples 1 and 2, which address financing and the impact on credit ratings of members of a MNE group by virtue of their membership of the MNE group, are removed and addressed during the forthcoming OECD discussion and drafting of guidance on financial arrangements in an MNE.

In examples 3 and 4 it is suggested that there should be no difference in remuneration regardless if the purchasing activities are done as a central service or if title is taken to the goods sourced from outside the group. We believe that such a view is not completely aligned with the arm's length principle and does not take into account the difference in risk between only providing a service and acting as a buy-sell distributor. We consider there should be more reference to the specific facts and circumstances in these examples. In many cases the procurement entity may indeed be acting like a service provider and the bulk of the saving should be shared between the participants, however this may not always be the case.

Chapter VI – Special consideration for intangibles

Section A- Identifying Intangibles

Paragraph 38- We welcome the substitution of the phrase "…*the party that should be entitled to retain the return derived from the use or transfer*…" with "…*legal ownership of intangibles and the contributions to their development, enhancement, maintenance and protection*…" when discussing the factors to be considered in functional and comparability analyses relating to the use and transfer of intangibles. As discussed above, we believe that legal ownership should be the starting point of any transfer pricing analysis related to intangibles.

Paragraph 40- Though the clarification made to paragraph 40 to include "… *and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances*…", is a welcomed change, we believe our comments from the previous Draft still apply as we find this definition to be quite general and lacking legal aspects; which in the final analysis are what govern interactions between third parties. Though we agree that the analysis of the terms should be based on comparable third party data, we believe that the identification of the intangibles should be done in the context of law, accounting, finance and commercial business transactions. We would also welcome further clarity around the term "…*capable of being owned or controlled*…"

Paragraph 42- This paragraph states that the presence of legal or contractual protection affects the value and the return of the intangible, and is not a condition for an item to be characterised as an intangible asset for transfer pricing purposes. We disagree with this statement as we do not believe that it is possible for an entity to make use of an asset over which it has no legal ownership. Furthermore, we consider the definition in paragraph 42 to be in contradiction with the majority of the principles of section B which rely on legal ownership and rights as a starting point for the transfer pricing analysis; specifically paragraphs 65, 66 and 67 (see below).

Paragraph 41- We would welcome a more robust and tangible definition of the term "*economic value*", as we believe this concept to be quite vague and may lead to an increased prospect of disagreement and possibly tax disputes.

Paragraph 44- Though we welcome the addition of a clarification that "*premium returns*" can be viewed as "*a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non-unique know-how.*", we would appreciate the addition of mirror wording regarding losses here.

Paragraph 48- In the context of this newly added paragraph, we are concerned with the last sentence as it currently stands, which appears to allow for double taxation to arise without providing for a way to resolve it.

"*The guidance in this Chapter is also not relevant to recognition of income, capitalisation of intangible development costs, amortisation, or similar matters. Thus, 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 permit amortisation 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 recognised that inconsistencies between individual country laws regarding such matters can sometimes give rise to either double taxation or double non-taxation***". (emphasis added)

Paragraph 50- We welcome the addition of the definition of marketing intangibles and await the further definition for trade intangibles (it is unclear if these are going to be defined as all other intangibles). We find the definition provided for marketing intangibles quite useful. We also welcome the inclusion of what is deemed as " unique and valuable" intangibles (paragraph 51), however, we would have preferred the definition to include further explanation around what is deemed as an "economic benefit" under this definition, as well as mirror wording around losses. We are, however, concerned about the "specificity " requirement stated in paragraph 50. The requirement appears to be quite vague, and in the absence of a more robust definition of intangibles we are concerned this will make compliance extremely difficult and double taxation potentially more likely.

Paragraph 58- We believe that the addition of this wording around contract rights etc. may result in an endless amount of transactions that would be qualified as intangibles and to which a transfer pricing analysis would need to be undertaken. We would recommend this definition be narrowed down and reworded to specific circumstances in which it may apply.

Paragraph 59- We note that the conclusion of paragraph 59 states that "*limited rights in intangibles are themselves intangibles*". We believe that the value of the limitation to licensed rights should normally be captured through the pricing of the license in third party situations. As drafted, it is unclear if this paragraph is implying that such limited rights would warrant a separate compensation for intangible related return.

Paragraph 61- We believe that the revised Draft's statement on the lack of necessity to establish a precise definition for goodwill or ongoing concern, as highlighted by the following statement "*It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or* *ongoing concern value for transfer pricing purposes",* to be at the heart of the problem caused by considering goodwill an intangible.

We note that in the lack of a unique ,clear and consistent definition of goodwill (while including it as an intangible for transfer pricing purposes) the prospects of transfer pricing disputes will be significantly higher. Moreover, based on the current wording of the revised Draft where goodwill is defined as *" the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets."* and ongoing concern value is defined as *" the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets."* the risk of capturing the same value in both items is highly likely.

Goodwill and ongoing concern values are accounting terms and by nature are difficult to measure, observe and value. The implication of including such items as intangibles can lead to the creation of "hypothetical" transfer pricing transactions by tax authorities that may not or could not have taken place at arm's length. Furthermore, from an accounting perspective, goodwill is merely used as a balancing figure and the items that make up that figure are almost impossible to observe. The accounting definition for goodwill is the purchase price over and above net asset position of the acquired company (which is composed of tangible assets, intangibles assets and liabilities). In many cases goodwill will contain subjective estimation of future value, hoped for synergies by the acquirer and, possibly, management enticement figures for acquisition purposes. Moreover, when an acquisition takes place under IFRS accounting rules, companies can opt to use the fair value method vs. the book value method for valuation. Under the fair value method, it is assumed that parties will assign a market value for the various intangibles (rather than using the book value) and that the assigned value ought to be derived from data and specialist valuations. As such, it would be more difficult to consider goodwill as containing intangibles of value in such cases, and moreover, by classifying goodwill as an intangible, there may be a risk of attributing value to a non-existent "intangible".

Further to the above, paragraph 62 of the revised Draft leaves the taxpayer with more confusion as to how to price items such as "goodwill".

"Accounting and business valuation measures of goodwill and ongoing concern value do not, as a general rule, correspond to the arm's length price of transferred goodwill or ongoing concern value in a transfer pricing analysis. Depending on the facts and circumstances, however, accounting valuations and the information supporting such valuations can provide a useful starting point in conducting a transfer pricing analysis. The absence of a single precise definition of goodwill in this list of illustrations in no way relieves either taxpayers or tax authorities of the obligation to describe specifically relevant intangibles in connection with a transfer pricing analysis, nor does it relieve them from the obligation to consider whether independent enterprises would provide compensation for such intangibles in comparable circumstances."

Paragraphs 63 and 64- Though we agree with the conclusions of these paragraphs, we question why "Assembled Workforce" was removed from this section. Our concern is that by removing the explicit statement that "Assembled Workforce" is not an intangible (as per assembled "Group synergies" and "Market specific characteristics"), the OECD is implying that workforce may be regarded as an intangible in certain circumstances. We strongly believe that workforce is not an intangible. People can join and leave businesses at will, and do all the time.

Paragraphs 65, 66, and 67- Generally, we agree with paragraphs 65, 66 and 67 as stated below.

Paragraph 65- "…Although the legal owner of an intangible may initially be entitled to receive the proceeds from exploitation or transfer of the intangible, other members of the owner's MNE group may have performed functions, used or contributed assets, or assumed risks that are anticipated to contribute to the value of the intangible and for which they must be compensated under the arm's length principle.…"
However, as noted above, we believe that it should not be assumed that third parties always get some return for enhancing the value of an intangible. Moreover, the statement of "anticipated value" appears to introduce a concept of future value, potentially allowing use of hindsight by tax administrations.

Paragraph 66- "The framework for analysing transactions involving intangibles requires the following steps: (i) identifying the legal owner of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership;…"

Paragraph 67- " Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles…"

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

We welcome the addition of examples of the important functions in paragraph 79 and the new " Assets" section to be considered when undertaking a transfer pricing analysis related to intangibles.

We believe that Section B (with the exception of paragraph 74), still appears to place higher value on the functions performed than on any other asset used or risk assumed when addressing the issue of who should retain "returns attributable to intangibles". A reader might also assume from some of the examples used to illustrate this section, that the OECD believes that paying for an activity which could generate an intangible (or even ownership of the intangible) will never entitle the payer to <u>any</u> intangible related return. While we agree that it should not be assumed that <u>all</u> intangible related returns necessarily flow to the entity which pays for an activity, this seems to promote the doing or control of activities (i.e. functions) over and above assets and risks in all cases, and appears to step away from the arm's length principle. Moreover, paragraph 73 appears to dismiss the financial commitment and risk that a legal owner may have undertaken in the intangible asset. Though we agree that the return from the enhanced intangible should not be attributed solely to the legal owner without further consideration of the relative contributions; we believe that the revised Draft should recognise the initial financial contributions that the legal owner may have undertaken to develop such an intangible in the first instance. Furthermore, we would have also preferred to have seen more focus in this section on the contractual terms as a starting point of any analysis related to functions performed, assets used and risks assumed in relation to intangibles. This point is highlighted in section A and Section C but seems to be lacking in this section.

Paragraph 66- We believe that the start of any analysis should surely be the identification of which (if any) intangible/s is/are involved. The lack of such statement may lead to an implicit assumption that each transaction will have an intangible aspect to it and thus should undergo the steps prescribed.

Paragraph 70- The final sentence in this paragraph can be misleading as it could be read as implying that the intangibles that cannot be legally protected could still be viewed as valuable, which we disagree with.

Paragraph 72- As mentioned in the previous section, we do not agree with the classification of a license as an intangible requiring "intangible returns" as appears to be implied by paragraph 72.

Paragraph 76 – "*If the legal owner of intangibles is to be entitled ultimately to retain the returns attributable to the intangibles, it will either perform the functions related to development, enhancement, maintenance and protection of the intangibles, or arrange to have such functions performed under its control by independent enterprises or by associated enterprises.*" We believe that this paragraph would be more appropriate if the following addition was made "…it will either perform the key/strategic functions related to development…"

Paragraph 77- States the following "*If other members of the group perform functions contributing to the development, enhancement, maintenance or protection of intangibles under the control of the legal owner, the legal owner of the intangibles 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.***" (emphasis added)

Our major issue with paragraph 77 is that it appears to imply that if functions are outsourced by the intangible owner to related parties, even when the intangible owner controls and directs these functions, the related parties are entitled to a portion of intangible returns. We disagree that the outsourcing of certain functions and the undertaking of activities such as contract research and development (which is done under the control and guidance of the legal owner of the intangible) should generally entitle the contracted entities to more than routine functional returns attributable to the research and development service that they are undertaking.

Paragraphs 80 and 81- Section B appears to be implying a higher prominence for the profit split over one sided methods (as per some of the wording in paragraph 80 and 81). We will pick up on our topic of profit split in our comments under section D.

Section B4 discusses various common scenarios that may arise when using intangibles. Section B4 part (a) covers the situation involving the development and enhancement of marketing intangibles. Paragraph 96 as currently worded is unclear in what is implied by "*…the distributor's share of benefits should be determined based on what an independent distributor would receive in comparable circumstances.*" . We would recommend the wording to be changed to explicitly state that in such circumstances the distributor would expect to earn a return solely for their distribution and sales activity and would not be sharing in the intangible returns.

Section B4 part (b) then covers research and development situations and highlights the fact that cost plus a mark-up is not an appropriate compensation in all cases involving R&D. Though we agree with that, we highlight that often it is an appropriate compensation.

Section B4 part (c), which covers the situations arising from the use of the company name, also covers the issue of payment for goodwill when using an unregistered company name. As mentioned earlier we do not agree with classifying "goodwill" as an intangible and thus do not agree with a need for payment. In addition, we believe that the use of the example of an "unregistered trademark" is confusing and not in accord with the arm's length principle as we would rarely see a third party with a legally unprotected intangible, that they would license to other parties. Finally, we do not agree with the conclusion of paragraph 103 as we struggle to see how we can attribute value to something like market position and struggle further to impute a payment for it.

Section C- Transactions involving transfers of intangibles or rights in intangibles

We are concerned with the inclusion of various references in this section to recharacterisation and disregarding of transactions. Paragraph 109 still appears to advocate potentially disregarding the transaction undertaken and its recharacterisation by the tax authorities. This point is further highlighted through paragraph 121 which has been added to the revised draft. Though the addition of this paragraph is welcomed (as it refers to the use of the actual arrangements and conduct of the parties as starting point in analysing whether there is a need to aggregate or segregate intangibles for specific transactions), it also goes on to explain that the decision whether to aggregate or separate such transactions should be done for purposes of determining the most appropriate method and should not be treated as restructuring per section 1.64 and 1.69 of the Guidelines. As it currently stands, the last two sentences still appear to allow for recharacterisation. We believe that these sentences need to be reworded to explicitly indicate that recharacterisation <u>should be done in extreme cases only</u>.

Some of the examples used in section C appear to be confusing or inaccurate in regards to their content. Paragraph 112 uses the example of a pharmaceutical company to illustrate that certain intangibles would be more valuable in combination. We believe that the example used is potentially misleading as it could be read to suggest that these various intangibles are equal. For the pharmaceutical industry the intangibles related to patent, trademarks and regulatory approval do not carry equal value; often the patent for the active pharmaceutical ingredient would be the item with the most inherent value as without it there would be no product. A similar argument could be made about the examples used in paragraphs 118 and 119 where the reader is left unclear whether the statements are implying that segregation of intangibles would be required for every franchise arrangement while aggregation would be required in the case of software maintenance. Furthermore, paragraph 113 and 114 also appear to be providing contradicting advice as to when trademark and goodwill should be separated. Finally, we believe that some of the examples referenced in the text, do not illustrate the points being made within the text, as per example 17 which has been referenced within paragraph 114.

As per our comments above , we are concerned with the significant number of references to goodwill that have been made throughout Section C and the associated examples (for example refer to paragraph 113 and Example 16).

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

The view of section D in the revised Draft is that it is meant to serve as a supplement to Chapter I-III of the Guidelines and specifically to the comparability analysis found in Chapter III (paragraph 3.4 nine step process) as it relates to cases involving intangibles. We welcome the fact that section D is more streamlined now and is easier to follow and find the information related to comparability analysis quite useful and helpful.

Section D refers to options realistically available to the parties (example paragraph 129 et seq.). We are concerned that given the vague definition of intangibles, looking for <u>all</u>

realistically available options may prove highly burdensome to the taxpayer. Hence, we recommend providing further guidance on what is deemed as realistically available options in the context of intangibles.

In addition, we believe that Section D is inappropriately advocating the use of profit split method over the other methods as it relates to situations involving intangibles. This is evident through the statements made in paragraphs 130, 156, 159.

*Paragraph 130- " In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis **does not** provide a sufficient basis for evaluating a transaction involving intangibles."* (emphasis added). We believe that the paragraph would be more appropriately worded by adding the following " *A one-sided comparability analysis does not always provide a sufficient basis for evaluating a transaction involving intangibles."*

*Paragraph 156- "… it **will often** be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions..."* . (emphasis added). We believe that the paragraph would be more appropriately worded by adding the following "… *it will sometimes be the case in matters involving transfers of intangibles…"*

*Paragraph 159- "Care should be used, in applying certain of the OECD transfer pricing methods in a matter involving the transfer of intangibles or rights in intangibles. One sided methods, including the resale price method and the TNMM, are **generally not reliable methods** for directly valuing intangibles"* (emphasis added) this could be replaced by "may not be".

We believe these statements to be in contradiction with Chapters II and III of the Guidelines (paragraph 2.2 of the Guidelines in specific which stipulates finding the most appropriate method for the situation at hand). In addition, we believe that such statements will lead to some tax authorities requesting profit split analysis or unspecified "other methods" for any intangible related transaction. There are many situations in which the TNMM would be the most appropriate method. For example, if Company A is performing (routine) limited risk distribution functions while Company B owns the valuable intangibles and sells the branded product to Company A. This would be a case in which the TNMM could be used with company A as the tested party despite the presence of intangibles.

Furthermore, we do not feel that section D has highly expanded on the guidance provided in Chapter I-III of the Guidelines (specifically paragraph 2.108 to 2.145) and may prove quite unhelpful in issues involving matters such as co-developing of intangibles. We also believe that if more reliance is to be placed on profit split, then we would prefer to see more guidance on how to apply the method in relation to the various aspects of intangible transfer, transfer of rights to intangibles, and co-development of intangibles.

Section D2 allows the use of the valuation method as an additional method for estimating the arm's length price for intangibles transferred. The section seems to focus on the income based approach (specifically on the discounted cash flow method) and appears to discourage the use of the cost based approach (please see our comments below regarding paragraph 160). There is also no mention of the market based approach, including "relief from royalty". We do not believe that a detailed discussion of valuations is required in these Guidelines, as it is a complex and judgemental area by itself and is only tangentially related to transfer pricing.

If discussion is thought to be needed, why stop at DCF? Surely "relief from royalty" valuation would be more closely aligned to transfer pricing for intangibles? However, could then end up with a discussion of valuation that takes up many pages in this chapter while adding little useful guidance.

Paragraph 148- This paragraph appears confusing as the first sentences seems to imply the importance of ensuring comparability between the transaction at hand and the comparable licenses obtained from databases, while paragraph 3.38 of the Guidelines suggests broadening the criteria in cases when we cannot find perfect comparables and thus allowing for the fact that it may be impossible to ever find an exact match.

Paragraph 150- We disagree with the example in this paragraph and we find it misleading. The long term economic benefit of a transfer of an intangible will reflect the transferee's ability to make use of the intangible in various aspects, improve and make changes to the transferred intangible, as well as possibly licensing out the intangible themselves. In our opinion, this is dissimilar from merely using an intangible.

Paragraph 160- This paragraph seems to be discouraging the use of cost based approaches as methods to use for the valuation of intangibles. However, it is our experience that the pricing of intangibles between independent parties can in some cases reference costs of developing the intangible.

Paragraph 162- Statements made in this paragraph may have implications on the profit split method as in many circumstances rules of thumb may be used to split the residual profit between the parties including in third party case law. Although we agree that rules of thumb and industry norms should not be used as definite answers absent any other analysis, we believe that they can be helpful in transfer pricing analysis.

Paragraph 165- Statements in this paragraph appear to imply that share and asset acquisitions are one and the same.

" Depending on the facts and circumstances, the third party acquisition price in such situations will have relevance in determining arm's length prices and other conditions for the controlled transaction, <u>even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets.</u>"

We believe that this statement is incorrect. It is our experience that share acquisitions tend to be priced differently to reflect certain risk elements or contingent liabilities not present through the acquisition of assets. For example, we are currently dealing with a case where the vendor wishes to sell shares in an overseas entity because it has trapped cash. For the same reason, the purchaser wants to acquire the assets. The price agreed could depend on which route is followed.

We note that Section D3 will be discussed and addressed as part of BEPS and hence the language may change significantly. We should be pleased to comment further at that point regarding this section and its suggested changes.

Section D4, as it currently reads, is a little confusing as its mixes the "non-unique" and "unique" intangibles together and in some cases alludes for a need to only adjust for some of the intangibles as part of the comparability analysis, and in others appears to be implying that a profit split should be used. We would appreciate if the section can be further streamlined to give a better understanding of when to use "intangibles" only as part of a comparability analysis and when they would be significant enough for the taxpayer to have to use a method different than the one sided methods.

Paragraphs 209, 210 and 211- These state that in some cases, an intangible is used by a less complex party or by the independent comparables, and such intangibles should be taken into account in the comparability analysis. Furthermore, if both the tested party and the comparables have comparable intangibles, then it can be understood that the intangible used is not unique or valuable and thus will not warrant a comparability adjustment. We welcome the comment and we agree that some of the intangibles listed in the example should not be viewed as ones requiring "premium" returns.

Examples

We commend the drafters on including so many examples. However, several of the examples appear to illustrate unlikely scenarios and we think some should be removed.

Examples 1,2 and 3- These examples cover the issue of legal ownership and illustrate the point made in the revised Draft around ensuring that the return be attributed to the entities performing the functions rather than the legal owner. The examples are quite simplistic and seem to overlook the issue of who bears the risk in case of a product default or malfunction. Would company S as the legal patent owner be liable for such expenses, and if so shouldn't its return also reflect that risk? It seems an extreme result that company S should get no return for its ownership.

Example 4- This example touches on ensuring that contractual terms are in fact observed in the transactions and if not then there could be a need for a transfer pricing adjustment.

Examples 5 and 6- These examples cover the topic of development of marketing intangibles. Both examples appear to be broadly sensible. Example 5 assumes that company S is bearing no (financial) risk or control and therefore is entitled to an arm's length return for routine distribution activities and cost plus return for its marketing activities. This seems an unlikely scenario at arm's length however. Most distributors would expect to do some local marketing and would not expect separate compensation, but would expect to buy the watches at a price that allows them to make a fair distribution return. Example 6 then adds the assumption that company S does slightly more marketing activity with minimal control from the parent company. The compensation of the marketer is deemed to be arm's length as it is observed that the functions performed are similar to those undertaken by third party marketers, and thus the sales of the watches should provide company S with sufficient return.

Example 7- States that a transfer pricing adjustment would be appropriate in such circumstances. We would prefer if the rewording of the statement below was more neutral and would highlight how the transaction ought to be priced as opposed to outlining an adjustment that would be required.

" In this example, the proposed adjustment is based on Company S's having performed functions, incurred risks, and incurred costs that contributed to the development of the marketing intangibles for which it was not adequately compensated under its arrangement with Primair."

In our experience, it is extremely unlikely for third party distributors to be compensated separately for marketing, and particularly not via a residual profit split. It appears much more likely that the price would be adjusted and this also avoids the apparent endorsement for recharacterisation.

Example 8- Paragraph 255 indicates that Company S would be entitled for compensation for the anticipated value created through the marketing intangibles. It is unclear what is implied by this comment. Is this example implying that Company S should expect to have its incurred marketing costs reimbursed with the addition of a mark-up or is it implying that company S will now be considered to be a part owner of the trademark of R in country Y and thus entitled to intangible related return? Again, it is our view that this looks like a recharacterisation.

Example 12- Deals with legal ownership vs. undertaking the key functions relating to intangibles (as described in paragraph 79). Though we agree that legal ownership ought to be considered alongside the functions undertaken, we believe that this example seems to overlook the key issue of risks associated with defending patents and product liability risk which will ultimately be borne by the legal owner of such patents. Moreover, we consider the conclusion to be over simplistic in assuming that all product B profit should be passed to S, including potentially deeming a reverse royalty to be required (as before this advocates recharacterisation).

Example 13 and 14- A footnote is made that these examples will be discussed under BEPS as there is a debate whether such transactions should be disregarded and recharacterised. We strongly believe they should not, consistent with the gist of the revised Draft.

Example 15- We welcome the change made to this example in order to reduce the potential of inferring that a recharacterisation of the transaction would be needed. The final sentence was changed from *"The provision of the agreement limiting Company S's rights to Country B should not be respected for purposes of a transfer pricing analysis of the amount of compensation due Primarni from Company S for the licensed intangibles"*, to *"In a transfer pricing analysis of the transactions between Company S and Primarni, Company S's licence should be treated as extending to Asia and Africa, and should not be limited to Country B, based on the conduct of the parties."*

Example 16- As per our earlier comments, we disagree with classifying goodwill as an "intangible" especially as third party would not be able to sell or exploit such right. Moreover, we find the example confusing especially whether the "goodwill" belongs to Ilcha or company S. In specific, the sentence"… *In conducting a transfer pricing analysis related to the amount to be paid by Companies T and U to Company S for the manufacturing and marketing assets,* ***and to Ilcha*** *for the licensed right to use the intangibles in countries C and D, the value of the business transferred to Companies T and U that would be reflected as goodwill for accounting purposes in a comparable transaction with an independent enterprise should be taken into account…"* appears to be an incorrect analysis. We should be pleased to assist the drafters with commentary on the accounting if it would be helpful.

Example 17- We would prefer to have this example removed as there is no clear indication of what it is attempting to illustrate. We believe that this example would be better dealt with as part of BEPS if appropriate.

Example 18- We believe the analysis and assumptions of this example to be flawed and inconsistent. Firstly, the example assumes that the price paid for the shares would be reflective of the value of the business when in fact asset and share acquisitions are quite different (please refer to our earlier comments). The example also seems to mix the present, past and future and imply the use of hindsight when this would be in contradiction to the arm's length principle. Furthermore, as per some of the other examples, there is an implicit assumption that goodwill is an intangible and the statements end up mixing true intangibles (such as patents) with something nebulous and hard to measure and determine such as goodwill. How can it be determined how much of the goodwill has been transferred and how much remains in T and how can we decide whether what has been transferred does in fact contain valuable intangibles separate and distinct from the intangibles already paid for? It can also be argued that had significant returns been achieved later on, such returns could have been related to company S's ability to commercialize the products resulting from the patents equally as much as the possibility that T's patents were valuable (which, given the facts of the case and T's limited profit prior to acquisition, seems highly possible). Though, we appreciate that delegates may be concerned with the idea that businesses may make share acquisitions and then transfer piecemeal the "intangibles" acquired at less than a true value, this appears to have coloured several of the less satisfactory examples. We believe that this example should be removed or reworded significantly.

Examples 19 and 20 are much clearer and more helpful dealing with software/services respectively with and without the transfer of intangibles.

Example 24- As noted above, we do not consider that extensive examples on valuations are helpful in a transfer pricing analysis. Moreover, we find this example confusing and believe that changes are required in order to increase clarity. In specific, in the assumptions listed in paragraph 313, it is unclear whether the distribution affiliates consistently sell 1000 units of Product F or a number of units valued at 1000. This point is clarified in the following paragraph where cost of goods sold is identified as 600, confirming that it is indeed a valuation. We believe that further clarity could be provided to the reader either through the introduction of a fictional currency or by stating that they achieve sales of 1000 of their local currency from Product F. Furthermore, though tables one, two and three may be reasonable examples of how to use the discounted cash flow method to find a valuation for an intangible, it would be more clear to readers if a separate row containing the before tax functional returns was inserted. Ideally, this should be shown separate from the 'NPV' row currently above the 'after tax functional returns'. Finally, though at first glance it appears that the three tables are using an income based method rather than a cash based method to value the intangible, it is later clear that a cash based method is being used. We believe that clarity would be improved if an assumption is added to paragraph 313 stating that the revenue and operating income is equal to cash received and cost of goods sold and selling expenses is equal to cash paid.

Example 26- Though we agree that related party transactions should mirror those undertaken by third parties, we struggle with the concept and reasoning provided in this example. Analysis regarding intangibles is highly complex and in most circumstances uncertain. The parties should make a reasonable effort to ensure that they mirror third party arrangements, however, it would be very difficult to assume that just because the contract looks different than that of a third party then an adjustment would be necessary. The level of uncertainty stated in this example also illustrates how the uncertainty can go both ways, and thus their decision could have been based on the more favourable option that was more likely at the time they made their decision.

Concluding Comments

We already have a business restructuring chapter in place and in our view this revised Draft should be concerned with pricing transfers and use of intangibles. Making policy just to target the perceived "worst cases" would end up with huge uncertainty and problems for the compliant taxpayer and we urge the OECD to keep this in mind as it proceeds forward in completing this draft.

We appreciate the opportunity to contribute our comments and sincerely hope that our remarks will help WP6 move the revised Draft forward to a point of consensus. We wish WP6 well in the next stages of the project.

Kind regards,

Yours sincerely

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