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Japan Foreign Trade Council, Inc.

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

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (Revised Draft)."

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC's Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

## Overall Comments on Section A (Identifying Intangibles)

JFTC, which consists of member companies engaging in business operations over the world, desires that tax administration be conducted appropriately and stably in each country or jurisdiction. We are concerned that the broadened definition of intangibles may create an additional class of allegations for imposing taxes by tax authorities in each country, which might lead to double-taxation on the same income. We are also seriously concerned that taxes may be imposed beyond those calculated based on actual profits and losses resulting from real transactions. Such taxation would not only undermine the individual company's operations but also seriously shall hamper each country's economic development and growth and inevitably shall cause less global growth. It is undesirable for tax authorities and taxpayers to be forced to face or become accustomed to tax disputes or to operate under the threat of such potential tax disputes in countries throughout the world.

Regarding the Revised Draft, we feel that sufficient attention has not been paid to the definition of intangibles. In order to accurately assess the conditions of transactions, it is necessary, as a prerequisite, to recognize the transactions undertaken. This requires a very clear definition of intangibles. If the definition is ambiguous, it is impossible to determine whether or not a transaction has actually taken place, and the relevant conditions cannot be examined. The business community has voiced serious concerns that predictability and certainty cannot be ensured without a clear definition. However, it cannot be said that the Revised Draft responds effectively to these concerns.

We believe the scope of intangibles for transfer pricing purposes should be limited to intangibles protected under law and other intangibles that are contractually or otherwise stipulated and not subject to dispute. We also believe that concrete illustrations should be provided for clearly differentiating intangibles from service transactions. We therefore conclude that the discussions of Section A should be continued and that further efforts should be made to clarify the definition of intangibles both in the Transfer Pricing Guidelines (Guidelines) and under national laws.

Furthermore, it is undesirable to have situations where taxes on profits from the transfer of intangibles that taxpayers cannot predict and recognize are imposed by tax authorities, resulting in double- or multiple-taxation. Therefore, we strongly urge the establishment of correlative adjustment for eliminating exposure to such double- or multiple-taxation, in such a way that intangibles identified in a country are considered amortizable assets in the counterpart country through the mutual agreement process.

## Specific Comments

### Proposed Amendments to Chapter I-III of the Transfer Pricing Guidelines

### D.7. Assembled Workforce

Paragraph 17

Regarding assembled workforce, we welcome the addition of the supplementary guidance in Chapter 1 (Chapter 1. D.7). However, we would like to make a point that skills and capabilities obtained through the experiences of an individual generally belong to the individual and not the enterprise. Insofar as corporate ownership of these assets is not protected under law, ultimately these cannot be owned and controlled by the enterprise. Therefore, even if know-how through the transfer or secondment of employees is transferred, the skills and capabilities of which such know-how consists do not belong to the enterprise and do not give rise to the need for remuneration. In particular, in the presence of highly fluid labor markets, ultimately it is very difficult for an enterprise to continue to own and control its employees as a corporate asset and thus we believe that individual skills and capabilities within an assembled workforce should not be included in intangibles.

## D.8. MNE Group Synergies

Paragraph 27

In Example 2, the benefits generated by Parent's guarantee are reflected by the lower interest rate resulting from the enhancement of credit standing from A to AAA. However, under the arm's length principle, all benefits would not be allocated to Parent (that is, if all the benefits were to be allocated to Parent, S would have no reason to seek Parent's guarantee). Therefore, the guarantee fee would fall within the range of the benefits, that is, the benefits would be appropriately divided between Parent and S. Furthermore, we consider that determining the guarantee fee based on a 50-50 division of the benefits would represent one of the reasonable methods.

## Chapter VI. Special Considerations for Intangibles

## Section A. Identifying Intangibles

Paragraphs 39 – 40

Paragraph 39 does not explicitly refer to the conceptual scope of intangibles, while paragraph 40 presents a comprehensive definition of intangibles by stating that "the word 'intangibles' is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities." The wording of the latter paragraph would result in a very broad definition of intangibles. We are concerned that the adoption of such a broad definition would provide tax authorities with excessive room for interpretation, undermining predictability and certainty from the perspective of taxpayers.

Paragraph 40 states that "the word 'intangibles' is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances." Therefore, as the first step toward identifying intangibles based on this definition, "asset," "own" and "control" should be clearly defined. However, the Revised Draft does not present sufficient guidance on this matter. Whereas the Revised Draft contain no reference to "economic ownership" in connection to "own," explicit provisions should be included stating that, as a general rule, ownership of intangibles in Chapter VI shall be determined on the basis of legal ownership.

Furthermore, paragraph 40 contains the following addition to the previous Draft: “whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.” However, as stated in paragraph 134, “intangibles often have unique characteristics” and are not necessarily subject to comparable circumstances. Hence, it would make practical determination more complex to include compensation under comparable circumstances in the concept of intangibles.

If, as shown above, a definition cannot be specified because the participating countries cannot reach consensus, then it can be said that the Revised Draft go no further than to present an approach toward defining intangibles. However, this does not mean that the matter should be left to the interpretation of tax authorities as adopted in the process of application in individual countries. Rather, we suggest that the Guidelines should explicitly state that countries should establish a clear definition of intangibles in their laws and regulations.

Paragraph 48

In paragraph 48, the first sentence states that “The guidance in this Chapter is also not relevant to recognition of income, capitalization of intangible development costs, amortisation, or similar matters,” while the last sentence states that “It is recognised that inconsistencies between individual country laws regarding such matters can sometimes give rise to either double taxation or double non-taxation.”

On the other hand, the premises of the Public Consultation are closely correlated to the Action Plan related to BEPS, whose principle theme is the avoidance of double taxation and double non-taxation. In view of this, we strongly urge that a specific direction be stipulated and a framework be created to increase predictability from the perspective of taxpayers and to prevent excessive taxation.

Paragraph 52

Even if it is difficult to define the scope of intangibles with specificity, objectivity can be ensured by providing illustrations. To a certain degree we understand that it might not be possible to provide an exclusive list of illustrations because consensus has not been reached among countries. However, if this is the case, the Guidelines should contain provisions to the effect that exclusive listing should be included in the laws of individual countries and that the tax authorities should not recognize unlisted items as intangibles.

Paragraph 54

Know-how and trade secrets obtained through the experiences of an individual ultimately cannot be owned and controlled by the enterprise. An employer cannot obtain compensation when an employee in possession of such know-how or trade secrets transfers to an unrelated enterprise on his or her own accord. Hence, we believe that these do not constitute intangibles.

Paragraph 58

Rights and obligations under contacts and government licenses in and of themselves do not necessarily constitute valuable intangibles. For instance, when an enterprise obtains a government license pertaining to the sale of a product, the value of the license cannot be realized if marketing activities are unsuccessful. In such cases, the enterprise probably would not be able to obtain compensation by transferring the license to an unrelated party. Government licenses and concessions related to rights to exploit natural resources are also listed as intangibles in the illustrations. In this connection, we would ask you to add a statement to the effect that government licenses do not in and of themselves constitute intangibles. Income generated from rights to natural resources is attributed to the location where the resource has been extracted. Therefore, with the exception of specific services that utilize extraordinary exploration or production technologies and other intangibles protected under law, provisions should be added indicating that such items come under general service transactions and lie outside the scope of the use or transfer of intangibles.

Paragraph 60, 62

Regarding goodwill, paragraph 62 states that “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.” We welcome the fact that, compared to the previous Draft, greater attention has been paid to practical matters. However, because the Revised Draft does not concretely define goodwill, we are concerned that tax authorities would be given extensive scope for interpretation. Therefore, we believe the definition should be more limited and clarified. Paragraph 60 refers to the concept of differential value by stating, “Goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets.” The paragraph continues, using the terminology of the International Accounting

Standards, "Goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually indentified and separately recognized." As can be seen from the foregoing, goodwill "cannot be segregated or transferred separately from other business assets." On the other hand, as stated above, intangibles are defined as an asset that "is capable of being owned or controlled for use in commercial activities." However, it is not possible for assets that are not individually identified and separately recognized to be "owned or controlled." Thus, we conclude that it is not appropriate to include goodwill in the definition of intangibles for transfer pricing taxation purposes. Even if these are to be included in intangibles in certain special cases, they should be clearly differentiated from service transactions (including high value-added service transactions).

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

Paragraph 73

Regarding legal ownership of intangibles, paragraph 73 and other related paragraphs state that, "The question of legal ownership is separate from the question of remuneration under the arm's length principle." We welcome the fact that paragraph 73 goes on to state that, "In most cases, the legal owner will accrue receipts from the exploitation of the intangible in the first instance." However, in this formulation, remuneration is ultimately based not on legal ownership but on functions, assets, and risks related to intangibles.

However, from a standpoint of taxpayers, we are seriously concerned that completely ignoring legal contractual relations and allowing the re-characterization of intangibles and transactions involving intangibles can result in disputes related to interpretations on the character of the transactions and claims of the rights to tax in the source country. Therefore, as stated in Paragraph 66, in principle, we would ask you to emphasize that legal arrangements should be respected, and the re-characterization of transaction attributes should be restricted to exceptional cases where remarkable inconsistencies exist between legal ownership and economic ownership, and intent to avoid taxation can be clearly detected.

Paragraph 79

Reference is made to important functions, but these are limited to functions related to research and development. We suggest that it would be also useful to provide guidance on important functions to be taken into account when considering the allocation of returns related to marketing intangibles.

Paragraph 96

Paragraph 96 states the following. "In some cases, a distributor may incur marketing costs, assume risks, or perform functions that exceed those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities and that create value beyond that created by other similarly situated marketers/distributors. An independent distributor in such a case would typically require additional remuneration from the trademark owner. Such remuneration could take the form of higher distribution profits (resulting from a decrease in the purchase price of product), a reduction in royalty, or a share of the profits associated with the enhanced value of the trademark or other marketing intangibles, in order to compensate the distributor for its functions, assets, risks, costs, and anticipated value creation." In this context, we believe reference should also be made to the point that an intangible asset should not be immediately recognized merely because the entity has incurred high marketing costs.

**Section C. Transactions Involving the Use or Transfer of Intangibles**

No comments.

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

**D.1. General principles applicable in transactions involving intangibles**

Paragraph 130

By stating that, "a one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving intangibles," paragraph 130 seems to require the use of two-sided comparability analysis at all times. However, such a requirement would face various practical problems. For instance, consider a company transacting with a related party in which the company has no majority of the voting right. If a tax system deems this to be a transaction between related parties for transfer pricing purposes, it may prove difficult to obtain information that is objective from the counterparty's perspective. Therefore, taking into consideration the administrative burden to taxpayers and tax authorities, we consider that some form of materiality criterion should be adopted for the application of a two-sided approach. Similarly, in arm's length transactions, it is frequently impracticable to estimate with a certain degree of accuracy the assumptions made by the counterparty. Therefore, where a two-sided approach is to be adopted, a comment should be added to the effect that, as long as analysis and/or evaluation has been conducted on the basis of information available to the taxpayer on the measurement date or on the basis of reasonably estimated information, the analysis and/or evaluation would in principle be respected.

**D. 2. Supplemental guidance regarding transfers of intangibles or rights in intangibles**

Paragraph 148

Paragraph 148 states that "it is important to assess whether publicly available data drawn from commercial data bases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles." Regarding this point, it is unclear how detailed the information to be obtained needs to be. The appropriate standard for the required level of detail should be one that allows taxpayers to collect practically the necessary information without incurring excessive costs.

Paragraph 151

Paragraph 151 expresses concern regarding the facile application of the residual profit split method by stating, "In matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles." This is followed with the statement that a transfer pricing method "should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions." On the other hand, regarding the adjustment of differences in comparability analysis in the process of computing arm's length prices, it has been assumed that, as stated in paragraphs 1.33 and 3.47 of the Guidelines, "none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences." Therefore, we consider it would be more appropriate to stipulate that only those factors that do not "materially affect the condition" and can be quantified in the process of adjustment should be considered.

Paragraph 173

Paragraph 173 states: “In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes and should be utilized in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.” This marks an improvement over the previous Draft (paragraph 110) in that purchase price allocations performed for accounting purposes may also be used for transfer pricing purposes under certain conditions. In the actual business world, the DCF methodology is a commonly used valuation method for accounting purposes and rather it can be said that valuations performed for accounting purposes contain highly useful reference information. Therefore, from a standpoint of business community, we would like to make a point that it is not necessary to completely set apart from valuation methodologies for transfer pricing purposes and, except for cases that pose significant problems, the use of and reference to valuations performed for accounting purposes should be accepted.

Paragraph 175

Fair value measurement based on the DCF method generally yields a range of values. The concept of “range of values” is referred to in the following wording of paragraph 175: “The calculation of the discounted value of projected cash flows attributable to the intangible should be evaluated from the perspective of both parties to the transaction in arriving at an arm’s length price. The arm’s length price will fall somewhere within the range of present values evaluated from the perspective of the transferor and the transferee.” Regarding this point, it should be noted that ranges of values appear in the valuations conducted by both the seller and the buyer. Therefore, we suggest that the Guidelines state that the use of both ranges is allowed, on the condition that the analysis is performed based on appropriate valuation assumptions.

Moreover, in using the DCF method, the results of the valuation should be respected as long as it has been conducted on the basis of information available to the taxpayer on the measurement date or on the basis of reasonably estimated information. While, inevitably, there will be differences between projected cash flow as of the measurement date and actual cash flow at some future point, tax authorities should not use hindsight based on actual future results. We suggest that the Guidelines reiterate this point in this Chapter.

Paragraph 182

Paragraph 182 states that “it is usually the case that projections prepared for non-tax business planning purpose are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis." However, it should be noted that financial forecasts prepared for business planning are based on different assumptions depending on their intended use. Normally, when preparing a business plan, an enterprise develops multiple cash-flow models by conducting a sensitivity analysis based on different sets of risk factors and assumptions. Therefore, while it cannot be said that the projections based on the single cash-flow model that the enterprise has chosen from the multiple available models is always highly reliable, we consider that the range of present values obtained from the multiple available models provides an indication of the range within which the arm's length price will fall.

Paragraph 219

Paragraph 219 states: "In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. While such facts may not be intangibles as that term is described in Section A.1. of this Chapter, they can nevertheless have important effects on arm's length prices in matters involving the use of intangibles." Thus, while having "important effects" is identified as a reason for adjustment, the foregoing provision requires numerous other adjustments or important adjustments to be made. Therefore, we consider that it would be necessary to be explicitly stated in the Guidelines that arm's length transactions requiring such numerous and material adjustments may not be sufficiently comparable, and that they may not constitute valid objects of comparison.

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