

Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
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1 October 2013

Our ref MJZ/EYW

Dear Sirs

We write in response to the request for comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles of 30 July 2013. We are pleased to offer our comments as follows:

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

Treatment of local market features and location savings D.6. paragraphs 1 – 13

We welcome the clarifications to the guidance concerning local market features and location savings. We believe that the correct treatment of these considerations is to regard them as comparability factors which would be considered in carrying out a comparability analysis under Chapter III. As such they would determine the suitability of potentially comparable data or the adjustments that might be made. These factors do not represent intangibles in their own right. The recognition that location savings are commonly passed on to customers or suppliers is helpful. This is likely where the respective markets are competitive ones. It is helpful to recognise that reliable local market comparables are often unavailable. Guidance that comparability adjustments should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed and assets is a first step. However we feel that more specific guidance on how those adjustments might be determined would be helpful. An understanding of which underlying economic assumptions would be acceptable to treaty partners would greatly assist taxpayers in producing consistent economic models for reasonable compliance.

Assembled workforce D.7. paragraphs 14 – 17

Again we welcome the explicit guidance that the nature of an assembled workforce is a comparability factor to be taken into account in the comparability analysis. Specifically the recognition of detriments, as well as benefits, of a unique assembled workforce is important in assessing potentially comparable transactions. However we are concerned that the comments relating to the transfer or secondment of an individual and the transfer of know-how may be confused with the requirement to base the transfer pricing on a functional analysis. As stated widely throughout the document a full analysis of the functions, assets and risks associated with know-how and other intangibles, from which it might not easily be distinguished, is necessary to determine the correct transfer pricing treatment. It should be clarified that a

transfer of a person who has undertaken a function that adds significant value does not automatically trigger the transfer of an intangible.

Group synergies

D.8. paragraphs 18 – 23

Section D.8. distinguishes between incidental benefits and those that arise from deliberate concerted efforts to create benefits. In practice it can be difficult to distinguish between these two categories. Groups must undertake functions in order to achieve a wide range of related corporate objectives. Whether any individual benefit may be viewed as arising directly, specifically or deliberately from particular functions will frequently be a matter of interpretation. In some cases it will be clear. In many cases it will not be. While the examples given highlight some cases, further guidance is needed so that tax administrations may be expected to apply a common standard.

Proposed Amendments to Chapter VI: Special Considerations for Intangibles

Proposed definition of “intangible” for transfer pricing purposes

A.1. paragraphs 39 – 40

We note that the definition has been expanded and we welcome the reference to the arm’s length principle implicit here. However it is not entirely clear how to interpret this for transactions that would not occur between independent parties at all or would occur only with very different facts and circumstances.

Relative value of important functions

B.1. paragraph 66 and B.2. paragraph 79

We are concerned that there are apparent inconsistencies with regard to the relative value of important functions. There are those functions which represent the entrepreneur element within the business. These will be unique to a business and are associated with a competitive advantage. There are also those functions that are primary elements in the value chain and are ‘important’ in the context of paragraphs 66 and 79 but are not the principal entrepreneurial functions. For example, the development of an intangible will always represent important functions. However the decision-making to adopt intangibles identified thereby, and bring them to market, which puts the firm’s capital at risk, is a different level of functionality. Whereas the former might be outsourced the latter must be conducted within the firm.

This partly stems from the reward to capital, which should be proportionate to the level of risk. It also depends on the compensation for performing labour functions according to the degree of value added. A simple classical economic analysis would examine the rewards to labour, land (or raw materials) and capital as factors of production. While it seems clear that the use of the term ‘function’ usually means labour functions there are instances where it seems to refer to capital through assets and risks. This is inferred in order to interpret Chapter VI consistently with the other chapters of the Guidelines, where an analysis of assets and risks as well as functions is required. We refer to this point further, below.

Functions Performed

B.2. paragraph 80

We are concerned that the wording of paragraph 80 makes it too easy to recharacterise transactions even where the arm’s length principle applies. While it is fair to say that it is uncommercial to outsource the most important elements of the value chain, it cannot be a requirement that internal transactions must have corresponding transactions between third parties. Rather, the transfer pricing must apply the arm’s length principle to arrive at an equivalent result.

The absence of an equivalent transaction between independent parties can not automatically lead to recharacterisation. The commercial facts and circumstances, themselves, determine whether arrangements make economic sense. It is the absence of any commercial coherence in arrangements that may give rise to recharacterisation not the lack of an 'independent equivalent'. Nor is this concern mitigated by the illustrative Examples, 13 and 14, provided.

Discounted cash-flow method

D.2. paragraphs 171 – 180 and Example 24 paragraphs 311 – 320

In our view the guidance on the application of the discounted cash-flow method is neither sufficiently detailed to be conclusive nor kept at a high enough level to retain the benefit of simplicity.

A fundamental problem of discounted cash-flow models is that they are highly dependent on the underlying assumptions. This problem seems to be glossed over. Example 24 acknowledges that the assumptions used are necessarily simple, for the purpose of illustration, guidance on how to tackle the issue in practice is lacking.

We would prefer some explicit clarification that while discounted cash-flow models may be used there is no obligation to do so unless it is the most appropriate method. Furthermore if the circumstances indicate that attempting to use the model is impractical this may be a legitimate reason why it would not be the most appropriate method.

General Comments

Terminology

We welcome the use of the terminology "return attributable to (the / an) intangible" in preference to IRR or "intangible-related return" that is easily confused with "internal rate of return" which in finance is also abbreviated to IRR.

Smaller and medium-sized international businesses

Given the complexities raised in the proposals, we are concerned by the "one size fits all" implication of many of the outcomes. From the perspective of medium-sized and smaller international groups with cross-border intangibles, especially in growth markets, the compliance obligations imposed may prove too onerous. We welcome recent changes to the guidance on Safe Harbours but these will usually apply to simple transactions rather than those covered by Chapter VI. Despite the smaller size of the transactions and business activities medium-sized and smaller international groups may find that they do not qualify. We therefore recommend an alternative simplified regime be made available for smaller transactions and SME groups. This would be comparable to some financial services regulations where smaller players may adopt a standardised approach which costs less to implement, while larger groups will opt for a more sophisticated approach as they have the economies of scale to justify the additional cost.

Functional approach

We believe that the current wording risks a misunderstanding that the intention is to prefer a purely functional approach over the consideration of assets and risks. Once the revised Chapter VI fits into the Transfer Pricing Guidelines, the emphasis on important functions may create the impression that intangibles are a case apart from the guidance elsewhere to analyse functions, assets and risks.

We understand that the OECD will hold a public consultation, in Paris on 12 – 13 November, on the above. We would be pleased to attend the consultation and would be ready to address any of the issues we have raised as requested.

Please contact the undersigned with any questions or comments.

Yours sincerely

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