TAX EXECUTIVES INSTITUTE, INC.

1 October 2013

Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development

Via email: TransferPricing@oecd.org

RE: Tax Executives Institute Comments regarding the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

To Whom It May Concern:

On 6 June 2012 the OECD published a Discussion Draft regarding special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines (Discussion Draft). A public consultation on the Discussion Draft was held with interested stakeholders in November 2012. On the basis of the comments received, the OECD published a Revised Discussion Draft on Transfer Pricing Aspects of Intangibles on 30 July 2013 (Revised Discussion Draft or Draft) along with a request for written comments from interested parties.

On 19 July 2013, the OECD released an Action Plan on Base Erosion and Profit Shifting (Action Plan). The work on intangibles in the Revised Discussion Draft is closely related to items discussed in the Action Plan, and therefore some portions of the text and examples in the Revised Discussion Draft may be revised during the course of the work produced under the Action Plan. Nevertheless, the OECD's Committee on Fiscal Affairs asked for comments from the business community and others on the Revised Discussion Draft. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the OECD's request for comments.

TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organisation has 55 chapters in Europe, North America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 members represent over 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

Overall Direction of Revised Discussion Draft

TEI commends the OECD for its work in addressing the transfer pricing aspects of intangible assets and for the open consultative process that produced the Revised Discussion Draft. In TEI's view, the OECD's effort should be directed toward preventing transfer pricing disputes between taxpayers and tax authorities and avoiding double taxation, rather than pursuing an approach that may increase such disputes. A common set of rules equitably applied by all countries and taxpayers would benefit all parties while reducing the risk of double taxation and double non-taxation.

The new text of the Revised Discussion Draft is an improvement over the OECD's previous effort and a more coherent document. TEI especially appreciates the expansive definition of intangibles and the increased emphasis on a holistic value chain analysis. However, we urge the OECD to recognise that any transfer pricing analysis must begin with the contractual and legal arrangements between the parties. Regrettably, in many places the Draft is too quick to recharacterise transactions between related parties in its transfer pricing analysis without first analysing the relevant legal contracts, as we discuss further below.

The Revised Discussion Draft also emphasises the use of the profit split transfer pricing method. The profit split method may be the most appropriate method in cases where comparable time and effort are spent developing valuable intangibles by both parties to a related party transaction. However, because this method requires a great deal of international cohesion, expertise, and dialogue among different tax authorities, we are skeptical of the ability of certain authorities to apply the profit split method fairly and efficiently. Regular use of the profit split (and similar) methods also raises the specter of increased transfer pricing documentation and compliance costs. In sum, the profit split method presents complex and difficult administrative issues for tax authorities and similar compliance problems for taxpayers.

Regrettably, the overall content of the Revised Discussion Draft creates confusion with respect to key principles. It appears that the OECD's recent focus on base erosion and profit shifting, as reflected in the Action Plan, has given the Draft an "anti-abuse" bias. The introduction of new concepts, such as the focus on "important functions" and "control" in setting transfer prices for intangible assets, has also muddied the waters. The new concepts give the impression that the Draft's direction in setting transfer prices is not driven by respecting contractual arrangements between parties that satisfy the arm's length principle. The many examples that permit tax authorities to recharacterise contractual relationships strongly implies that contracts and legal ownership[1] can be easily disregarded or that they must at least be challenged.

Transfer pricing is not an exact science, and the guidelines should allow for a pragmatic and flexible approach. In that respect, the Draft is at times too detailed and prescriptive and also misses the nuances and complexity of intangibles transfer pricing. We fear that certain subjects in the Revised Discussion Draft are susceptible to literal application by tax authorities without further analysis, which will lead to unnecessary controversy and double taxation.

The Draft also downplays the investor and governance role of intellectual property (IP) holding companies (also called "central entrepreneurs"), while overstating the contribution of other affiliates. Where multi-national enterprises have such a structure in place, the central entrepreneur is unquestionably the primary investor in intangibles and bears most (if not all) of the risk with respect to IP. By allocating intangible related returns from an IP holding company to other affiliates in a multi-national enterprise's (MNE) group, the Draft risks creating a significant increase in international tax disputes.

In addition, the suggested piecemeal approach that consists of analysing each intangible item separately is likely to lead to non-arm's length valuations. A fragmented methodology to intangible valuation contradicts the business reality of many MNEs where the combination or centralisation of many innovative activities (*e.g.*, research and development, product, process, marketing and organisational) creates a competitive advantage.

Finally, it is unfortunate that the Revised Discussion Draft reflects a general anti-abuse orientation, which we attribute to the influence of countries that are generally less experienced in applying the arm's length principle. Such countries already have a regrettable inclination to apply the arm's length standard in an unprincipled manner. As a result, the in-country affiliates of MNEs face great difficulty in justifying arm's length payments for the use of intangibles held abroad and often must resort to costly litigation to obtain a fair result. The combination of unclear guidelines and an anti-abuse bias of the Draft will further incentivise those countries to pursue opportunistic and unprincipled adjustments in contradiction of the arm's length principle. The Revised Discussion draft should clearly state that the arm's length principle is not a tool to tackle tax avoidance or abusive transactions but a standard to value transactions. A shorter and less prescriptive document setting key and clear principles would better serve taxpayers and tax administrations.

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[1] For purposes of this letter, an entity is considered the "legal owner" of an asset if it (i) holds legal title to the asset and (ii) bears the risks and rewards of holding the asset (*i.e.*, it is also the "economic" or "beneficial" owner). Given the varying treatment of intangible ownership, it is the responsibility of the legal owner of the intangible asset to ensure that legal ownership of the asset and the economic consequences that flow from holding the asset (both costs and benefits), are properly organised and consistent with each other.

General Comments

The Overall Tax Climate – Global Economic Policy

TEI's members are concerned that economic globalisation and the revenue needs of countries after the 2008 financial crisis have seriously eroded the relationship between MNEs and tax authorities. As a result, our members have seen a sharp increase in the number of unprincipled adjustments, most acutely in the transfer pricing area, in both developed and developing countries with a corresponding increase in unrelieved double taxation.

From a global economic policy view, it is clear that this negative relationship and the hostile political climate with respect to MNEs increases the cost of conducting international business. This generates an economic distortion at the expense of companies, both those who want to expand internationally and ones that are already active internationally, because they incur increased compliance costs. Unprincipled adjustments present an unpredictable risk that is not conducive to the rule of law, a key component underlying the global economy.

In addition, the ability of taxpayers to appeal disputed adjustments or to invoke a mutual agreement procedure (MAP), if one is available, is limited for many reasons. For example, a local appeal may render a MAP process unavailable, tax authorities may threaten increased penalties if the taxpayer does not waive its right to appeal or to the MAP process, or the cost and length of time required to complete an appeal or MAP process makes them unappealing.

For these reasons, local government agendas are not necessarily aligned with the OECD's goals for its intangibles project. In the current difficult economic climate it is critical that the OECD limit this divergence by reinforcing transfer pricing principles rather than suggesting deviations from those principles as the Revised Discussion Draft does in several respects (*e.g.*, by downplaying the significance of legal ownership and risk bearing).

Influence of the OECD's Base Erosion and Profit Shifting Project

Much of the Revised Discussion Draft is "testing focused," that is, it is aimed at systematically challenging or testing the arm's length principle in different ways, such as looking to the conduct of the parties, through the use of hindsight, *etc*. We attribute this to the OECD's current focus on base erosion and profit shifting (BEPS), as reflected more fully in the Action Plan and the general anti-abuse approach toward MNEs taken by many OECD Member States. TEI agrees that addressing abuse is necessary, but in our view the Revised Discussion Draft (and therefore the OECD Transfer Pricing Guidelines themselves) should concentrate on fundamental concepts that explain the arm's length principle and how to substantiate a taxpayer's transfer prices.

The current approach of the Draft creates several misconceptions First, that a majority of MNEs do not respect the terms of their own intercompany contracts. Second, that intangible related returns are disconnected from legal ownership in MNE groups. And third, that returns from core intangibles must be spread to all affiliates who had a hand in creating, controlling, improving, protecting, *etc.*, the intangible when in fact MNEs often concentrate legal ownership and risks with respect to core intangibles in a single or just a few entities for both tax and non-tax purposes. In general, the OECD Transfer Pricing Guidelines should not create the impression that most MNEs are non-compliant or arrange their affairs solely for tax reasons.

The Basic Approach to Transfer Pricing for Intangibles

The Revised Discussion Draft clearly reflects a bias against allocating intangible related return to its legal owner under the relevant contracts in favor of looking to other factors, such as who developed the intangible and who controls its use (among others). In our view, this is incorrect; the first step in determining legal ownership of an intangible is to look to the contractual arrangements. When legal ownership is confirmed pursuant to this analysis, there should be little room – other than in extraordinary cases – for tax authorities to disregard or recharacterise the contractual arrangement.

Income generated by the intangible should inure to the legal owner of the IP; other affiliates or third parties who contributed to the development of the IP should be remunerated according to their respective contributions under the arm's length principle. Normal transfer pricing rules should apply to benchmark the contribution of those parties without the need to recharacterise the contracts or ownership of the intangible.

Contractual Analysis

Chapters I-III and IX of the OECD Transfer Pricing Guidelines stress that legal rights and contractual arrangements form the starting point for any functional analysis of transactions involving intangibles. They also form the keystone of Article 9 of the OECD Model Tax Convention. The Revised Discussion Draft supersedes this approach by quickly disregarding contracts and applying a purported "substance based" analysis. This approach resembles a global formulary apportionment regime, which the OECD has disavowed in the Action Plan.[2]

For example, the Draft downplays the importance of contracts between related entities by testing them against ''the actual conduct of parties'' and *ex post* events, either of which may "overrule" the contractual arrangements. Depending on the circumstances, this *ex post* testing may reallocate who bears the risk of the intangible asset, as well as who is the legal owner. Experience teaches that the conduct of a party rarely deviates from the controlling contractual

[2] Action Plan, page 14 ("there is a consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward . . . .").

terms. Therefore, tax authorities should not dispute legal ownership in the vast majority of cases. Once legal ownership is determined, the economic contribution of the affiliates involved in the development, maintenance, *etc*., of the intangibles should be assessed through the normal functional analysis. There should not be any need to "recharacterise" the contractual arrangements that underlie the transaction at issue.

In this regard, it would be helpful if the OECD clarified the differences between the Authorised OECD Approach (AOA), which was developed under Article 7 of the OECD Model Tax Convention, and the Draft's envisaged approach under Article 9. Tax authorities tend to apply the AOA under Article 7 in an Article 9 context, and it is unclear to what extent the revised guidelines in Chapter VI, as reflected in the Draft, aim to establish or confirm this tendency.

The AOA under Article 7 provides an analysis to attribute profits to a permanent establishment (PE). Essentially, the PE is treated as a distinct and separate enterprise, and assets and risks related to the PE's (hypothetical) business are allocated to it. Because there are no contractual arrangements between a parent company and its PE because the PE is not a separate entity, assets and risks are allocated between the PE and the parent company by reference to the place of performance of "significant people functions." The PE is considered to assume the risks if significant people functions relevant to the risks are performed by the personnel of the PE at the PE's location. Unlike in the separate entity context under Article 9, it is not possible to separate risk from the people function of managing risk when assessing a PE ("risks follow functions").

Under Article 9, the comparability analysis is based on five comparability factors. One of the comparability factors is contractual arrangements, which do not exist in the PE context of Article 7. Contractual arrangements provide the terms and conditions of transactions between the parent company and its affiliate and stipulate the allocation of risks. The OECD Transfer Pricing Guidelines generally accept the risk allocation set by the parties unless under paragraph 1.53 it can be disregarded or modified because the conduct of the parties does not conform to the terms of the contract (or show that the contract is a sham). Where the parties follow the contractual risk allocation in practice, then the risk allocation should be accepted. Under Article 9, unlike Article 7, contracts can be used to separate risks from the people that manage the risks.

Thus, while the current OECD Transfer Pricing Guidelines clearly recognise that contractual risk allocations should be accepted if the risk allocation is followed in practice, it is unclear whether the Revised Discussion Draft follows that recognition. Where the Draft refers to legal agreements, in most instances it also refers to the "conduct of the parties." It is unclear in the Draft whether legal agreements are decisive for risk allocation if they are followed in practice. If risk allocation is determined by both the legal contracts and the conduct of the parties, the question arises as to how that is different from the "risks follow functions" paradigm under Article 7.

To remove this ambiguity, the Revised Discussion Draft should confirm that where parties follow their contractual risk allocation in practice, the allocation will be accepted. This would show that, under an Article 9 analysis, risks follow contracts not functions (unless the contract is not followed in practice or is a sham). To the extent the OECD intends to change the existing allocation of risk under Article 9 in the Draft, it should clarify the intended difference between the AOA, as developed under Article 7, and the envisaged approach under Article 9. It should especially clarify where and how the concept of conforming the consistency of the legal agreements to the actual conduct of the parties (Revised Discussion Draft/Article 9) deviates from the paradigm of "risks follow functions" (Article 7).

Finally, when reviewing contractual terms in a transfer pricing analysis, tax authorities should refrain from using hindsight. The use of hindsight does not reflect arm's length conditions since the information used is not available to the taxpayer at the time the transaction took place and can lead to deviations from Article 9.

Recharacterisation

The Draft suggests that income generated by intangible assets should be recognised in the hands of parties that contribute to the intangible's value, and not the asset's legal owner pursuant to the underlying contractual arrangement. Recharacterising the contractual arrangement to allocate income from the asset to those who contribute to the asset's value does not respect the arm's length principle. Assessing the relative "contributions" to an intangible's value is a fluid and untested concept and will result in double taxation as jurisdictions grapple with this new approach.

Entrepreneurial Risk

The Revised Discussion Draft pays little heed to the financial risk involved in investing in intangibles. Paragraph 84 in particular seems to disregard funding and risk bearing altogether, noting that bearing a funding risk without more "generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested, but not more." Instead, the Draft looks to control of the funds and the funded activity. Funding intangibles is a substantial risk for the legal owner of the intangibles and should be compensated based on the success or failure of the project.

Intangibles Legacy

The Draft gives very little consideration to intangible anteriority or legacy in a specific MNE. Intangible assets, especially those that are the most valuable to an MNE, are the result of a long chain of actions and initiatives usually driven centrally by the IP owner and sometimes stretching back decades. A proper value chain analysis should illustrate the origin of the intangibles, which should be taken into account when allocating intangible related returns.

Holistic Analysis

TEI welcomes the suggestion that MNEs should provide tax authorities with a "big picture" or holistic view of their businesses and embedded value chains for purposes of educating authorities on their businesses. This should accelerate the authority's understanding of the key value drivers of a particular MNE, which in turn should enable tax authorities to better assess an MNE's transfer prices.[3] However, such an analysis should not replace the contractual analysis of specific operations as the starting point for analysing transfer pricing.

As to this last point, providing the full picture of an MNE's business to tax authorities has resulted in aggressive and unprincipled tax adjustments in certain cases. In these cases, tax authorities disregard the contractual organisation and functional analysis of the MNE and proceed to directly apportion the MNE's consolidated profit under a different analysis. Emphasising the importance of beginning the transfer pricing analysis with the taxpayer's legal arrangements should discourage this kind of results-oriented analysis by tax authorities.

Use of Two-sided Methods

The Revised Discussion Draft advocates the wider use of two-sided transfer pricing methods (such as the profit split method) for benchmarking transactions that include intangibles developed by both parties. While profit split and similar methods should remain available for use under the OECD Transfer Pricing Guidelines, as a practical matter we fear that wider use of the profit split method by tax authorities will result in increased controversy and the risk of double taxation.

We believe it is advisable to continue to benchmark the least sophisticated party with a traditional method or the transaction net margin method (TNMM) if that party does not own unique and significant intangibles. Similarly, contract research and development services can be properly compensated on a cost plus basis if the IP owner is akin to an entrepreneur or an active investment center.

Overall, the profit split method does not generally constitute a pragmatic and advisable approach for an MNE since this method requires tax authorities to accept significant year-end adjustments that do not align with financial accounting rules or the underlying sales transactions. It also requires local tax authorities and judges to appreciate and understand

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[3] We emphasise that tax authorities should guarantee strict confidentiality of sensitive business information gathered in this process.

sophisticated economic analysis (*e.g.*, game theory)[4] and accept the outcome of such an analysis even where it leads to large swings in profit (or loss) of the entity that has the highest bargaining power. Moreover, profit split payments may suffer severe withholding and indirect tax issues especially in emerging countries.

We urge the OECD to recognise that there is generally no consistency in the way local tax authorities apply international tax principles, especially in countries less familiar with the OECD guidelines. Indeed, in our estimation only a handful of countries are equipped to deal with the complex analysis envisioned in the profit split method as contemplated in the Draft. As a result, utilisation of one sided methods would dramatically reduce the risk of tax misalignment, even if the methods fall short of perfection. If the OECD recommends that tax authorities routinely apply two-sided transfer pricing methods, it should be prepared to enhance the economic and transfer pricing education of tax authorities and judges.

Organising the Fair Treatment of International Tax Disputes

Far too often a priority of tax authorities in international tax disputes is to defend their own budgetary interest with secondary regard to underlying tax principles (such as the arm's length standard) and the double taxation implications of their actions. While this approach can be expected to a certain extent in an adversarial process, it is the experience of our members that an increasing number of taxing authorities have resorted to such an approach after the financial crisis. To combat this problem, an effective and responsive advanced pricing agreement program should be available to taxpayers with a goal of a prompt reply (ideally within six months). Similarly, the MAP process should be revamped to resolve highly sophisticated cases in a reasonable time. Both procedures should allow for mandatory binding arbitration.

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[4] With respect to the functions performed by various members of an MNE group, if profit split methods are promoted by the final guidelines, several examples could be provided using key game theory concepts such as the "Core" and "Shapley Value." Those theories are powerful tools to set arm's length transfer prices, especially in cases where the group's activities are very integrated and unique and valuable intangibles are jointly developed. Game theory may be a reliable tool either as the primary approach where a solid economic analysis is feasible (also dependent on the existence of external market evidence) or as a back-up approach to test the plausibility of the outcome of alternative valuation techniques. However the lack of sophistication of some tax authorities may make the acceptance of those theories very difficult. Hence, it is important for the OECD to illustrate those concepts in detailed examples. This will facilitate their use by all tax authorities. For background, *see* Vögele, Gonnet, and Gottschling, *Transfer Prices Determined by Game Theory: 1 – Underlying*, Transfer Pricing International Journal (BNA) (16 October 2008).

Options Realistically Available

TEI appreciates the Revised Discussion Draft's recognition that MNEs have the freedom to structure their internal arrangements. The Draft repeatedly states that such structures and transfer pricing arrangements are acceptable so long as they satisfy the arm's length principle.

The Draft, however, retains the requirement that any transfer pricing analysis should consider "options realistically available" to all parties to the transaction. In other words, the Draft suggests that tax authorities apply a systematic two-sided transfer pricing analysis in which the alternatives of each related party are considered. In reality, multi-national groups usually employ a common business model, brand, and strategy. In many cases, therefore, the options realistically available for affiliated companies are very limited, as would be demonstrated by a holistic or group value chain analysis. For this reason alone, consideration of "options realistically available" should not be required in a transfer pricing analysis. Such an analysis would also be burdensome, expensive, and time consuming for MNEs and tax authorities.

Burden of Proof and Tax Compliance Costs

Over the past five years, the compliance costs and controversy associated with transfer pricing have increased substantially. Because transfer pricing is not an exact science, the OECD Transfer Pricing Guidelines should allow for a pragmatic and flexible approach. The Revised Discussion Draft goes too far in analysing individual intangibles and does not give enough credence to the business model and intangible legacy existing in many MNEs – most of which were in place prior to the release of the Revised Discussion Draft.

The OECD should give clear instructions in the Draft to tax authorities with respect to the burden of proof and assertion of penalties. The large cost of complying with the OECD Transfer Pricing Guidelines and concomitant documentation requirements will only increase when the OCED finalises the Revised Discussion Draft. TEI therefore suggests that the burden of proof shift to the tax authorities and full penalty relief be granted to the taxpayer once the taxpayer has provided: (i) the contractual framework; (ii) a basic group value chain analysis; and (iii) a local functional analysis and related benchmarks.

Detailed Comments

Proposed Amendments to Chapters I – III of the Transfer Pricing Guidelines[5]

Section D.6.1. Location Savings

The analysis of location savings should closely review the relative competitive positions of buyers and sellers in each market. The allocation of location rents (or "super profit") between parent (the intellectual property owner) and the local affiliate should be analysed using their relative bargaining power. An economic analysis needs to demonstrate where the location advantage originates: the group IP owner that has created large barriers to entry for local competition, the local affiliate that has secured itself by its positioning, *etc*.

While TEI does not dispute the theoretical advantages of location savings, applying the Draft's guidance to routine, day-to-day transactions implies a level of minute detail that is unusual for transfer pricing analysis and documentation. TEI urges the OECD to clarify that the guidelines should only be applied where material contributing location savings factors can be specifically identified. Supplementary guidance on how such detail is to be derived and valued in practice and to what extent negative location savings will be shared among the MNE group should also be provided.

Section D.6.2. Other Local Market Features

Paragraph 11 states that valuable contractual rights and government licenses obtained by a local affiliate, in contrast to features of the local market, may be considered to constitute intangibles. TEI notes that it will also be important to analyse whether those rights and licenses were obtained based on the merit of the local affiliate alone or on the global reputation of the MNE group to which the affiliate belongs.

Section D.7. Assembled Workforce

This section of the Revised Discussion Draft addresses the intangible status and transfer pricing aspects of an assembled workforce, especially where a workforce is transferred from one associated enterprise to another. The economic success of a business is the result of many features, including unique intangibles that create entry barriers to competition as well as the financial strength of the group and the quality of the workforce. MNEs consider their workforce as a valuable resource that can be increased, reduced, or outsourced as needed depending on market conditions and opportunities. Labour and civil law, however, allow employees to leave their employers at any time with a proper notice period subject to, in limited cases, a non-compete agreement. For these reasons, assembled workforce is not something that can be owned by an MNE and is certainly not transferrable. Instead, it is a resource used to

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5 Revised Discussion Draft, pages 5-12.

achieve operational and strategic objectives. Thus, considering assembled workforce as an intangible asset is inconsistent with the definition of an intangible. Similarly, consideration of assembled workforce in a transfer pricing analysis will taint the quality of the comparables used in benchmarking. It will also raise difficult questions such as: does the higher profitability of a comparable arise from exceptional workforce or from other intangibles? If so, how should we adjust the comparable? What are the characteristics of an exceptional workforce?

In TEI's view, the transfer of individual employees or groups of employees between associated enterprises should never give rise to a need for compensation other than compensation for employee services. The valuable know-how referenced by the draft is not embedded in the employee, but in the company employing those persons. The end result – the unique know-how – should not be confused with the resources that produce it (employees, equipment, *etc.*). Therefore, we believe that there is no need for a specific analysis under Chapter VI of transfers of a workforce from one associated enterprise to another.

Section D.8. MNE Group Synergies

The Revised Discussion Draft does not consider MNE group synergies to be an intangible asset but rather a comparability factor that may or may not need to be taken into account when setting transfer prices.[6] Paragraph 19 provides that incidental benefits attributable solely to being part of an MNE group do not require a comparability adjustment or payment from an associated enterprise to the rest of the group. We disagree. If the mere membership in a group benefits local affiliates, it is important to analyse how this economic benefit or premium arises and whether this premium would be available to the local affiliate on a standalone basis (*i.e.*, without belonging to MNE group). Experience generally shows that any such premium can be attributed to group intangibles (*e.g.*, brand, reputation, process, organisation, *etc.*) and should give rise to compensation from the local affiliate.

Paragraphs 20-23 generally provide that the economic benefit originating from group synergies and attributable to concerted actions should be shared among the members in proportion to their contribution to the creation of the synergy. TEI notes that there will be reason to share the benefit originating from group synergies only in the case where each affiliate actively contributes to the origin of the coordinated activity. For example, centralised purchasing structures require highly specialised talents, and very little responsibility is left to the local affiliate. Thus, the added value of affiliates to the structure is passive, and they should not generally be entitled to share in the full savings to the group, which should mostly inure to the centralised team.

More generally, the economic risks and rewards generated by a central activity are clearly reflected in the contractual terms and conditions agreed between the participants in the

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[6] *Id*. at paragraph 63.

program and the party coordinating the centralised activity. The contract should also clearly indicate how the risk will be allocated, including any negative synergies. If the central activity is contractually concentrated and controlled in one specific legal entity (*e.g.*, in a principal company or central entrepreneur), local affiliates should not participate in the risks and rewards of the activity. We recommend the OECD develop examples to illustrate this contractual pattern.

Revisions to Chapter VI, Special Considerations for Intangibles[7]

Introductory Paragraphs[8]

We suggest the following new paragraphs be added after Paragraph 35 in the Draft:

Paragraph 35B: "*In arm's length transactions, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be the first and leading part of any functional analysis of intangibles. Careful respect of MNE contractual arrangements should drive the intangible analysis by tax authorities.*

Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises."

As in Chapter IX of the OECD Transfer Pricing Guidelines,[9] an analysis of the parties' contractual arrangements should drive the transfer pricing analysis of intangible assets. Based on the Revised Discussion Draft, it seems that for purposes of Chapter VI of the Guidelines this first step is too easily bypassed or ignored. If contractual arrangements between associated enterprises are easily disregarded, what is the alternative? The risk and control tests derive first from contracts. From that perspective, there is a large disconnect between Chapter VI and Chapters I–III and IX, all of which insist on the importance of contracts.

Paragraph 37 should also include a cross-reference to Chapter IX of the Guidelines because many of the relevant principles are mentioned there, such as the importance of contractual terms and the notions of risk and control, among others.

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7 *Id*. at 13-51.

8 *Id*. at 13.

9 *See* OECD Transfer Pricing Guidelines, paragraphs 9.10 – 9.46.

Section A. Identifying Intangibles[10]

Paragraph 46 stresses the importance of identifying the relevant intangibles with specificity. While we understand the need to identify specific intangibles, the success of multinational groups typically results from the combination (or bundling) of all intangible elements. A separate quantification and valuation analyses of each intangible in an isolated manner may lead to unreliable results, as it disregards the combination with related IP elements and may conflict with the profit split method. Moreover, identifying individual intangibles in the first place may be complex and difficult for tax authorities. This is especially difficult for intangibles where formal legal protection is dependent upon confidentiality (trade secrets and know how).

Section B.1. Intangible ownership and contractual terms relating to intangibles[11]

TEI applauds the statement in paragraph 67 that "[l]egal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles." However, many paragraphs in the Draft are tainted by anti-abuse considerations that will prompt tax authorities to ignore an MNE's structure as reflected in its legal documents. In addition, the document too quickly discards this analysis and consideration of legal ownership, which are critical components of the return on intangible assets.

We recommend that this section of the Draft define and include a discussion of "economic ownership." Economic ownership and beneficial ownership are difficult concepts to apply in practice. The term economic ownership has no legal meaning in most of the world, while the term beneficial ownership means something very specific in a few countries, may have multiple meanings depending on the context, and has no legal meaning in others. Thus, it would be helpful for the OECD to discuss economic ownership, provide indicators of economic ownership, and explain the methods used to measure the relative value of economic compared to legal title.

Many MNEs have a centralised policy of concentrating legal ownership of core intangibles in a limited number of entities. For commercial reasons, some other MNEs separate legal title to an asset from the economic or beneficial ownership of that asset into more than a single legal entity. Depending on the contractual framework in place, the economic or beneficial owner (if completely disconnected from legal title) may be entitled to a significant piece of the return generated by the intangible. For this purpose, the economic or beneficial owner should be entitled to the intangible related return even if legal title to the asset is held in a separate company. Given the varying treatment of intangible asset ownership, it is the responsibility of the owner of the asset to ensure that legal ownership of the asset and the

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10 Revised Discussion Draft, pages 14-19.

11 *Id*. at 20-21.

economic consequences that flow from holding the asset (both costs and benefits), are properly organised and consistent with each other.

If the legal and economic test cannot be met because the MNE has an extremely decentralised intangible ownership policy, then MNEs should document the new functional analysis or "material test" (described in paragraphs 74-88). MNEs with consistent business models and solid centralised intangible policies, however, should not be forced to apply the "material test" described in those paragraphs. The burden of proof should lie with the tax authorities to challenge the MNE ownership policy.

Section B.2. Functions, assets and risks related to intangibles[12]

The "material test" or functional analysis set forth in paragraphs 74-88 should only apply to MNEs with a highly decentralised intangibles ownership policy or approach. In other cases (*i.e.*, centralised ownership policies), this test should be applied only when the conduct of the parties is inconsistent with the terms of the parties' contractual arrangements.

MNEs do not create intangibles through "important functions" alone. By their nature, intangibles arise progressively from a complex and lengthy combination of acquisitions, actions, decisions, and investments made over time and are usually driven by the parent corporation or IP holding company. MNEs organise themselves in such a manner so that they do not become overly dependent on individuals or functions. On a standalone basis (*i.e.*, without access to the MNE's organisational network, infrastructure, *etc.*), a specific function cannot drive exceptional intangible value.

In many cases, the IP holding company may outsource the work of creating and developing intangibles. The outsourcing can be to internal and external parties and it is the contractual framework that clearly sets the roles and responsibilities of each party. It is highly unlikely that the individual contribution of one such party without access to other company assets and the full organisation would be sufficient to generate a valuable intangible. For example, a Global Marketing Director plays an important role in enhancing the reputation of an MNE's brand but can hardly be considered as a nexus for intangible creation and ownership. The same can be said for the executive leading a research and development center. Such an executive's program and budget is tightly set and controlled by the company making the investment and all the risks and reward should inure to that company as the actual entrepreneur.

In addition, employment contracts generally ensure that an individual employee who creates IP in the course of his or her employment does not have any individual claim to the IP rights associated with those inventions. It is therefore conceptually incorrect to relate intangible

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12 *Id*. at 22-25.

ownership to important functions, as demonstrated by the contracts that result from the third-party relationship between the MNE and its employees.

MNEs usually locate their core intangibles (or "crown jewels") in the entity that took the entrepreneurial risk. Such an entity is generally financially strong enough to both fund IP investments and withstand their failures. Central ownership of IP also allows for efficient and effective registration of patents and trademarks. MNEs naturally capture the ultimate decision making at the top level (*e.g.*, in an Executive Committee of the IP holding company). Further, it is not uncommon for an IP holding company to pay a management fee to another affiliate company for corporate services rendered on its behalf. It is therefore fair to say that important functions spread throughout the group are rendered on behalf of the IP holding company that funds and controls them. Because the physical location of important functions is no longer a concern, the global governance model in place in an MNE should be the foundation for applying the control test.

In MNEs, there are different levels of (formal) decision making and different levels of preparatory work (without formal decision making), which can be exercised in different places. The catalyst in terms of ultimate decision making is the Executive Committee of the relevant entity. If the IP holding company exercises control over those important functions through its Executive Committee, the control test should be met.

It is conceptually incorrect to relate intangible ownership to contract research and development arrangements. Thus, TEI agrees with Paragraph 9.23 of the OECD Transfer Pricing Guidelines, which provides that "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 other party." TEI urges the OECD not to depart from the definition of control in Chapter IX of its transfer pricing guidelines.[13]

Moreover, even in the absence of the technical capability necessary to assess the outcome of outsourced activities at the IP holding company level, intangible ownership of an IP holding company should not be disputed as long as control is exercised by the company's Executive Committee. Control in such circumstances can be demonstrated by the negotiation and approval of the yearly budget and periodic reporting on deliverables.

Further, contribution to intangible development should not be confused with leadership and control. Because it is within the entrepreneurial decision making of the IP holding company to trust or not trust the outsourced parties with varying levels of control, tax authorities should not challenge the entrepreneurial function and controlling role of the IP holding company. If the IP holding company is satisfied with a lower level of control over the many players who contribute to intangible creation or maintenance, that should not be a reason

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[13] *See* paragraphs 9.23-24, and 9.29 of Chapter IX.

for tax authorities to dispute the ownership of the intangible asset and the entitlement of the IP holding company to the returns therefrom. A high degree of outsourcing and willingness to concede some control to others does not mean that ownership is spread among the different contributors. In this respect, the arrangement is similar to that seen in venture capital or private equity funds, where the investors turn over day-to-day control to the managers of the funds, but nevertheless retain the vast majority of the return on those assets.

Paragraphs 83 and 84 discuss funding and risk generally, and note that bearing the funding risk for development of intangible assets entitles the bearer to no more than a risk-adjusted rate of anticipated return on invested capital. We believe this statement should only apply to cases where legal ownership is questionable after application of the contractual analysis discussed above. In a market economy, funding normally coincides with risk-taking. Depending on the circumstances, the anticipated return on capital invested in IP development should be the same as for a venture capitalist, *i.e.*, an exceptional return or a complete loss. It is therefore very difficult to determine the anticipated compensation in the case of risk capital invested in IP. These paragraphs should be revised to recognise that funding matters immensely in the functional analysis.

Paragraph 89 states that "the legal owner of an intangible is entitled to all returns attributable to the intangible only if, in substance," the legal owner satisfies certain factors. TEI recommends those factors should be written as follows:

- The legal owner controls important functions related to the development, enhancement, maintenance and protection of the intangibles; this also includes the outsourcing of those functions to independent enterprises or associated enterprises (duly compensated on an arm's length basis); control means at the minimum the acceptance and the control by the legal owner of the budget and objectives set on a yearly basis for the functions in charge of those activities; and

- The legal owner bears and controls all risks and costs related to the development, enhancement, maintenance and protection of the intangibles.

Section B.4. Application of the foregoing principles in specific fact patterns

With respect to the discussion of the development and enhancement of marketing intangibles, we recommend that "the bargaining position of the distributor" be added to the four criteria set forth in paragraph 95. That is, what would the sales and profitability of the distributor be on a standalone basis without access to MNE branded products and other intangibles? If there is little or no alternative option for distributor, the local marketing intangibles (if any) should be of very limited value and should not be compensated separately.

Paragraph 96 states in part:

> For example, a distributor may have the ability to obtain benefits from its functions performed, assets used, risks assumed, and costs incurred in developing the value of a trademark from its turnover and market share when it has a long-term contract providing for sole distribution rights for the trademarked product. In such a situation the distributor's efforts may have enhanced the value of its own intangibles, namely its distribution rights.

This statement should be more nuanced. To avoid confusion, the OECD should first state that the transfer pricing on goods should normally reflect local marketing intangibles of a distributor. It is rare to recognise non-routine and long-term marketing intangibles at the distributor level independently from the group brand, network, and reputation, even when the distributor has a very long term distribution relationship with the group. Normally the transfer pricing on goods sold by the distributor should already include local marketing intangibles in the distribution margin (the TNMM approach). In that case, there are no valuable marketing intangibles at the local level.

The last sentence of paragraph 97 states that "[c]ompensation based on a reimbursement of costs plus a modest mark-up will not reflect the anticipated value of or the arm's length price for the contributions of the research team in all cases." This statement is incorrect and should be eliminated since it does not reflect the principles and nuances set forth in the first sentence of that paragraph. It would be better to state first that contract research and development usually entails no risk taking for the service provider. Hence, cost plus compensation should normally meet the arm's length principle.

We disagree with the conclusion of paragraph 99 setting forth a general rule that no payment should be recognised for transfer pricing purposes for "simple recognition of group membership or the use of the group name merely to reflect the fact of group membership." As indicated in our comments under paragraph 19, there is usually a benefit for the use of the group name (which is generally also the brand name). The arm's length principle consists of testing how the parties would behave on a standalone basis. Access to the MNE name should be duly compensated.

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

We recommend that paragraphs 130-132 also include the respective bargaining power of each party as a consideration in setting the transfer price. In many MNEs, it is generally the case that – on a standalone basis –many active local affiliates have little or no bargaining power.

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

Paragraphs 171-175 discuss valuation techniques. TEI agrees that valuation techniques can be useful to benchmark one-off and isolated transactions, like the disposal of an intangible. However, valuation techniques cannot supplant the five transfer pricing methods for assessing standard transactions.

Expectations of future benefits are specified as a comparability factor by paragraph 145, but the earlier section of the Draft that discusses other factors (such as location savings) does not mention this concept. Although theoretically it could be said that intangibles that are comparable in other factors, but have different expectations of future benefits, are not comparable, in practice the question is not that simple. First, different parties in the market can have widely varying expectations of future benefits, even if all other aspects of the intangible are the same. In addition, comparability factors are intended to provide practical guidance in the search for comparable transactions or entities. However, most companies consider their internal assessment of expectations of future benefits a commercial or trade secret, and thus information on such expectations is not readily available. Therefore, this comparability factor is purely theoretical and does not contribute added value to the practical application of the normal comparability factors. We recommend the OECD exclude it from the Draft.

Paragraphs 168-169 and 181-186 discuss the struggles that arise in devising transfer prices for hard to value intangibles. TEI agrees that additional guidance regarding these assets is needed – for example, it is often quite difficult to get a reliable forecast of future revenue and development costs required to complete partially developed intangibles. Such a forecast is even more difficult to obtain if the revenue and costs are split by legal entity or if the intangible is subject to continuous development or enhancement. Thus, guidance from the OECD in this area would be welcome, including examples of how the profit split method would apply in such circumstances.

Section D.3. Arm's length pricing when valuation is highly uncertain at the time of the transaction[14]

In paragraph 199, the OECD recommends determining what an independent enterprise would do in situations where valuation is highly uncertain at the time of the transaction ("reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.") However, it may be difficult to determine what an independent enterprise would do – there may be different alternatives available and each independent enterprise may opt for a different alternative. Is the OECD suggesting that the taxpayer must hypothesise and analyse each potential

[14] Id. at pages 47-49.

alternative? Some additional clarification of what is expected of taxpayers in this regard would be very informative.

Paragraph 205 discusses price adjustment clauses and refers to "unforeseeable subsequent developments" that are "so fundamental their occurrence would have led to a prospective renegotiation of the pricing of a transaction . . . ." That is, "if independent enterprises" would have insisted on such a clause or renegotiated the price due to the subsequent development, then the tax administration should be able to modify the price in the contract.

The problem with this proposition is that it is impossible to know whether independent parties would have insisted on changing the prices of the contract. Such decisions are based on the parties' intent, their risk profile and relative negotiating power. Thus, any "re-set" of the intent of the parties with hindsight by one tax authority to the detriment of the other will almost certainly lead to double taxation. This clause could therefore lead MNEs to include a renegotiation clause in all intra-group contracts out of fear of abuse by tax authorities, independent of what third parties would have done. If, for practical reasons, the OECD wants to depart from the arm's length principle by introducing a "commensurate with income" standard, it should state it clearly; otherwise, the OECD Transfer Pricing Guidelines will lose their credibility. Regrettably, a departure from the arm's length standard will increase uncertainty and controversy.

Examples in the Revised Discussion Draft

The examples in the Revised Discussion Draft are, perhaps by necessity, based on simplified facts patterns and thus their practical use is limited. In MNEs, there are different levels of (formal) decision making and different levels of preparatory work (without formal decision making), both of which can be exercised in different places. Many of the examples in the Draft are therefore difficult to comprehend or apply in practice.

Examples 13 & 14

Examples 13 and 14 indicate that some country delegates believe the illustrated transactions should be disregarded or recharacterised because they would not normally occur between independent enterprises. Authority to disregard or recharacterise transactions for this reason should only be used in exceptional circumstances to avoid the substantial uncertainty such use would create. Therefore, additional guidance is needed on when transactions should be disregarded or recharacterised. It has long been accepted that associated enterprises may engage in transactions for legitimate business reasons, even if such transactions would not ordinarily occur between independent enterprises.

For example, this occurs where partially developed intangibles are transferred to an associated enterprise because the associated enterprise has the people with the expertise needed to complete the development of the intangible. Therefore, while it may be difficult to determine what an independent enterprise would do, it is not appropriate to disregard or recharacterise the transaction itself.

Example 16

TEI submits that the example reaches the conclusion in paragraph 284 without conducting an analysis of the contractual arrangement between the parties. That analysis could be conducted as follows:

- If the initial distribution agreement from Ilcha to Company S had reached its term, and Company S was compensated during the life of that agreement in accordance with the risk and term of that contract, then Company S would not be entitled to any compensation. It would then be a matter between Ilcha and Companies T & U to determine how to structure their relationship and an initial goodwill payment by Companies T & U to Ilcha would only be payable if it is in accordance with the risk profile the parties have decided for their future relationship.

- If the initial distribution agreement from Ilcha to Company S had not reached its term, or if Company S was compensated during the life of that agreement in accordance with the risk and term of that contract, then Company S would be entitled to compensation. TEI nevertheless submits that it is actually Ilcha that owes this compensation to Company S. It would then be a matter between Ilcha and Companies T & U to determine how to structure their relationship and an initial goodwill payment by Companies T & U to Ilcha would only be payable if it is in accordance with the risk profile the parties have decided for their future relationship.

Example 17

TEI submits that the hypothetical in Example 17 is very unusual and unlikely to occur. In nearly all cases, the interposition of Company S must have a business purpose, which likely would be reflected by Company S performing functions.

TEI agrees with the OECD that a price reduction from Första to Company S seems unwarranted. If the prices between Första and its distributors were arm's length before Company S was interposed, and the functions and risks of Company S and the distributors were not altered in later years, the pricing from Första to Company S should, absent other factors, remain unchanged.

The real question, however, is whether a price increase from Company S to the distributors should be made some time after Company S has incurred the risk of absorbing marketing costs from the distributors. Between third parties, the allocation of the financial risks is an important factor for determining remuneration. Third party transactions where an investor lets someone else control its investment in exchange for the future returns on the investment are common. If, for practical reasons, the OECD wants to depart from the arm's length standard on this particular point, it should state so clearly.

Example 19

In this example, TEI agrees that compensation is to be paid by Company S to Zhu for the rights in the software and for the service. The real question is the amount of the compensation and what form it should take. TEI recommends the example incorporate the principles of the following discussion:

- While the compensation for the rights in the software is "easily" fixed based on existing OECD guidance, the compensation for services needs to be reviewed based on the new draft OECD guidance regarding assembled workforce (*i.e.*, is this service sufficiently remunerated via a secondment fee or is an additional fee due for the provision of an assembled workforce). We fear that providing this example together with the guidance on assembled workforce in the body of the Revised Discussion Draft may lead tax authorities to conclude that assembled workforce is almost always transferred any time a secondment of employees takes place. TEI submits that a normal secondment fee should be sufficient.

- Example 19 involves remuneration for the rights in the software and the services of the employees. It is common, however, for third parties to agree on a royalty agreement for software that includes the provision of a specialist team to support the software without separately stating a fee for the specialists. TEI urges the OECD to clarify in its guidance that the overall amount of remuneration should be assessed by tax authorities and that the absence of a separate remuneration for the provision of seconded employees or an assembled workforce does not call for an adjustment as such compensation may be embedded in the royalty.

Conclusion

The arm's length principle balances the rights, duties, and risk allocations reflected in contractual relationships and TEI strongly believes that it aligns related party transactions with unrelated ones. With respect to intangible assets, it is even more important to respect contractual arrangements because an intangible asset is generally a monopoly established by law.[15]

In a fact-based matter like transfer pricing, and even more so for intangibles, there is a large incentive for the tax authorities to make unprincipled adjustments by departing from key principles without regard to the double taxation consequences. Because it appears that double taxation, once it arises, cannot be efficiently solved by national or international bodies or the current incarnation of the MAP process – and is becoming more difficult to address – the OECD should draft guidelines that reduce the risk of unprincipled adjustments, and therefore of double taxation, in the first place.

The Revised Discussion Draft (Chapter VI) brings a paradigm change to the OECD Transfer Pricing Guidelines by clearly deviating from the key principles already provided in Chapters I-III and IX of the Guidelines. Regrettably, the new wording of Chapter VI may encourage some tax authorities to issue unilateral transfer pricing adjustments that are not aligned with the arm's length principle. In our view, the arm's length principle, when properly applied, cannot be manipulated to satisfy the unilateral ambitions and needs of governments or taxpayers.

TEI regrets the lack of dialogue and mutual administrative procedures between tax authorities; if applied in an efficient and timely manner, they would considerably neutralise the unilateral or one-sided adjustments made by each tax authority in the context of transfer pricing corrections. If tax authorities at both ends of an international transaction would make the intellectual and technical investment to capture the legal and economic reality of transactions among associated enterprises, many transfer pricing questions would be solved or not arise in the first place. The absence consistency across countries in their domestic laws and the lack of international administrative cooperation, however, cannot be solved by diluting the underlying standard of the arm's length principle.

We appreciate that it is difficult to defend a cohesive and rigorous application of the arm's length principle. The mission of the OECD, however, should be to stand firm on the principle, which is embodied in Article 9's respect for the contractual arrangements of the parties, and to draft guidelines that reinforce this principle instead of creating exceptions to it.

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[15] *See, e.g.*, Henshall, *Difficult questions around "recharacterisation"*, Transfer Pricing International Journal (21 August 2013) ("Intellectual property is critically dependent on the legal arrangements that are established between the parties, because intellectual property is a monopoly established by law over the exploitation of an idea, be that a patent, copyright, a business secret or any other form of intellectual property. To ignore the legal position is to step away from the reality of the transaction and to replace that with a fiction.").

Contact Information

TEI appreciates the opportunity to comment on the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. If the OECD believes our participation in the announced public consultation is warranted, we would be pleased to do so.[16] These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Alexander Kölbl, and the Transfer Pricing Subcommittee of TEI's European Direct Tax Committee, whose Chair is Alain Berlier. If you have any questions about the submission, please contact Mr. Berlier at +41 79 201 21 79, alainberlier@hotmail.com or Benjamin R. Shreck of the Institute's legal staff, at +1 202 638 5601, bshreck@tei.org.

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TAX EXECUTIVES INSTITUTE, INC.

Terilea J. Wielenga
International President

[16] TEI has participated in several previous OECD public consultations regarding transfer pricing, most recently in November 2012 with respect to the proposed revisions of the section on Safe Harbours in Chapter IV of the OECD Transfer Pricing Guidelines.