NERA
ECONOMIC CONSULTING

28, avenue Victor Hugo
75783 Paris Cedex 16
Tel +33 1 45 02 30 00
Fax +33 1 45 02 30 01

OECD - Revised Discussion Draft on Transfer Pricing Aspects of Intangibles of 30 July 2013

Comments by NERA Economic Consulting

Introduction

When dealing with intangibles for transfer pricing purposes, the following basic questions have to be faced by a company.

1. What are the intangibles concerned?
2. Who owns the rights to their value in use?
3. When used by parties other than the owner(s), what is the appropriate price for the use?
4. What is the value when alienating the intangibles?

Overall, it is our view that the Revised Discussion Draft gives very valuable guidance in respect of the transfer pricing issues around intangibles. The main vulnerability is not so much in that guidance, as in its reliance on the basic functional analysis as described in Chapters I – III and its potential over-reliance on contracts. The current Chapter III simply fails to deliver the tools necessary to the analysis of the relationship between parties and of the notion of value creation, both of which are necessary in the often complex world of intangibles.

In our comments, we'll first verify that the basic questions are effectively dealt with in the guidance offered by the revised draft for Chapter VI, and then conclude with some tentative remarks on the effects of the current draft in the broader perspective of the current public awareness of transfer pricing.

1. *The definition and identification of "intangibles" (section A)*

The Revised Discussion Draft of July 30, 2013 has maintained its valuable starting point of using an open definition of intangibles and distinguishing comparability factors from intangibles, while steering clear of limits that are inherent to the strict use of legal or accounting definitions.

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As in the initial Discussion Draft of June 6, 2012, the first step is the identification of intangibles in the specific case at hand. Inevitably, such identification is informed by, although not limited to, both legal concepts and accounting conventions. Given the fact that intangibles represent a wide spectrum, exceeding both what is defined as intellectual property from a legal point of view and what can be recognized for accounting purposes; the challenge is in how the draft formulates its guidance in this respect. Where the guidance is useful and extensive at the same time, there is nevertheless reason to express reservations.

For the analytical approach of relevant facts about the relationship between and behavior of parties involved in the specific case of the company concerned, the text systematically refers to Chapters I – III. We question whether these Chapters, even after the amendments proposed in the revised draft, can effectively carry out this mission. We think that the Chapters concerned fail to give the necessary framework for analyzing the relevant facts and circumstances and for understanding how value is being created within the business concerned. We refer in this respect to our comments to the first discussion draft of last year.

2. *Ownership and "important functions": the analytical framework for attributing entitlement(s) to the "intangibles-related returns" (section B)*

The party (or parties) that can claim ownership and/or control is (or are) supposed to be entitled to an "intangibles-related return", which needs to be established and, ultimately, attributed at arm's length.

The analytical framework for identifying ownership used in the Revised Draft has undergone a refinement in comparison with the original Draft of June 6th of last year. The Revised Draft steers away from any formal notion of economic ownership.

The first step is now explicitly the identification of the legal owner of the intangibles concerned, followed by an analysis of entitlement to returns based on what is called the important functions. This change arguably improves the coherence of Chapter VI with the rest of the Guidelines, in particular with Chapter IX, by emphasizing the importance of registrations and contractual arrangements. It is not certain that it always leads to an increased relevance of the approach. Our more specific comments are as follows.

Other than for transactions between third parties, contracts are not always essential in intercompany transactions. Between parties within a group there are more important and effective ways to set patterns for behavior than contracts: strategic directives, business plan budgets, manuals, and instructions are usually more relevant. For management purposes, the measurement of performance generally does not rely on profits of legal entities and may be based on parameters that don't necessarily correspond with those that decide the outcome of the contractual arrangements.

In other words, contracts should not so much be seen as creating or establishing a reality, but rather as confirming, and supporting, the reality of intercompany relations.

Also, in a slightly different context, we can wonder what the effect would be of recognizing the relative authority of contracts in related party transactions. Isn't the relationship between two related parties involved, in the absence of a (written) contract, in a long-term, cooperative relationship to jointly create value, materially identical to that between two parts of a single legal entity (read: headquarters and permanent establishment) in the same factual circumstances? The coherence necessary between positions taken by OECD should logically be extended to the Report on the Attribution of Profits to Permanent Establishments of December 2006. We will come back to this PE issue after looking at the second step in the process.

That second step in section B in Chapter VI is essential: the verification of conduct as the test of the relevance of the contractual arrangements and of the economic substance of ownership, while explicitly avoiding the term "economic ownership". This conduct reflects how parties behave in the performance of the roles allocated between the different parties involved inside the group, as decided by management. Parties concerned can only assume the role attributed to them, and carry the responsibilities concerned, if they dispose of the necessary capabilities, financially and operationally. The revised draft effectively describes this (par. 74), and refers to the functional analysis as described in Chapter III. It also demands "to consider comparability factors that may contribute to the creation of value or the generation of returns related to intangibles". This seems to express a certain degree of ambiguity about what such consideration can and should achieve. It seems to assume that parties involved in ownership and important functions are jointly producing something (an asset) that has a value of itself which value in turn indicates what should be charged for the use of the intangibles. This ambiguity seems to be confirmed in the new version of section C and in the distinction between value in use and value in an asset transfer, as discussed below.

In the context of the "important functions" the key criterion is control. The guidance there is relevant and useful. 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 at risk) and decisions on whether and how to manage the risk, internally or using an external provider.

How does this compare with the position taken by OECD on the attribution of profits in substantially identical factual circumstances in the context of a PE? Where the Revised Discussion Draft explicitly avoids use of the concept of economic ownership, the Report is explicitly based on that concept. It states (par. 101) that "it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity". It is not comprehensible that Chapter VI now introduces a different framework for answering the materially identical question.

In our view, it would be helpful if OECD reconciles the analysis of attribution of intangibles-related returns based on performance and control of the "important functions", with the use of the AOA, the Agreed OECD Approach, for the attribution of economic ownership of intangible property to a permanent establishment.

3. *Determining the price for the use of intangibles (section C.2)*

Whether as the key references for applying a profit split method as a primary method, or as a corroborative test of the relevance of the outcome applying one of the other TP methods, it is usually important to apply a bargaining analysis. Bargaining positions of the parties involved are then based on an assessment of their respective bargaining power, derived from their contributions to the joint value creation in which they are involved and taking into account their alternatives including market transactions available to them.

The necessary view of the total process of value creation can only be developed by way of a value chain analysis, rather than the functional analysis as it is described in the current Chapters I - III. Ideally, functional analysis should include a value chain analysis. The current approach of those Chapters concentrates on a "tested party" and the transactions that that party is involved in. What is needed is an analysis that looks at all of the parties involved and their respective roles in the joint operations. Such a relationship-wide approach, starting from the context of the total enterprise (sector, business line, business unit etc., whatever is relevant), enables development of a view and understanding of the total value creation process within the relevant enterprise, and of the contribution thereto of the individual parties (ultimately legal entities) involved. This insight can then serve as the input for an assessment of the relative bargaining positions of the parties involved. The bargaining analysis can be used, either to suggest to which extent parties involved can claim a part of the jointly generated economic profit, or to serve as a sanity check on conclusions reached using the transaction-focused approach.

4. *Some observations in respect of Valuation (section C.1)*

Section C.1, dealing with transfers of intangible assets surprisingly precedes C.2, which deals with the use of intangibles. It should be recognized however that the value of intangibles is derived mainly from the income generated by the use of them. It seems therefore more logical to reverse the order (and re-establish the order as retained in the first draft) of sections C.1 and C.2.

Similarly, it seems as if the draft looks at valuation methods as "other transfer pricing methods". In general, we would view the transfer pricing methods as key inputs to evaluating the intra-group flows relating to the use of an intangible. Cash flows can then be derived from the application of these methods.

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Valuation methods generally apply to asset transactions, where one party sells the assets to another. In many valuation methods, the transfer pricing policy (hence the transfer pricing method) will be an essential input in the valuation. Hence, we believe that in many circumstances, valuation methods will need to be combined with transfer pricing methods to value an asset and to ensure consistency between the pricing of recurring flows related to the use of an intangible and the valuation of an intangible asset sale.

In addition, we also note that the transactions distinguished in the current C.1 still lack a category "(iv), Transfers of intangibles as part of the transfer of an enterprise". It is in this category that we see the appearance of intangible elements like goodwill and other intangibles that can't be transferred per se independent of the enterprise.

Finally, we wish to point out that Chapter VI should not be static with regard to the use of valuation methods. Like many disciplines, valuation is a dynamic field, and valuation methods may evolve, and new techniques may appear. By restricting the methods to a limited number of approaches, the relevance of the analysis will be limited. As an example, real options are a range of valuation methods (arguably part of the income approach) that can shed light on valuing some hard-to-value intangibles, and in uncertain perspectives, by attempting to reflect information that become available only as the intangible is being developed.

5. *The pros and cons of using examples*

The use of examples can be enlightening but may also be misleading, as they tend to be cited as case examples that are representative for what happens in a specific situation for a company that deals with its intangibles issues. The examples are all based on stylized, relatively simplistic or idealized fact patterns. Real-life cases demand a functional analysis that is broader than the one described in Chapter III, i.e. one that looks at the relations between parties involved before drawing conclusions regarding conditions for transactions, and that includes an analysis of how value is created in the business concerned. The value of examples without reflection of the full relationship between parties that are involved in joint transactions is limited.

6. *The wider context*

Arguably, a re-drafting of Chapter III seems to be made even more urgent by the recent White Paper on Transfer Pricing Documentation. The same potential over-reliance on the current Chapter III comes forward as a vulnerability in that paper where the expectation is developed that the current analytical framework of Chapters I – III is sufficient to deliver the basis for a meaningful reporting on a *country-by-country* basis in order to achieve the fairness requested of the allocation of income to different countries involved in operations of multinational enterprises. The decisive reference there can only be the relative role of parties in the joint creation of value, and Chapter III in particular would benefit from further guidance than the one developed currently in section D of the Revised Draft.

Conclusion

In our view, the Revised Discussion Draft gives relevant and useful guidance. It has gained in terms of coherence with the other Chapters of the OECD Transfer Pricing Guidelines. On the one hand, Chapter VI relies heavily on the analytical framework of Chapters I – III and, on the other, it aligns its analytical process with the contract-based approach to analyzing transactions that characterizes Chapter IX.

This explicit coherence also exposes the potential vulnerabilities in the other Chapters that, as a consequence, have a direct impact on the effectiveness of the guidance of draft Chapter VI.

In that respect we suggest that it would be helpful to:

1. Broaden the analytical framework of Chapters I – III from transactions to relations in order to develop a relevant understanding of the most critical basis for the attribution of intangibles-related returns, i.e. the role and contribution of parties involved in the joint value creation within the enterprise, and
2. Qualify the reliance (and sometimes, overreliance) of Chapter IX on the presumed relevance *per se* of intercompany contracts.

Therewith, an increased coherence would be paired with an increased effectiveness.

In terms of coherence of the guidance, we suggest that it would be important to resolve the possible discrepancies with the AOA framework developed for the profit attribution in the OECD Report on the Attribution of Profits to Permanent Establishments. A reconciliation of the “important functions” in the Revised Discussion Draft with the AOA, the Agreed OECD Approach, in the Report would constitute valuable additional guidance for a more effective and sustainable treatment of intangibles in the practice of transfer pricing.

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Pim Fris

Harlow Higinbotham

Emmanuel Llinares