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Written Comments on the Revised Discussion Draft
Transfer Pricing Aspects of Intangibles
The OECD
Paris, France

Re: Legal Ownership of Intangibles- a concept worthy of Protection

These comments are made by Shaun T. MacIsaac, Q.C. on behalf of the law firm of Pittman MacIsaac & Roy (PMR Law), Calgary, Alberta, Canada with respect to the Revised Discussion Draft on Transfer Pricing Aspects of Business Intangibles dated July 30, 2013.

Multinational enterprises ("MNEs") seek to comply with the laws of the jurisdictions within which they operate, including transfer pricing laws. The OECD promotes world trade by preventing double-taxation. All stakeholders, including tax authorities seek clarity and guidance when determining prices for the transfer of intangibles, just as they do with transactions relating to goods and services, loans and guarantees.

The Importance of Legal Ownership

While good new ideas are critical to the progress of mankind, legal protection for the legal owners of those new ideas from those that want to enjoy what others have developed without paying for it is equally important. These laws are followed in legal cases. Transfer pricing laws should also follow these principles, as legal ownership is a valuable right that has been recognized and protected in international law, legal cases, and in the functioning of the marketplace.

Proposed Treatment of Legal Intangibles

The existing revision draft makes the following comments regarding legal ownership:

- Paragraph 65 of the revision refers to the obligation of a legal owner of an intangible to pay compensation for the functions performed, assets used or contributed, and risks assumed in the development, enhancement, maintenance or protection of intangibles by others.

- Paragraphs 67 and 68 explain the bundle of rights enjoyed by the owner of patents, trademarks and copyrights as holders of rights known to law protected by registration, the legally protected intangibles.

- Paragraph 69 refers to the rights to protection for trade secrets and know-how, or the marketing intangibles, so that these too are legally protected intangibles.

- Paragraphs 73 and 74 then suggest that, for transfer pricing purposes, "… legal ownership of intangibles, by itself, does not confer any right to retain any return from exploiting the intangible…" Instead, the return

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that a legal owner should receive depends on the owners' contributions through an analysis of functions performed, assets used and risks assumed regardless of legal ownership.

- Paragraph 80 then ties the right the legal owner of intangibles has to retain all or material parts of a return attributable to an intangible to the role of the legal owner in the functions performed, just like the contract performer of research and development. The section goes on to say that the right to retain a portion of the return is "highly doubtful" where most of all functions are outsourced.

Paragraphs 65 to 67 recognize the importance of determining legal ownership of rights capable of registration, and represent an improvement on the earlier draft of these proposed revisions.

Paragraph 69 adds references to trade dress, trade secrets and know-how, and notes that these are protected by law, which recognizes other legally protected intangibles.

Paragraphs 73, 74 and 80 then take away the rights of legal owners, and suggest that legal ownership of an intangible is not relevant to establishing a right to a return attributable to an intangible.

Paragraphs 73, 74 and 80 are in conflict with established principles of legal ownership. Legal ownership should be the basis for the right to a return on assets, while those that have rights to use and contribute to the development of assets by contractual agreements, such as licensees and other participants in cost sharing agreements, should have something less that can be usefully quantified by assessing the value of the services.

Laws of Intangibles

The laws of the countries of the world in the field of patent, trademark and copyright have set forth mechanisms whereby a legal owner is entitled to protect by registration his or its interests against others who use the intangibles without license. MNEs also have extensive rights to intangible ideas, products, business imagery and goodwill associated or embedded in tangible goods which they also seek to protect from those who might seek to use them without compensation.

Individual efforts of nations to protect legal ownership of intangibles have been supplemented by international agreements such as the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), which forms part of the World Trade Organization (WTO) Agreement of 1994. A good example of the privileges and rights afforded to an owner of a patent are Articles 28 and 41of the TRIPs Agreement, which read:

> Part II — Standards concerning the availability, scope and use of Intellectual Property Rights
> *Article 28*
> *Rights Conferred*
>
> 1. A patent **shall confer on its owner** the following exclusive rights:
>
> (a) where the subject matter of a patent is a product, **to prevent third parties not having the owner's consent from the acts of: making, using, offering for sale, selling, or importing** (6) for these purposes **that product;**

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(b) where the subject matter of a patent is a process, **to prevent third parties not having the owner's consent from the act of using the process**, and from the acts of: using, offering for sale, selling, or importing for these purposes at least the product obtained directly by that process.

2. Patent owners shall also have the right to assign, or transfer by succession, the patent and to conclude licensing contracts.

Part III — Enforcement of Intellectual Property Rights
Article 41

1. Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement, including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements. These procedures shall be applied in such a manner as to avoid the creation of barriers to legitimate trade and to provide for safeguards against their abuse.

The above provisions explain that the legal owner has exclusive rights that it can use to prevent others from using its products or processes. There are other similar articles in the TRIPs Agreement that relate to other items of intangible property. The TRIPs Agreement is described by the WTO itself as having this effect[1]:

> At the heart of the system — known as the multilateral trading system — are the WTO's agreements, negotiated and signed by a large majority of the world's trading nations, and ratified in their parliaments. **These agreements are the legal ground-rules for international commerce**. Essentially, they are contracts, guaranteeing member countries important trade rights. They also bind governments to keep their trade policies within agreed limits to everybody's benefit.

I agree with the WTO when they say that "… the WTO's agreements … are … the heart of the system" and that the provisions of the agreements, including the two articles mentioned above are the "legal ground-rules for international commerce … and trade rights. Essentially, they are contracts, guaranteeing member countries important trade rights." As the protection given to the legal owners of intangibles is described by the WTO as a cornerstone of the world's trade agreements, it is clear that **the countries of the world have agreed on the pivotal role of legal ownership of intangibles in international commerce**.

Patents and Patent Infringement Actions

The world's companies have seen the importance of legally protected intangibles by their vigilance in increasing registrations to protect their intangibles. Billions of dollars are spent on research and development. Registrations of patents have doubled in the last decade in most countries.

Registration has been enforced by patent infringement actions in the courts of the world. Enforcement of patent rights is the privilege of the legal owner. An example from my jurisdiction of Alberta, Canada, is the decision in *Schlumberger Canada Ltd. v. Trican Well Service Ltd*. 2005 FC 1344 (Fed C.A.). Shlumberger held Canadian patents

[1] http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm

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for use in hydraulic fracturing, a process widely used to improve oil and gas flow. In the legal proceedings, **Schlumberge*r* sought, as a Plaintiff must do in any patent infringement action, a "declaration that they are the owner of the 311 and 659 patents".** Legal ownership was the foundation for the claim that the patent was infringed. In that case, as in many patent infringement cases, the Plaintiff asserted that as legal owner, it had developed something unique. Those challenging the patent suggested that the intangible has been described in prior art, and is now public, or that the claims made by the legal owner of the patent were too broad. The defences are ways of stating the owner owns nothing of value. The factual premise of patent litigation is that only an owner of a patent can claim protection of rights.

The courts also recognize the importance of legal ownership and protection of rights to intangibles in the way they enforce intangible litigation.

Risk versus Reward and the Premium Payable to a Legal Owner

In the jurisdiction of Alberta, Canada, where I practice law, the oil & gas sector is dominant. Legal owners of intangibles exploit rights to oil & gas by employing tangible goods in a manner that has the support of legally protected intangibles and marketing intangibles. It is a world of risk and reward. Legal owners of intangible property that control when to transfer and license those rights have, in arm's length transactions, the right to the income and profits from these transactions after payment of reasonable market rates to others that contribute to the development or enhancement of such intangibles. **When the efforts to exploit intangibles fail, then the losses of the venture are suffered by the legal owner of the venture**. These are the usual business terms of the legal and contractual relationships that govern the use of legal intangibles in the oil & gas business.

Some examples from business are the following:

> A pharmaceutical company that owns a patent bears the economic risk that its patent protects a product or process that may or may not have economic value.
>
> An oil & gas company may have a patent over a product that is used to encourage enhanced recovery from a well it has drilled, but the technology is of no value if the well finds no oil.
>
> A car maker may have designed a new luxury car, but it has no value if the market has a demand for smaller cars.

There is a real consensus in the marketplace that any premium return that is due to the presence and use of intangibles should accrue to the legal owner thereof, as they are also the party that bears the economic risk of failure. Business principles thus also support the value of legal ownership of intangibles.

Laws that Treat Intangibles Differently

The US added to Code Section 482 of the Internal Revenue Code[2] that dated from 1928, a law in 1986 whereby income from the transfer or license of intangibles was to be "**commensurate with the income**" attributable to the

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[2] In the United States, Code Section 482 of the Internal Revenue Code authorizes the Internal Revenue Service to reallocate income, deductions or tax among members of a controlled group. The wording dates from 1928. The last sentence of existing

intangible, usually as part of a cost sharing agreement[3]. The stated reason for the legislation was that intangibles were being transferred to low tax jurisdictions. The various generations of regulations interpreting this clause are a source of ongoing controversy. Many disputes in transfer pricing are very much linked to tax authorities reviewing carefully a transaction whereby a valuable intangible is transferred.

In the well-known *Veritas Software Corporation v. Comr*. (2009) 133 T. C. 14, decision from the United States, the courts looked at a buy-in payment made by an Irish subsidiary new participant in a cost sharing agreement at $166 million dollars. The tax authority had originally sought a $2.5 billion dollar adjustment.

In the judgment that decided the case, Justice Foley commented that "Veritas Ireland prospered, **not because Veritas US simply spun off a portion of an established business and transferred valuable intangibles**, but because Veritas Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA (Europe Middle East Africa) and APJ (Asia Pacific Japan) markets. For the foregoing reasons, we conclude that respondent's allocations set forth in the amendment to amended answer and at trial are arbitrary, capricious and unreasonable." The court felt that the tax authority was simply trying to read too much into the value for intangibles, and thus rejected the evidence offered for its consideration.

Had the tax authority limited the scope of compensable intangibles for which it sought an adjustment to legally protected intangibles, the evidence would have pointed to a more reasonable arm's length price that may have assisted the court. In this case, there was a comparable uncontrolled transaction (CUT) introduced by the taxpayer that was used and relied upon by the court. **The wide gap between the results of the CUT and the amount originally sought by the tax authority is troubling. It tells us that when too much value is attributed to intangibles, unacceptable results follow.**

By restricting the search for compensable intangibles to legally owned rights, the values obtained from intangibles will be much more in line with market forces, and thus unnecessary disputes can be avoided.

Base Erosion and Profit Shifting

The Action Plan on Base Erosion and Profit Shifting ("BEPS") does identify in Action item 8 the need for "a broad and clearly delineated definition of intangibles" and also that there should be "transfer pricing rules or special measures for transfers of **hard-to-value intangibles**". The BEPS report acknowledges that intangibles are difficult to value.

By respecting legal ownership of intangibles, transfer pricing policy can provide the required clarity and common approach that will assist in making a difficult area simpler to deal with.

The potential for double taxation is an inevitable result of intangibles that are valued too highly. **Guidance from the OECD that assists in valuing intangibles fairly will help avoid these disputes, and collect tax revenues in a manner that respects the arm's length principle.**

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section 482 was added in 1986, and states that "in the case of any transfer (or license) of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

[3] Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at pages 1013-1014 (1986).

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Conclusion

Comments in the guidelines such as "for transfer pricing purposes only" and "economic ownership" are unnecessary, as the transfer pricing ought to follow legal ownership of intangibles. **This is supported by the WTO Agreements, the laws of patent infringement, the principle of risk and reward, and the strange results that can occur in litigation when too much is made of intangibles.**

Extending the classes of compensable intangibles past legally protected rights will cause conflicts with the legal rights of businesses in contractual arrangements even where these do reflect the actual nature of business relationships. This will lead to transfer pricing conflicts, disputes and double taxation.

The challenge of the OECD in these *Guidelines* is to articulate **a reasonable approach respecting legal ownership of intangibles** that will invite future courts to follow the *Guidelines*, and lead tax authorities to successfully collect reasonable adjustments where necessary.

Yours truly,
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