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To	Joseph L. Andrus, Head of Transfer Pricing Unit, OECD's Centre for Tax Policy and Administration	Date	September 28, 2013
From	KPMG's Global Transfer Pricing Services professionals		
cc	Clark Chandler (KPMG in the U.S.), Francois Vincent (KPMG in France)		

Re: OECD Invitation to Comment on the "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles"

Overview

Professionals in the Global Transfer Pricing Services practice of KPMG welcome the opportunity to comment on the OECD's Discussion Draft titled "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" dated July 30, 2013 ("Revised Discussion Draft").

KPMG believes that the Revised Discussion Draft provides much clearer guidance than the first draft. However, there are still instances where the guidance provided in the Revised Discussion Draft is internally inconsistent, does not address key issues, or provides answers that are inconsistent with observed dealings among independent parties. KPMG's initial comments focus on these instances. Moreover, KPMG believes that a number of the comments that it provided on the prior discussion draft on intangibles have not been addressed adequately. To avoid excessive repetition, KPMG lists, at the end of this document, comments previously provided to the OECD that it continues to believe are important to consider in drafting the final guidance on intangibles.

At a more fundamental level, KPMG is concerned that the Revised Discussion Draft fails to accomplish one of the three primary goals of the OECD Model Tax Convention on Income and on Capital to "clarify, standardise, and confirm the fiscal situation of taxpayers." The Revised Discussion Draft falls short on furthering the objective of clarity or certainty in the fiscal situation of taxpayers, and may worsen it under some important circumstances.

For instance, the draft potentially opens the door to widespread recharacterizations of transactions involving intangibles. It provides significant leeway to tax authorities in pricing a transaction as if it were structured differently, which is akin to recharacterizing the transaction. The resulting disregard for taxpayer structures is likely to cause greater uncertainty for both taxpayers and tax authorities, and make the resolution of disputes harder.

Similarly, the Revised Discussion Draft states that the guidance it contains is not intended to have relevance for other tax purposes. However, the mere statement of no relevance for other tax purposes is unlikely, from a practical standpoint, to be sufficient to sever all links between the Revised Discussion Draft and other tax matters. For example, KPMG believes that in many cases the characterization of a transaction as an intangible for transfer pricing purposes is likely, as a practical matter, to lead to the same characterization for withholding tax purposes.

Adding to the uncertainty is the seeming departure of the Revised Discussion Draft from some basic principles of transfer pricing. A basic building block of transfer pricing is comparability analyses. If comparable transactions exist then those provide evidence of arm's-length pricing. Despite the revisions to its section B, the Revised Discussion Draft seems to overlook this basic principle in its discussion of which entity deserves the returns from an intangible. Instead, it dictates "arm's-length" conduct by assumption rather than by reference to the observed behavior of third parties.

KPMG realizes that tax authorities are currently very concerned with structures in which a substantial amount of income is left in associated enterprises with very few people or limited "substance." However, the practical reality is that unrelated third parties often manage very valuable intangibles with very few people – it does not necessarily take more people to manage the license of spectrum rights worth billions of Euros than to manage the license of spectrum rights worth only a few million Euros. The objective of the OECD's guidance on the transfer pricing of intangibles should be to ensure that the transfer pricing is consistent with the arm's-length standard, which is a much more limited objective than dealing with the broad range of base erosion and profit shifting issues.

Summary of Key Comments

KPMG's major comments can be summarized as follows:

- The Revised Discussion Draft includes goodwill and going concern value that is under the control of a specific member of an MNE group as an intangible, but provides very little guidance on how to distinguish this from goodwill and going concern value that exists for the MNE group, but which is not controlled by any single member of the group;
- The Revised Discussion Draft essentially ignores the implications – as observed in dealings among independent enterprises – of legal rights on remuneration, instead, focusing predominantly on "important" functions, whose description KPMG believes is overly restrictive, poorly defined, not referenced to the arm's-length standard, and will create undesirable controversies over the entitlement to returns from the development and use of intangible property;
- In contradiction to the parameters set out in paragraphs 1.65 to 1.69 of the OECD Guidelines, the Revised Discussion Draft potentially opens the door to treating transactions structured in a given way as if they were different transactions for transfer pricing purposes, which would create greater uncertainty for both taxpayers and tax administrations, as well as making resolution of resulting double taxation more difficult to achieve;
- The Revised Discussion Draft notes the possibility of negative group synergies, but provides no guidance on how to address them;

- The Revised Discussion Draft's guidance on the relationship between prices paid for equity and the pricing of intangibles obtained through an acquisition and subsequently transferred to another member of the MNE group is inconsistent with and directly contradicts its treatment of group synergies;
- The Revised Discussion Draft's treatment of intangibles that are transferred when their value is highly uncertain ignores the basic implications of uncertainty on value;[1]
- While the Revised Discussion Draft provides some general guidance on location savings and other local market features, it does not address the root cause of disagreements related to them, namely the differing views on the empirical issue of identifying and adjusting comparables.

As part of its response, KPMG has provided specific commentary on the following examples listed in the Revised Discussion Draft:

- Examples 3 and 4 in revisions to Chapters I – III;
- Examples 5 – 10 in Annex;
- Example 16 in Annex;
- Example 18 in Annex;
- Example 21 in Annex.

Treatment of Certain Goodwill and Ongoing Concern Value as a Compensable Intangible

The Revised Discussion Draft states clearly that goodwill and ongoing concern value has to be considered an intangible for transfer pricing purposes even though it cannot be transferred separately from other business assets. While the Revised Discussion Draft states that it is "…not necessary for the purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes…" (paragraph 61), the lack of reasonably precise boundaries distinguishing when goodwill and ongoing concern value is relevant for transfer pricing and when it is not will inevitably lead to substantial difference of opinion not just between taxpayers and tax authorities, but also among different tax authorities. Therefore guidance on boundaries/definitions is appropriate.

KPMG suggests the following guidance, consistent with the approach adopted in the Revised Discussion Draft. To be compensable for transfer pricing purposes, goodwill and ongoing concern value must:

[1] KPMG notes that this discussion is unchanged from the first draft and subject to review under the OECD's broader BEPS initiative.

- Be controlled by a specific member of the MNE group. Goodwill and ongoing concern value that arises solely because an associated enterprise is a member of the group is not compensable.
- Be transferred. Transferring a specific function and/or a specific intangible does not imply that the goodwill and ongoing concern value that is controlled by a specific member of the MNE group has also been transferred.

Control by a Specific Member of the Group

Regardless of how it is defined, conceptually, some goodwill and ongoing concern value may be viewed as being under the control of a specific member of the MNE group (e.g., the local market goodwill and ongoing concern value associated with being an established business producing and marketing hard disc drives in Country Y) while other goodwill and ongoing concern value will be associated with the MNE group as a whole (e.g., the belief from shareholders and MNE customers that the MNE group will make appropriate decisions as to which technologies to support or not support over time). The Revised Discussion Draft clearly implies that the former should be taken into account if there is a transfer of the hard disk drive business from the associated enterprise in Country Y to a different associated enterprise. It should also make it clear that the latter should not be taken into account since it is not controlled by a specific member of the group. Goodwill and ongoing concern value generated by group decisions can be likened to "stewardship" – stewardship costs are not allocated to group members and, similarly, goodwill generated by group decisions should not be allocated to members.

Goodwill and Ongoing Concern Must Have Been Actually Transferred

It is possible to transfer specific functions and assets without the transfer of the associated goodwill and ongoing concern value. Turning back to the associated enterprise producing hard disc drives in Country Y above, it is entirely possible to transfer the manufacture of hard disc drives from Country Y to a different associated enterprise without transferring the goodwill and ongoing concern value of the associated enterprise at the same time (e.g., if the manufacturing is transferred to a related or independent contract manufacturer in a different country). This may lead to a reduction in local income equal to the arm's-length profit associated with the manufacture of hard discs (contract manufacturing profit), and may or may not require a payment for the transfer of other specific tangible or intangible property (e.g., equipment), but the transfer of one of multiple functions or one of multiple assets does not imply a transfer of the goodwill and ongoing concern value of the local entity.[2]

[2] There is a statement in paragraph 61 that reputational value or goodwill can be connected with a trademark, and "that reputational value should be taken into account in determining appropriate compensation." This may mean that the comparables have to have similar reputational value, or it may mean comparables need to be adjusted on the basis of reputational value. It will be helpful if the Revised Discussion Draft provided further explanation of what is to be done.

Further, goodwill does not arise merely because an operation has been successful in the past. For example, the MNE group may decide that, given technological change, it will stop investing in, and possibly terminate, its hard disk drive business in favor of cloud based storage units that rely upon a completely different technology, are delivered in a completely different way, and are marketed and promoted through different channels than the hard disc drive business of the associated enterprise in Country Y. These decisions may reduce, or appear to reduce, the prospective profitability of one group member while simultaneously increasing the future prospects of another member. The reduction in local goodwill and ongoing concern value does not automatically translate into a transfer of such value out of the local hard disc drive manufacturer. There has only been a loss of commercial value due to changing circumstances but not a transfer of goodwill, going concern or other intangibles. There should be no expectation that the associated enterprise in Country Y would be compensated under such circumstance, unless the new cloud business uses functions or assets of the existing enterprise (e.g., if the same trademark is used) as there has not, in fact, been a transfer, simply an investment decision.

Example 16

Example

In Example 16, Ilcha (headquartered in Country A) owns Subsidiary S (located in country B). S has conducted business in countries B, C and D for a number of years. Ilcha decides that its business would be enhanced if it were run by separate subsidiaries in each country. Following the formation of new entities in countries C and D, S transfers its tangible manufacturing and marketing assets to the new companies, and Ilcha terminates the distribution rights of S in countries C and D without the payment of any compensation. The question at issue is whether the new subsidiaries have to pay for the goodwill in the established business, and who should they pay (Ilcha or S). The example concludes that the new subsidiaries should pay the price "that would be paid by an independent enterprise, including payment for amounts that would be treated as goodwill for accounting purposes in such an acquisition." (Paragraph 284)

Comment

The core problem with Example 16 is that it does not distinguish between goodwill and ongoing concern value that is specific to and controllable by S, and goodwill and ongoing concern value that is controllable by Ilcha as an MNE but not by any of its individual subsidiaries. A substantial part of the goodwill and ongoing concern value of an MNE is the belief by equity holders and customers that the MNE will make responsible business investment decisions going forward. Such investment decisions will often involve decisions to withdraw from or not to invest in certain functions, businesses, or geographic areas while investing in new functions, businesses, or geographic areas. To the extent that the new functions, businesses, or geographies are significantly different from the old, they will involve different risks, different intangibles, and different decision-making or expertise than the old. Under the principles set forth in the OECD Guidelines, there should be no obligation of payment unless the new functions, businesses, or geographic areas rely upon the functions, assets or risks undertaken by the old.

The failure of the Revised Discussion Draft to explain what portion of goodwill would be compensable may allow multiple tax authorities to claim the right to tax income related to the same goodwill and ongoing concern income. Assume that the tax authorities of S compute an adjustment assuming that all goodwill and ongoing concern value is compensable. If the tax authorities of Countries C and D view only a portion of or none of the goodwill and ongoing concern value as being compensable, the MNE would be faced with double taxation. The basic point is that goodwill and ongoing concern value arising because of intangible assets that are controlled by a specific member of the associated group only have value as long as the MNE group believes that it is economically viable to keep using those assets and to rely upon them in its business operations.

It would therefore be helpful if the OECD guidance included an example where goodwill and ongoing concern value does not have to be paid for to make it clearer that goodwill and ongoing concern value are not always compensable.

Impact of Legal Ownership on Remuneration

Legal Ownership

The Revised Discussion Draft states that the legal owner is the entity identified under applicable law or governing contracts. If those do not exist, the owner is the member of the MNE group which controls decisions concerning the use and transfer of the intangible and has the practical capacity to restrict others from using the intangible. However, the Revised Discussion Draft goes on to say that legal ownership is only a reference point for determining who is entitled to intangible returns.

We agree that a group member that merely serves as the registered owner of intangible property for administrative or legal reasons, but has not funded the acquisition or development of the intangible property or participated in the group's development of the property, should not be regarded as the member of the group entitled to the returns attributable to the intangible property. However, we do believe that the guidelines should affirmatively and clearly provide that where a group member has funded the acquisition of intangible property, or has, with appropriate oversight, borne the full risk of the development of intangible property, that group member should be entitled to the returns attributable to the intangible property. An example should be added, as a counterpart to Example 3 in the Annex, making this point.

Similarly, we believe that the guidelines should also recognize that two or more members may split the entitlement to the returns from intangible property based upon an agreed division of interests where each provides an appropriate share of the funding of the cost of acquiring or developing the intangible property and each has appropriate management to approve and manage the funding of any intangibles the group develops.

Finally, the guidelines should make it clear that if other group members agree to support the development of intangible property on a limited risk basis in exchange for fixed current compensation, they have no residual claim to an additional share of residual profits resulting from the employment of the intangible property. Rather, in such cases, the only proper inquiry is whether the current compensation the limited risk participants received was arm's-length for their contributions.

The Revised Discussion Draft appears to be preoccupied with the potentially egregious case in which a "cash box" company provides the funding for the development of intangible property, but has little or no ability to control the course of the intangible property development. While in such a situation the funding entity may be recharacterized as a passive provider of risk capital, we believe that such situations are not the norm. We believe that it is more important for the OECD to define clearly and appropriately the level of activity that the funding entity must have to ensure that it is entitled to the returns from the resulting intangible property. The failure to do so is likely to result in various countries inappropriately claiming an entitlement to additional profits for performing functions which have already been fully compensated on an arm's-length basis.

Important Functions

The Revised Discussion Draft states that "An entity claiming the right ultimately to retain all or material parts of the return attributable to a given intangible on the basis of legal ownership will *generally perform, through its own employees the more important functions* related to the development, enhancement, maintenance and protection of that intangible that are described in paragraph [79]" (paragraph 80)(emphasis added). We believe that this standard is overly restrictive and will create undesirable controversies over the entitlement to returns from the development and use of intangible property. In particular, this standard is:

- Much broader than the standard set forth in Chapter IX (see paragraph 9.23 of Chapter IX[3])
- Inconsistent with observed arm's-length behavior. For example, senior executives who may not have a technical background are often responsible for deciding to invest in research and development projects or to acquire target companies which they believe own attractive intangible property. In these cases, the executives may or may not seek the counsel of their own development groups.

[3] "In the context of paragraph 1.49, 'control' should be understood as the capacity to make decisions to take on the risk (decision to put the capital as risk) and decisions on whether and how to manage the risk, internally or using an external provider. This would require the company to have people – employees or directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that party." (Paragraph 9.23 of OECD Guidelines)

- Inconsistent with the way in which MNEs actually run their businesses – an MNE often has plants operating in 20 or more different associated enterprises, each of which may both own and/or use different intangibles, with decisions as to which products to source from which plants, which technologies to use and invest in, and which approaches to use to protect these intangibles made by a centralized group of perhaps 3 to 5 C-level executives, each of whom may be employed in a different associated enterprise. Moreover, when these executives either leave the MNE or change roles, they may be replaced by an executive that is employed by a different associated enterprise. The Revised Discussion Draft ignores the complexities of how MNEs run their business in the real world.
- Subject to differing interpretations by different tax authorities. The lack of guidance in Section D of the Revised Discussion Draft in identifying and pricing important functions is likely to lead to different interpretations by different tax authorities.

The Revised Discussion Draft's focus on knowhow and other such resources or capabilities seems excessive. At arm's-length, a group member would not contract someone (e.g., a third party with specialized expertise) if they didn't have a certain expertise; if they weren't good at what they did. That doesn't mean, however, that it would give them a share in the ultimate value of the intangible they are contracted to develop. The explicit references to profit split methods is particularly troubling in this area.

In addition, the references to "anticipated value" in connection with all functions is confusing since it seems to imply that all functions, important or otherwise, need to be evaluated in terms of their contribution to the intangible return. The arm's-length compensation to "routine" functions is unlikely to have much relation to the value created by the intangible, and linking such compensation to the anticipated value of the intangible will only lead to confusion.

KPMG believes that the requirement that the legal owner must pay an arm's-length compensation to associated enterprises, with the compensation reflecting the functions that they perform, the assets that they contribute (including specifically the intangible assets that they contribute), and the risks that they bear, should be adequate to ensure that each member of the associated group receives arm's-length compensation.

Such arm's-length compensation can be structured either as (i) a payment in full at the time that the activity is carried out or (ii) an equivalent claim (taking timing and risk into account) on expected future profits, but not both. If the OECD feels that this, along with the guidance provided in Chapter IX is still not adequate to prevent MNEs from sourcing an excessive amount of income in associated enterprises without much substance that are located in low tax jurisdictions, then paragraph 80 should be amended to:

- State that the determination of which functions are "important functions" will be made in a manner that is consistent with observed behaviors in similar transactions among independent enterprises; e.g., if independent enterprises funding clinical trials always have scientists and others that design and monitor the trials, this will be treated as an important function. If independent enterprises owning mineral rights only have someone that makes a hold/buy decision, this will be treated as an important function. In particular, "design" of R&D programs in addition to control, and "management" of budgets in addition to control are excessively broad and greatly susceptible to differing interpretations. Those terms, in particular, should be deleted. For example, what degree of involvement in design or management of R&D programs and budgets, respectively, is envisioned? Clearly, there could be a wide range of involvement and there is a possibility of tax authorities broadly interpreting these terms to indicate that any design or budget management activities in their jurisdiction entitles them to tax intangible profits.

- Replace "perform through its own employees…" with "participate in through its own employees to the extent that this is consistent with the way in which the MNE and arm's-length parties actually run their business."

Examples 5 – 10

Examples

In these examples, Primair, a resident of country X, manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Primair is the registered owner of the R trademark and trade name. The R name is widely known in countries where the watches are sold and has considerable economic value because of Primair's marketing efforts. R watches have never been sold in country Y, however, and the R name is unknown there. Primair incorporates a wholly-owned subsidiary, S, in country Y to act as a distributor of R watches. Examples 5 – 10 provide different scenarios relating to this basic fact pattern covering different contractual relationships between Primair and S, and different functions and risks of Primair and S, among others.

Comments

The examples as presented seem to be overly detailed while missing the key point. Primair is contracting with a distributor (S) for the joint development of the local market for R watches. Assuming for simplicity that S has no intangible assets to start with, Primair can either (i) pay S an arm's-length amount for the costs and risks that it incurs on a current basis over the term of whatever the contractual arrangement is, in which case S should not acquire any rights to R after the term of the contract, or (ii) not pay S fully for the costs and risks that it incurs on a current basis, in which case S would expect to retain some rights in R after the term of the contract. The question of whether S's costs are higher or lower than those of other distributors will have an impact on the level of compensation that is required, but does not change the fact that a taxpayer should be able to elect either of the two options listed above provided that it enters into a contract that meets the standards set forth in Chapter IX. If S owns intangibles at the outset of the transaction, then the value of those intangibles should be taken into account in determining the level of arm's-length compensation.

Assets and Risks

The Revised Discussion Draft's discussion of the remuneration of assets (paragraphs 82-84) is largely focused on financial assets, and it is very difficult to separate the contributions of financial assets from the question of risk. In this regard, the factors listed as key considerations in Paragraph 84 are appropriate. However, it is important to realize that the commitment of financial assets in a high risk investment can result in very substantial returns if the investment is successful. For example, if an associated enterprise contributes 100 to an investment project with a 50 percent chance of complete failure, then the associated enterprise making that investment must expect to receive at least 200 if the investment is successful. Moreover, at arm's-length, parties contributing financial assets to high risk investments often receive partial or complete ownership rights, including the right to share in the appreciation in the value of the asset.

The Revised Discussion Draft also makes a distinction between funding risk and other risks (see for example, "Bearing a funding risk, without the assumption of any further risk," paragraph 84) but it is unclear how funding risk is separated from other intangible-related risks. For instance, for an entity that funds the development of an intangible and is at risk of getting no return on its investment if the development is unsuccessful, funding risk is equivalent to development risk. There is no meaningful way of separating funding risk from other risks related to development, enhancement, maintenance and protection of intangibles. The funder who is not risk-free will bear some of the risks associated with intangibles and not just some nebulous "funding risk."

Recharacterization

By asserting that certain transactions are "economically equivalent" to others (or indicating that transactions structured in different ways may have similar economic consequences – i.e., performance of a service versus transfer of an intangible), by stipulating that legal owners may not be entitled to the full rights that their ownership would otherwise entail at arm's-length, by insisting that realistically available options be reviewed and used in "pricing" transactions, the Revised Discussion Draft may inadvertently be opening the door to the recharacterization of transactions outside of the parameters set out in paragraphs 1.65 to 1.69 of the OECD Guidelines. KPMG is using the label "recharacterization" to refer to instances where tax authorities disregard the transaction as structured by the parties, either formally by insisting that some other transaction occurred, or informally by determining the price payable pursuant to that transaction on the basis of another transaction where the rights and obligations of the parties are not the same.

There are at least two issues associated with this widening of the scope of recharacterizations. The first is the resulting uncertainty. Taxpayers cannot know whether and how a given tax authority will treat a given transaction (whether under the guise of "realistically available alternatives" or otherwise) and, consequently, cannot price or document their transactions in line with such recharacterizations (this may also mean the automatic application of a transfer pricing penalty). Second, because one tax authority will treat, for instance, the sale of an intangible as the provision of a service, should there be double taxation as a result of an adjustment by that tax authority, resolution of the double taxation via the mutual agreement procedure will be made more difficult given that it is very likely that the other tax authority will still want to treat the transaction as if it was the original transaction as structured by the parties.

MNE Group Synergies

Negative Group Synergies

The Revised Discussion Draft notes that negative group synergies may exist (paragraph 18) but provides no discussion on how to address them. In addition, the paragraph conflates a competitive inefficiency affecting the entire group (e.g., an inefficiency caused by group scale) with an inefficiency suffered by a single member created by its forced conformity with the rest of the group (e.g., a group member is forced to adopt a computer or communications system that is not the most efficient for it on a standalone basis, although that system is optimal from the group's perspective). These two situations should be distinguished and addressed separately. In the former case, the negative group synergy may conceptually be the same as a positive synergy and treated symmetrically. In the latter case, the disadvantaged member in theory should be required to bear only the cost of its optimal alternative, with the remaining cost shared by the group members that benefit from the alternative that is optimal from the overall group perspective. This theoretical approach will lead to practical difficulties that need to be addressed, such as how to identify which group members are truly disadvantaged, measuring the amount of their detriment, and determining an appropriate method for allocating those amounts to the other group members. In our experience, these issues create considerable factual and conceptual disagreement among countries for which guidance is needed.

Examples 3 and 4 in Revisions to Chapters I – III

Examples

In each of these examples, Company A is assigned the role of central purchasing manager on behalf of the entire group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group, is able to negotiate with a supplier to reduce the price of widgets from $200 to $110. Company A is entitled to a service fee of $6 per widget for the coordinating services it performed on behalf of other group members and group members purchasing widgets would retain the remaining $84 benefit of the group purchasing discount attributable to their individual purchases. The $6 per widget service fee is determined as a mark-up on Company A's costs based on comparable uncontrolled transactions.

Comment

In the examples provided, Company A is able to negotiate a lower price based solely on the negotiating leverage provided by the purchasing power of the entire group and is entitled to a "cost plus" service fee charge. While procurement functions similar to Company A's may exist in some cases, the OECD should make it clear that there are often situations where the centralized procurement company carries out functions that are key to the procurement effort (e.g., locating suppliers, monitoring their adherence to company policies, negotiating terms, setting up policies that ensure that the MNE gets the best possible results that it can under the agreement). Under such circumstances, the procurement company is carrying out important functions that create and manage risk, and that can have a significant impact upon profits. Such procurement company arrangements should therefore be entitled to a return that is greater than a simple markup on costs. The pricing terms of third-party procurement companies are often useful benchmarks under such circumstances.

The Discussion Draft's Treatment of Prices Paid in Acquisitions is Inconsistent with Its Treatment of Group Synergies

The Revised Discussion Draft indicates that prices paid to acquire intangibles indirectly through share purchases can be used to infer the value of intangibles for transfer pricing purposes. In this regard, there are several statements to the effect that "It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring." (Example 18) However, the analyses proposed in the Revised Discussion Draft essentially ignore the impact of assets owned by the acquiring company, and are inconsistent with the guidance provided in other parts of the Revised Discussion Draft, particularly with respect to group synergies. This can be illustrated using the examples provided in the Revised Discussion Draft with respect to group synergies.

Analysis

Case 1: Using essentially the same facts as are set forth in Example 3 (paragraph 28) and Example 4 (paragraph 29), assume that independent companies A and B located in countries X and Y are essentially twin companies. Each company buys 10,000 widgets from the same manufacturer and then resells the widgets in its country. Each company pays 200 per widget (for a total cost of 2,000,000), incurs additional SG&A costs of 200,000, receives revenues of 2,500,000, and earns profits of 300,000.

Company A learns that the supplier will lower the price of widgets from 200 per widget to 110 per widget if there is a minimum purchase volume of 15,000 widgets. Company A then acquires Company B, consolidates the purchase volumes of the two companies, and therefore is now able to lower the combined costs of the two companies from 200 * (10,000 + 10,000) = 4,000,000 to 110 * (10,000 + 10,000) = 2,200,000. The profits of the combined company therefore increase from 300,000 * 2 = 600,000 to 600,000 + (4,000,000 – 2,200,000) = 2,400,000.

Focusing on just one year for simplicity, the lowest price that Company A would be expected to pay for Company B would be 300,000 (the profits earned by B as a standalone entity) while the highest price would be the total increase in profits realized because of the acquisition, which is equal to 300,000 + (4,000.000 – 2,200,000) = 300,000 + 1,800,000 = 2,100,000. The question then becomes what implications, if any, does the price paid in the acquisition have on the transfer pricing between A and B?

The Revised Discussion Draft's treatment of group synergies states clearly that the benefits of group synergies realized through combining purchase volumes should be shared in proportion to the purchases; that is, the new parent Company A should pay 110 per unit, and therefore report profits of 300,000 + 900,000 = 1,200,000. Similarly, newly acquired subsidiary B should pay 110 per unit, and therefore report profits of 300,000 + 900,000 = 1,200,000. There is no intangible transaction (group synergies are not intangibles), and therefore no payment for intangibles is required.

Suppose that Company A paid 2,100,000 for Company B – the highest purchase price possible. Does the fact that Company A paid 2.1 million for the equity of Company B, and is getting to use the volume leverage of B without payment, imply that value "has been destroyed" as part of an internal restructuring, or that something is wrong from a transfer pricing perspective?

No. Company A has paid 2.1 million to unrelated shareholders. In return, it received benefits equal to 900,000 as an increase in its own profits, 300,000 in increased income from Company B's standalone profits and 900,000 in increased income from Company B's group synergy profits. (The latter could either be viewed as a dividend payment from B to A or as an increase in the value of the equity in B that is held by A.) There is no need, from a group perspective or under the transfer pricing principles set forth in the Revised Discussion draft, to consolidate these profits into either Company A or Company B.

Case 2: Assume that the facts are the same as above, but that Company A and Company B both have identical supply contracts with their supplier that gives them exclusive distribution rights in their respective countries. Company B now has an intangible (an exclusive supply contract) that has to be factored into the analysis. However, while the intangible may contribute to the 300,000 in profits that B earns as a standalone company, it has no impact upon the incremental profits that arise because of the consolidation of the purchase volumes of the two companies. Therefore, the allocation of profits between the two now affiliated companies should be the same as above. This result could be obtained in three ways:

- Company A and Company B both pay the supplier 110 per widget; or
- Company A pays Company B 900,000 for the exclusive contract to supply widgets to Country Y, and then buys the widgets needed to supply this contact for 110 and resells them to Company B for 200;

- Company B pays Company A 900,000 for the exclusive contract to supply widgets to Country X, and then buys the widgets needed to supply this contact for 110 and resells them to Company A for 200.

In any of these cases, the price paid in the acquisition is irrelevant in reaching the right conclusion.

Case 3: Assume the same facts as above, except that Company A has a supply contract that provides for a price of 200 if volumes are less than 15,000, and 150 if volumes are more than 15,000. Company B's supply contract provides for a price of 200 if volumes are less than 15,000 and 110 if volumes are more than 15,000. Note that the range of prices paid in the acquisition remains the same as before because the increase in income is the same, but now Company B owns an intangible that brings specific incremental value to A (e.g., the ability to pay 110 rather than 150 for the consolidated purchases). The analysis of the value of this intangible is likely to be complex (in that it is valuable only once the purchase volumes of the two companies are combined), but its maximum value following the principles set forth in Example 2 (paragraph 27) would be 150 (the price that A could pay under its contract or with no contract) minus 110 (the price that is made possible by Company B's contract). Therefore the maximum value of the intangible related to the superior terms of Company B's contract would be 40 * 10,000 = 400,000. Of course, this assumes that B would be able to capture 100% of the value at arm's-length, which may not be the case.

Case 4: The facts are the same as for Case 3, except that Company A has the contract that allows it to buy widgets at a price of 110 when purchase volumes are 15,000 or more, while the lowest price that Company B could get is 150. The analysis would be the same as in Case 3, but the payment would go in the opposite direction – even though Company A has paid between 300,000 and 2,100,000 for the shares of Company B, from a transfer pricing perspective Company B would logically have to pay Company A for access to the lower prices made possible by Company A's contract with their joint supplier.

Examples 18 and 21

Example 18

Birincil acquires 100 percent of the equity in Company T, which has developed several promising technologies but which has only minimal sales. A PPA is carried out which attributes 20 of the price to tangible and identified intangible property, and 80 to goodwill and going concern. The intangibles owned by T are subsequently transferred to another associated enterprise (S) which takes over responsibility for ongoing R&D. The Revised Discussion Draft states that: "… a substantial portion of the value described in the purchase price allocation as goodwill of Company T may be seen transferred to Company S with the other Company T intangibles…. Company T should be entitled to compensation for such value either as part of the price paid by Company S for the transferred rights to technology intangibles, or through the compensation Company T is paid in years following the transaction for the R&D services of its workforce. It should generally be assumed that value does not disappear, not is it destroyed, as part of an internal business restructuring." (Paragraph 292).

Example 21

Osnovni acquired Company S for 160. Prior to the acquisition, Company S shares were trading at 100; other buyers were willing to pay between 120 and 130. Presentations to the board of directors state that Osnovni was willing to pay the high price of 160 because of the complementary nature of the existing products in the Osnovni group with the products and potential products of Company S.

Osnovni arranges for the transfer of the European and Asian intangibles that S owns to its subsidiary T. The Revised Discussion Draft states that, to the extent that the premium reflects the complementary nature of the Osnovni and S intangibles in Europe and Asia, the purchase price premium should be reflected in the payment by T for S intangibles; to the extent that the premium arises because of complementarities outside of T's territory, it should not.

Comment

Both of these examples ignore the fundamental difference between the price paid in an acquisition – which is based on the value of the target to the MNE group as whole – and the value of specific assets transferred between two associated members of the group. Consider the following. Independent Company S has intangible asset s with a market value of 100 and Company T has intangible asset t, also with a market value of 100, while the two companies operate as separate companies. When the intangible assets of the two companies are combined (either by S buying the equity in T or T buying the equity in S), the combined value of the intangibles s and t increases from 200 to 300 because of synergies.

For simplicity, assume that the entire value of S and T is derived from the intangible assets that they own. Given this, we know that the price that S will pay for T (or which T will pay for S) is at least 100 (the standalone value of their intangible assets) but no more than 200 (the standalone value plus total value of all synergies). Now consider two situations:

1) S acquires T for 200 and transfers T's intangible asset, t, to itself. If S uses the price paid in the acquisition to determine the payment to T for intangible asset t, S pays T 200 and T receives the entire benefit of the synergy. The implied price for the value of S's own intangible asset is 100. Or,

2) T acquires S for 200 and transfers s to itself. If T uses the price paid in the acquisition to determine the payment to S for intangible asset s, T pays S 200 and S receives the entire benefit of the synergy. The implied price for the value of T's own intangible asset is 100.

Note that in these two situations, the value of the intangibles based purely on the acquisition price would be different depending on which company was the acquirer and which was the target, which does not make intuitive sense.

Reconciliation

The price paid in an acquisition provides a measure of the financial gains that the acquiring company – as a consolidated group – expects to realize from the acquisition. However, it says nothing about the source of the increase in value – is it from an increase in the value of the assets of the target company, or is it derived from the value of the assets and other attributes of the purchaser, or a combination of both? Using the overall price paid in the acquisition to make inferences about the transfer prices that have to be paid for subsequent transfers of intangibles requires a careful analysis of the functions, assets and risks that lead to those gains, and to an allocation of the purchase price to those attributes that have led to this overall value. In this regard, the following steps are required:

- Determining the total value that may be attributed to intangibles, which is normally determined as the price paid in the acquisition plus liabilities assumed less the value of tangible property (or alternatively the present value of routine profits);
- Determining the value of the intangibles of the acquired company as a standalone entity. This represents the minimum payment that would be required to transfer those intangibles to a different member of the group.
- Determining the increase in the value of the intangibles owned by the acquired company that results from being a member of the group. The represents a possible incremental payment that would be required to transfer those intangibles to a different member of the group.
- Determining the increase in the value of the intangibles and other assets of the *acquiring* company that result from adding the acquired company to the group. This increase in value should conceptually be treated in the same way as an increase in the value of the intangibles and other assets of the acquired company, but income arising from these synergies should flow to whichever member of the associated group owns these intangibles or other assets.
- Determining the increase in value that is associated with group synergies, and which is therefore not owned or controlled by any member of the group. These should presumably be treated in the same way as group synergies generally.

Note that while the price paid for the intangibles of the acquired company may be substantially lower than the overall acquisition price, this in no way implies that value has disappeared or been destroyed. The MNE group has gained the full benefit; the question is how that benefit is allocated among the assets and other attributes that give rise to the gain, some of which are in the target company and others of which are in the acquiring company. An arm's-length payment to the target company that is less than the overall price paid in the acquisition simply reflects the fact that the functions, assets and risks that give rise to the overall value of intangibles are owned or controlled by different members of the group, or that value is created by group synergies rather than an intangible.

Impact of Uncertainty on Value

The Revised Discussion Draft has essentially the same discussion about how to treat intangibles when their value is highly uncertain at the time of the transaction as the first Discussion Draft, and indicates that the issue will be taken up as part of the BEPS project. This guidance is, in essence, to see what arm's-length parties would do, and if they would have transferred the intangibles at the time its value was highly uncertain, then it can be done in a related party transaction; if they would not have transferred the intangible when its value is highly uncertain, then it should not be transferred.

The key problem with this treatment is that it ignores both (1) the fact that intangibles with highly uncertain values are being transferred among independent parties on a regular basis (either as transfers per se or through transfers of equity) and (2) fails to discuss the basic relationship between uncertainty and economic value/arm's-length pricing.

While KPMG understands that tax authorities and the OECD are concerned that exaggerated claims of uncertainty may be used to support payments for intangibles that are priced below arm's-length levels, there are cases where the transfers clearly take place when there is substantial uncertainty and the transferee undertakes substantial risk. For example, if patent A is transferred from associated enterprise 1 in country X to associated enterprise 2 in Country Y, and the taxpayer can establish that (i) there is substantial risk of technical and/or commercial failure and (2) that associated enterprise 2 will be making investments of 100 million per year for five years before there is any chance of bringing a commercial product to market, then the transactions should be respected as involving a substantive transfer of functions and risks, and the risks and investment of associated enterprise 2 should be factored into determining an appropriate level of compensation.

The Revised Discussion Draft includes three examples (Examples 25, 26 and 27) illustrating pricing of intangibles with highly uncertain value. One of the key issues with these examples is that they greatly change the scope of the arm's-length principle – from a pricing concept to a structuring concept. Instead of using the arm's-length principle to price transactions as they are structured, they use the arm's-length principle to structure the transaction in a way the OECD believes third parties would.

Location Savings and Other Local Market Features

The Revised Discussion Draft includes a discussion on local market features (including location savings) and their impact on pricing. Local market features have become a bone of contention in transfer pricing involving emerging economies in recent times. The Revised Discussion Draft lays out general principles for evaluating local market features and notes that where local comparables exist, those "will provide" the most reliable benchmark for the impact of local market features on pricing. This statement should be softened to provide that local comparables "may provide" the most reliable benchmark. In some circumstances, comparables from other markets may provide a more reliable measure of an arm's-length result. For example, if a taxpayer in country A purchases fungible products from unrelated suppliers in country A and a related supplier in country B, which benefits from location savings, the most reliable measure of an arm's-length price may be the price the taxpayer pays the unrelated suppliers, properly adjusted for freight, customs, and other differences in the terms of sale. In that case, the existence of local comparables in country B regarding the profitability of manufacturers similar to the related suppler or even prices for similar, but not fungible, products may not provide as reliable a measure of an arm's-length result.

Moreover, given the position taken by some tax authorities that local comparables are impossible to find[4], this guidance is unlikely to further the cause of clarity. KPMG suggests that the OECD add examples illustrating how local market comparables may be used to reliably benchmark the allocation of location savings and to illustrate how and when those may or may not provide the most reliable measure of an arm's-length result.

Other Comments

We list below, in summary form, comments that KPMG provided to the OECD in response to its first draft that are still applicable to the Revised Discussion Draft (see KPMG's letter to the OECD on the first discussion draft dated September 13, 2012).

- The definition of intangibles should be more consistent with existing legal and accounting definitions of intangibles.
- The examination of uncontrolled transactions should be the starting point of any transfer pricing analysis, as emphasized by Chapter IX of the OECD guidelines.
- KPMG suggests that the concept of realistic alternatives be retained as a comparability criterion but not as a way to test the validity of the transaction, and certainly not as a means or reason for recharacterizing transactions.
- The discussion of realistic alternatives does not include sufficient restraints on recharacterization of transactions by tax authorities. This is particularly true since the entire concept of "realistic alternatives" is very broad, and may be defined very expansively by some tax authorities – does it include tax benefits, location savings, withholding and other taxes, specific synergies? It may be relatively easy for tax authorities to construct a "realistic alternative" that gives the seller a substantially higher expected price than the specific intercompany buyer can pay.
- In order to stay true to the concept of arm's-length or market pricing, KPMG believes that the concept of realistic alternatives should be defined in terms of market participants, i.e., the realistic alternatives should reflect the attributes of a likely market seller and buyer, and not the idiosyncratic attributes of the specific buyer and seller.

[4] See, for instance, the United Nation's Practical Manual on Transfer Pricing for Developing Countries, Chapter 10.

- The Discussion Draft is essentially silent on the treatment of licensing transactions among unrelated third parties, KPMG believes that additional guidance should be provided, and that the key points in such guidance are that (i) the arm's-length nature of licenses among controlled parties should be evaluated using the principles set forth in Chapter IX regarding respect for contractual terms (e.g., if they are the same as those that are found among uncontrolled parties, they should be respected, if not a further analysis is needed to evaluate the arm's-length nature of the terms); (ii) the licenses should be treated as a specific intangible giving the licensee and licensor specific rights that constitute a discrete intangible, and (iii) the terms of the license established by the taxpayer should be respected unless it can be shown that these terms would not be accepted, had the agreement been negotiated among unrelated third parties and only if the criteria of paragraphs 1.64 to 1.69 are met.
- While it is understandable that the Discussion Draft is meant to provide guidance for transfer pricing purposes, it is unfortunate that the OECD would not attempt to align the concepts of royalties (which are commonly thought of as payments for intangible property) with that of the new concept of intangible. The OECD has an obligation to recognize that the use of a transfer pricing specific definition of intangibles may undermine the traditional relationship between transfer pricing and local tax rules, possibly leading to significant exposure to double tax.
- The OECD should also make it clear that a party that is funding risky intangible investment must have an appropriate claim on the upside of such risky investments, within a framework on risk attribution similar to Chapter IX's. Similarly, the party funding a risky intangible investment should bear the losses that occur if the investment fails.