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COMMENTS ON THE REVISED DISCUSSION DRAFT ON TRANSFER PRICING ASPECTS OF INTANGIBLES

1 INTRODUCTION

I refer to the revised discussion draft on transfer pricing aspects of intangibles issued 30 July 2013 (the Draft). With this document I respectfully submit my comments on the Draft.

I am currently pursuing a PhD in tax law. I work as a research scholar at the Department of accounting, auditing and law at the Norwegian School of Economics (NHH). The comments below solely reflect my personal opinions on the matters discussed, and do not in any way purport to convey the opinions of NHH.

My comments are divided into three parts. First, I will comment on the guidance contained in the Draft pertaining to the selection of the most appropriate transfer pricing method for intangibles, cf. Section 2. My focus will be on the availability of the TNMM under the proposed guidance. Second, I will comment on some selected points under Section 3; i) on inconsistencies between the guidance of the draft and the examples, ii) on the "*reasonably foreseeable*" limitation for the profit split method, and iii) the proposed guidance on workforce in place. Third, I will comment on some of the examples drawn up in the Draft, cf. Section 4.

2 SELECTING THE MOST APPROPRIATE TRANSFER PRICING METHOD FOR PRICING OF INTANGIBLES (PARA. 149-136)

The stand of the current transfer pricing guidelines (TPG) is that the transfer pricing method most appropriate to the circumstances of the case should be chosen.[1] While this point of departure in principle is recognised and retained by the Draft,[2] the proposed language seems biased towards use of the profit split method for transfer pricing of intangibles. Para 163 states that "*the transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method*".

[1] TPG, Para 2.2.
[2] Draft, Para 149 and 154.

The emphasis of the Draft on similar profit potential and expectation of future benefit as comparability requirements for intangibles,[3] as well as its scepticism towards comparability adjustments for purportedly comparable transactions pertaining to unique intangibles,[4] will further reduce the relevance of the CUP method for transfer pricing of intangibles relative to the profit-based methods. On several points, the Draft also suggests or states that transfer pricing methods relying on comparables may not be applicable for transfer pricing of unique intangibles.[5] Further, the increased focus on performance and control of functions invites application of the profit split method.[6] In sum, the Draft clearly seems to point towards the profit split method as the *de facto* method for transfer pricing of unique intangibles.

In my view, the above approach has a firm basis in seeking to realize the substance view expressed in Para 36 that "*the key consideration is whether a transaction conveys economic value from one associated enterprise to another*" and is therefore commendable.[7] However, I do not agree with the Draft on the role envisioned for the other profit-based method; the TNMM. I will elaborate on this stand in the following.

Several statements in the Draft, all leading up to the "conclusion" in Para 163, either tones down the relevance, or discourages application, of the TNMM for transfer pricing of intangibles.[8]

First, at the end of the new guidance for functions related to intangibles, Para 81 of the Draft sums up that "*the reliability of a one-sided transfer pricing method will be substantially reduced if the party performing the important functions is treated as the tested party*". The TNMM is of course only meant to be applied in cases where only one of the parties to the transaction makes unique and valuable contributions.[9] In that context, the tested party will be the party performing the standard functions, which will only be allocated a normal return. The residual profit connected to the intangibles will in its entirety be allocated to the examined, and non-tested, party. The meaning of the quoted language of Para 81 is therefore not immediately intuitive, as it essentially states the obvious fact that the TNMM will not be reliable in a situation for which it was not meant to be applied at all. This point will also apply to all transfer pricing methods recognised by the TPG; they should only be applied when appropriate given the facts and circumstances of the concrete case. I therefore have difficulty in seeing exactly what Para 81 seeks to express here.

Along the same lines as Para 81, but significantly more forceful, Para 159 states that "*one sided methods, including the resale method and the TNMM, are generally not reliable methods for directly valuing intangibles…*". The quoted and following statements in Para 159 triggers several questions.

First, the distinction between directly and indirectly valuing intangibles is not clear. It is not elaborated what is meant by "*directly valuing intangibles*". Both the TNMM and the profit split method fundamentally rely on first allocating a normal return to standard functions before

[3] Id., Para 134 and 145.

[4] Id., Para. 147.

[5] Id., Para. 147, 149, 156, 159, 164.

[6] Id., Para. 74, 75, 80, 81, 90.

[7] Para 150 also emphasizes the importance of considering the economic consequences of the transaction when selecting a transfer pricing method.

[8] This approach is also emphasized by the fact that the Draft only contains supplemental guidance for application of the CUT and profit split methods for transfer pricing of intangibles; no such guidance has been prepared for the TNMM, cf. Para. 164-170. Cf. also the statement made in the last sentence of Para 170 that *de facto* seems to pertain to the TNMM.

[9] TPG, Para. 2.59.

allocating the residual profits. In principle, the difference between the profit-based methods is that under the TNMM, the residual profits are in their entirety allocated to one of the parties to the controlled transaction, while the profit split method divides the residual profits among them. Thus, both methods "*indirectly value intangibles*" in the language of Para 159. In this regard the TNMM is no different from the profit split method.

Second, Para 159 seemingly only allows application of the TNMM in "*some circumstances*", without elaborating on what such circumstances might be. An important background for the assessment of whether the TNMM should be applicable is that the method in deed has a narrow field of application. It can only be applied where one of the parties to the controlled transaction solely carries out standard functions. If this is not the case, but both parties contribute unique inputs, then the profit split method should be applied. Given that the TNMM as a point of departure already is a narrow method, it is not immediately intuitive whether the third sentence of Para 159 seeks to further narrow the field of application for the TNMM.

My impression is that the proposed language does in deed intend to do so. This interpretation is supported by the fourth sentence of Para 159, which refers to Para 151, and states that if the TNMM is applied, then "*all functions, risks, assets and <u>other factors</u> contributing to the generation of income are properly identified and evaluated*" (my underlining). This sentence seems to indicate that a normal market return for standard functions carried out by a local contract manufacturer or low risk distributor will no longer be sufficient, as such entities shall also be rewarded for "*other factors*". This triggers questions both from a principal and technical point of view.

I will comment on the principal point of view first. In my opinion, it is not clear why the TNMM should not be applicable in "plain vanilla" cases, where manufacturing intangibles are licensed to a local contract manufacturer, or marketing intangibles are licensed to a low risk distributor? Where the licensee only performs standard functions, there does not seem to be any rationale for allocating more income to the licensee.

Also, if access to the TNMM was cut off in such plain vanilla scenarios, MNE's could likely be better off by outsourcing the manufacturing and distribution functions to unrelated parties willing to perform the relevant standard functions for a normal market return, i.e. without claiming a portion of the residual profits. Yes, the MNE would then forego the normal profits that it otherwise would earn through its local manufacturing of distribution entities, but it would be able to keep the entire residual profits. Transfer pricing rules should seek to attain parity between controlled and uncontrolled transactions. If the TNMM is made unavailable, MNE's may for transfer pricing purposes be forced to accept conditions that are less favourable than those available between unrelated parties.

Second, the proposed limitation is not technically clear. Para 159 refers to Para 151, which in broad language lists a variety of factors to take into consideration – and presumably remunerate -, such as "*risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others*". Some of these factors are elaborated on in the Draft under the proposed amendments to Chapter I-III.[10] The main message I take away from reading Para 1-34 of the Draft is that identifiable location savings shall be remunerated, as shall other local market features, but that synergies likely will not be a large issue in practice. I will further comment on this below.

Location savings seem least problematic to identify, as this pertains to concrete cost savings. There is also a tradition in transfer pricing jurisprudence to separately remunerate such factors under profit-based methods. For instance, the US tax court while applying the profit split method in

[10] Draft, Para. 1-34.

the seminal transfer pricing case *Eli Lilly* allocated cost savings along with a normal contract manufacturer return to the foreign manufacturing subsidiary in Puerto Rico.[11] Remuneration for costs savings should be compatible with the TNMM, as such savings will not be allocated residual profits from intangibles.

Local market features seem more problematic to remunerate under the TNMM, as these generally will refer to the income side of the equation, making them hard to separate from the value of the unique intangibles at play in the value chain. This also has a strong side towards the potential existence of local marketing intangibles that should be awarded under the profit split method. An important point is here that if the manufacturing or distribution entity is in possession of unique intangibles then the TNMM will not be applicable. The relevant question is therefore, with respect to the TNMM, only whether local market features that decidedly should not be regarded as marketing intangibles should be remunerated, and with how much?

If the answer to this question is yes, and that the market features should be compensable with a “normal return”, that would not necessarily be incompatible with the TNMM as we know it. However, if the answer is yes, and that the market features should be compensable with a part of the residual profits, then the TNMM would essentially no longer be applicable for transfer pricing of intangibles. Of course, in practice it will be highly problematic to separate these two scenarios from each other, as the return allocable to the local market features will be difficult to separate from a split of the residual profits from intangibles; essentially transforming an application of the TNMM into a profit split method. This will at least likely be the case for large market jurisdictions where the market features are more clear, and perhaps less likely for smaller markets with average customer demographics etc.

I do not see the issue of compensating MNE group synergies, as described in Para 18-23 and exemplified in Para 24-33 of the Draft, as a potential problem for the application of the TNMM. Such synergies will only to a limited degree be compensated. Also, when subject to compensation, they shall be remunerated on a stand-alone basis, and not attract a part of the residual profits from intangibles.

However, Para 151 does not stop with cost savings, market features and synergies. Also “*risks borne*” and “*business strategies*” and “*others*” are mentioned as factors that may attract compensation. In my view, this language is too broad.

First, it is not clear what items are to be compensated. The inclusion of “*others*” entails a general uncertainty as to what factors may attract remuneration. Also, “*business strategies*” should in my view not in and of itself be subject to compensation. Of course, the strategies of an MNE will result in functions and assets and risks that are compensable, such as costly R&D efforts that produce unique intangibles, but that is a different matter entirely. “*Risks borne*” presumably refers to financial risk, but this is not clear under the broad language.

Second, in cases where the mentioned factors are to be remunerated, it is not clear under which principles income to them shall be allocated. A decisive question is here whether the Draft envisions that the factors to be remunerated shall be allocated some form of “normal return” or whether they shall be allocated a portion of the residual profits from unique intangibles. With respect to the factors “*others*” and “*business strategies*”, an answer to the question will necessarily first require an elaboration of what is referred to by these terms. With respect to “*risks*”, it is my opinion that financial risk should be rewarded a financial return commensurate with the risks

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[11] 84 T.C. 996 (1985).

taken, as determined in accordance with prevailing financial principles; not attract a part of the residual profits from intangibles.

In sum, it is my view that further development of the proposed language contained in the Draft is necessary in order to clarify the role of the TNMM.[12] Most significantly, it should be clarified what other factors associated with a "plain vanilla" contract manufacturer subsidiary or low risk distributor, apart from its performance of low risk and standard functions should be compensable, and whether such other factors should attract part of the residual profits from intangibles. If such factors should attract part of the residual profits from intangibles, the TNMM will essentially be abolished.

As the Draft language stands now, the question is to what degree the TNMM may still be applicable. There can be no doubt that the Draft seeks to reduce the importance of the TNMM. I am not convinced that this approach is useful in a *de lege ferenda* perspective.

From the fiscal perspective of local jurisdictions in which group contract manufacturers or low risk distributors operate, a profit split approach would be preferable to the TNMM, as it would open up the possibility of attracting something more than just a normal market return on the standard functions performed by the local entities. The popularity of the TNMM among MNE's in common principal models etc. accentuates this perspective.

However, from the perspective of the jurisdiction in which valuable and unique intangibles are developed, the case would be the opposite. Inapplicability of the TNMM could enable profit shifting.

The background for introducing the TNMM in the 1995 TPG was of course the US Basic Arm's Length Return Method (BALRM) as it was introduced in the 1988 White Paper,[13] or the Comparable Profit Method (CPM) as it was named in the 1994 Final Treasury Regulations.[14] The US method was developed as a weapon against aggressive profit shifting of income from US developed intangibles to foreign manufacturing and distribution subsidiaries located in tax favourable jurisdictions. The CPM continues to play a key role in US transfer pricing law, as recently confirmed by the final cost sharing regulations,[15] where the CPM is operationalized for a cost sharing context through the income method.[16] From its introduction in 1988 to the final cost sharing regulations in 2011, the logic of the CPM remains the same; an entity only providing standard inputs should not be entitled to any of the residual profits from unique intangibles.

Given the language of Para 159 and 163 of the Draft, it is questionable to what degree the TNMM is applicable in cases where intangibles are transferred from the jurisdiction in which it was developed to foreign manufacturing and distribution subsidiaries, regardless of whether the transfer is carried out through a licensing structure, a cost sharing agreement or in a restructuring scenario. If the TNMM would be inapplicable, this could of course lead to exactly the sort of profit shifting that the CPM originally was created to address, not to mention potential issues connected to corresponding adjustments under Art 9 (2) of the OECD Model Treaty.

[12] My comments pertaining to Para 151 of the Draft are also relevant for the profit split method; it should be clarified what factors should attract compensation, and whether or not such factors should attract residual profits from intangibles in order to make the profit split method practicable.

[13] Notice 88-123.

[14] 59 F.R. 34971-01.

[15] 76 F.R. 80082-01.

[16] Treas. Reg. § 1.482-7(g)(4).

Traditional transfer pricing jurisprudence enunciates that a concrete analysis of functions performed, assets used and risks incurred should decide the allocation of residual profits from unique intangibles. In “clean cut” cases involving contract manufacturers and low risk distributors, such an analysis would indicate that the unique value drivers lie with the examined party, and not with the tested party only performing standard functions. In such cases, the TNMM should be applied; allocating all residual profits to the examined party that provides the real value to the transaction. It is not clear why this logic should no longer be applicable. However, the Draft leaves doubt as to whether this is the case.

From a bird’s-eye view, there seems to be a conflict of interests with respect to application of the TNMM between jurisdictions in which unique and valuable intangibles are developed and jurisdictions in which the products based on the intangibles are manufactured and sold. Jurisdictions in which unique intangibles are developed need transfer pricing tools to protect against profit shifting. In this respect, the continued availability of the TNMM is essential. At the same time, from the perspective of local jurisdictions where manufacturing and marketing functions are performed, the TNMM ensures only a normal return on the functions performed there. This system will at least in theory, if properly applied, ensure that the residual profits from intangibles are taxed to the jurisdiction in which they were developed. In my view this is sound, but of course ultimately a matter of stand on policy.

In my view, the TNMM should apply with full strength in the narrow circumstances for which it was intended; where one of the parties to the controlled transaction only performs standard functions. An alternative for allocating more income to low risk distributor jurisdictions could possibly be to further develop the guidelines with respect to when the marketing activity of the local distributor entitles it to a share of the residual profits connected to the marketing intangibles in a more lenient way than indicated by Examples 5-10.

3 COMMENTS ON SELECTED POINTS

3.1 Inconsistency between proposed guidance and examples

The proposed guidance pertaining to the TNMM, as discussed above under Section 2, does not seem entirely compatible with the proposed examples contained in the Annex of the Draft. Several of the examples either rely on an application of the TNMM, or refer to the TNMM as an option for pricing, seemingly contrary to Para 163. In these examples, the subsidiary only gets a normal return on its standard functions; no additional “Para 159/151”-return for cost savings, market features, strategy etc. is provided. The residual profits from unique intangibles are allocated to the other party to the controlled agreement.

This seems to be the case for:

- Example 1, cf. Para 227.
- Example 2, cf. Para 230.
- Example 3, cf. Para 232.
- Example 4, cf. Para 236 (given that the true nature of the parent-subsidiary relationship is deemed to be a limited risk distribution relationship).
- Example 5, cf. Para 242.
- Example 6, cf. Para 246.
- Example 7, cf. Para 250, first bullet point.
- Example 11, cf. Para 265.
- Example 17, cf. Para 289.
- Example 24, cf. Para 317.

I will comment further on the proposed examples under Section 4.

3.2 The "*reasonably foreseeable*" limitation for the profit split method

Para 166 of the Draft states that the guidance contained in Para 2.108-2.145 of the TPG concerning the profit split method shall still apply. That guidance limits the application of the profit split method to profits that were "*known or reasonably foreseeable*" at the time of the transaction.[17] As the Draft has increased the general relevance of, as well as the complexity of applying, the profit split method for pricing of intangibles, further guidance should be given on the limitation contained in the TPG. I assume that this issue will be a part of the pending work on Para 199-206 of the Draft.

3.3 Workforce in place

Para 14-17 and Example 18 of the Draft provides guidance with respect to assembled workforce. Para 17 states that "*access to an assembled workforce with particular skills and experience, may in some circumstances, enhance the value of the transferred intangibles or other assets, even where the employees making up the workforce are not transferred*". In cost sharing and business restructuring cases, the combination of a transfer of early-generation intangibles along with on-going access to the talented researchers that produced the pre-existing intangibles is a key issue. Due to the significance of the problem in a profit shifting perspective, the Draft should elaborate on the determination of an arm's length value for such a combined transfer of early-generation intangibles and access to a workforce in place.

As it stands now, Para 15 of the Draft indicates that the value of a workforce in place may consist of the savings for a transferee with respect to "*the time and expense of hiring and training a new workforce*". Of course, such a point of departure is unrealistic in cases where the workforce in place that is made available (without transfer of the employees as such) to another group entity consists of a unique collection of extremely talented and innovative individuals with special training and skills, track-record, reputation, work culture etc. The realistic alternative for the transferee in such cases would be to not gain access to the unique workforce. Often, such workforces may have high market values and significant "brand names" in the market. This is for instance common within the software industry, where specific development teams are the key value drivers for specific product groups. Affiliation with such teams may comprise an essential part of the competitive advantages of R&D-driven MNE's.

A realistic view may therefore often be that if such unique teams, typically in combination with the transfer of early-generation intangibles, are made available to other group entities, the arm's length price should be one that commands the entire residual profits from the transferred intangibles and the entire or a portion of the residual profits from any intangibles developed on the basis of the transferred early-generation intangibles.[18] My view is therefore that the current language of Para 17, where it is stated that an assembled workforce with particular skills may "*enhance*" the value of transferred intangibles does not sufficiently convey the magnitude of value that *de facto* may be transferred in such scenarios, particularly if read in the context of the statements made in Para 15. Further development of the proposed language on this point would be in line with Para 36, which states that the "*key consideration is whether a transaction conveys economic value from one associated enterprise to another*".

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[17] TPG, Para 2.130. Given the methodological similarities between the two profit-based pricing methods, the limitations for the profit split method are presumably also applicable to the TNMM.

[18] Cf. Draft, Para 194, that indicates that cash flows from future intangibles could be attributed to a «base» intangible.

I also refer to my comments on Example 18 below.

4 COMMENTS ON THE PROPOSED EXAMPLES

4.1 Example 1

It should be clarified whether the result of Example 1 is a consequence of non-recognition of the transfer of intangibles or due to pricing. In my view, the latter should be the case. In principle, the transfer of intangibles to subsidiary S should trigger an arm's length charge, the amount of which should only enable the subsidiary to make a normal return on its standard functions. This would also ensure consistency with Example 2.

4.2 Example 3

Subsidiary S sells the intangibles to unrelated parties after a few years, realising a gain due to appreciation of value during its term of ownership. The conclusion of the example is to deny subsidiary S any part of "*the returns attributable to the intangibles*".[19] This solution does not seem consistent with Example 2.

In Example 2, the price charged for the transfer of intangibles was based on anticipated royalties from an alternative use through licensing less an appropriate normal return for the functions performed by subsidiary S. As long as that charge genuinely reflected an arm's length valuation at the time of transfer, there should be no basis to adjust the pricing as such, unless this was done on the basis of the periodic adjustment rule contained in Para 199-206 of the Draft. If so, the Example should clarify that the periodic adjustment rule is in fact applied here.

4.3 Example 7

In this example,[20] the subsidiary incurs costs in its market development functions that "*far exceeds*" those of comparable uncontrolled marketing and distribution agreements, causing lower profit margins for the subsidiary than those of unrelated marketers/distributors. The example proposes an adjustment to compensate for the additional costs of the subsidiary.

First, the adjustment is proposed to be carried out either by way of the resale method or the TNMM (first bullet point) and the cost plus method (third bullet point). These methods are consistent; an application of them will result in an allocation of the intangible related income to the parent company. Second, the residual profit split method is proposed (second bullet point). This approach fundamentally differs from those proposed above, as the profit split method will allocate part of the intangible related income to the distribution subsidiary.

In my view, it seems inconsistent that one is offered a choice between the resale, cost plus and TNMM on the one side and the profit split method on the other side, when the solution with respect to allocation of intangible related income likely would differ significantly between the two proposed sides. The example should clarify whether the subsidiary is entitled to any residual profits from intangibles.

4.4 Example 8

In this example, the distribution subsidiary enters into a short term agreement that it cannot benefit from. The parent company however, benefits from the local marketing activities of the subsidiary.

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[19] Id., Para. 232.

[20] The point of departure is that the distribution subsidiary was not entitled to intangible related returns in Examples 5 and 6. Examples 5-10 illustrates the guidance in Para 94-96.

As a result of the short term nature of the agreement and the level of marketing expenditures, the subsidiary experiences significantly lower profit margins than comparable unrelated enterprises.

In my view, it is not clear whether the proposed adjustments entitle the subsidiary to intangible related returns. The first proposed adjustment, a *"…compensation … for the anticipated value created through the marketing expenditures and market development functions*", does in deed indicate that the subsidiary is entitled to a part of the residual profits from the intangibles. The focus of the text is on the value created and not on costs incurred.

On the other hand, the second proposed adjustment does not seem geared towards providing the subsidiary with residual profits. It is stated that the adjustment could be in the form "*of a reduction in the price paid by*" the subsidiary to the parent for watches during Years 1 through 3. Given that Example 8 builds upon Example 6, it seems likely that the reduction in price would only go so far as to provide the subsidiary with a normal return on its functions, not to provide it with any residual profits from intangibles. The example should clarify whether the subsidiary is entitled to any residual profits from intangibles.

4.5 Example 9

This example is clear, but I will comment that the introduction of a royalty in a context where the subsidiary only makes a normal return on its functions seems somewhat out of place. When the starting point is small, normal profits, a royalty would of course cause excessive negative results.

4.6 Example 10

The parent company outsources its manufacturing function, and the distribution agreement between the subsidiary and the parent is renegotiated as a result. Para 262 states that consideration should also be given to whether the subsidiary should have received "*compensation in connection with the renegotiation of the agreement at the end of Year 3*".

I find this statement somewhat problematic. Example 10 builds upon Example 7,[21] in which the subsidiary only made a normal return on its standard functions. In order to be consistent with Example 7, the subsidiary should not be allocated any residual profits from the intangibles. It is therefore not clear what the proposed compensation should be for, as no residual profits are missed by the subsidiary as a result of the renegotiation.

4.7 Example 13

Example 13 builds on Example 11,[22] where the R&D-centre of the parent company controlled the dependent R&D-centre of the foreign subsidiary S. In Example 11, the parent company was "*entitled to returns attributable to the intangibles developed*" by the foreign subsidiary.[23]

In Example 13, pre-existing intangibles are transferred from the parent company to a foreign manufacturing subsidiary T. At the same time, subsidiary T enters into a contract research agreement with the parent company and subsidiary S, under which subsidiary T will fund on-going research on a cost plus basis, in return for ownership of the developed intangibles. Subsidiary T has no technical personnel, and the relationship between the R&D-centres of the parent and subsidiary S are as in Example 11.

[21] Also, the proposed solution of Example 10 for years 1-3 is the same as in Example 7. This is also the case for years 4-5, by way of reducing the royalty.
[22] Example 13 and 14 illustrates Para 76-80 and 97-98 of the Draft.
[23] Id., Para. 265.

Given that the relationship between the R&D centres are the same as in Example 11, in particular that the parent provides the unique functions and control necessary to develop the intangibles, one would expect that the allocation of residual profits from intangibles to be the same as in Example 11, i.e. that residual profits were allocated to the parent alone. The main change from Example 11 is simply that funding of the R&D-activities is routed through subsidiary T by way of a contract research agreement. However, Example 13 is not clear with respect to the allocation of residual profits from intangibles. Para 274 states that:

- The parent company is entitled to compensation for its functions for R&D, and for managing and controlling the R&D of subsidiary S.
- Subsidiary S is entitled to compensation for its research functions.
- Subsidiary T is entitled to compensation for its manufacturing function, for its investment in the acquired intangibles and for funding on-going R&D.

In my view, only the functions and assets contributed by the parent company are unique and only the parent company should command residual profits from the intangibles. Of course, subsidiary S's R&D contribution is unique, but dependent on the management and control of the parent company. The manufacturing functions performed by subsidiary T are standard functions only compensable by a normal market return. The question is therefore what return should the investment of subsidiary T in the acquired intangibles and the funding of R&D command?

In my view, this question cannot be answered properly without taking into consideration the pricing of the transfer of pre-existing intangibles from the parent company to company T. Depending on the connection between the pre-existing intangibles and future versions developed by on-going R&D, this pricing should likely be founded on the fundamental premise that the right to use the pre-existing intangibles in on-going research is a necessary platform contribution to the on-going R&D-activity, and thus forms the basis for the value of future versions of the intangible.

Such a pricing would set the arm's length consideration at an amount that would allow subsidiary T to earn an arm's length return for its cash contributions (investment in intangibles and funding of on-going R&D), but not take part in the residual profits from the exploitation of the developed intangibles.

Example 13 seemingly takes no stand in this respect. Para 271 simply assumes that the compensation paid by subsidiary T is arm's length. However, the combination of statements made in Para 274, in particular that subsidiary T is entitled to compensation for its "*investment*" and "*for funding ongoing R&D*" and "…*use of profit split methods*…", does indicate that Example 13 does not intend to allocate all residual profits from exploitation of the intangibles to the parent company.

In my view, a functional analysis supports the result of allocating all residual profits from exploitation of the intangibles to the parent company, as it contributes the unique functions and control necessary for development of the intangibles. Such a result will also be consistent with Examples 2 and 11. The example should clarify whether the subsidiary is entitled to any residual profits from intangibles.

4.8 Example 14

In this example, the R&D-performing parent transfers intangibles to subsidiary S. Pursuant to the transfer, a contract research agreement is entered into between the parent and subsidiary S, under which the subsidiary will fund the R&D to be performed by the parent on a cost plus basis. Both before and after the transfer of intangibles, all R&D is carried out by the parent. The subsidiary has no technical personnel. In my view, this example triggers two main questions:

1. What is the transaction to be priced?
2. What premises shall be applied in the pricing (TNMM/profit split)?

With respect to the first question, it is my view that the transfer pricing in this case is entirely dependent on determining the correct arm's length charge for the transfer of intangibles from the parent to the subsidiary. Para 276 simply assumes that the payment is arm's length, without any further mention, and then goes on to discuss allocation of residual profits in Para 278, as if the two issues were not connected. The arm's length charge for the transfer of intangibles will determine the allocation of residual profits from the intangibles connected to Product M. Further, if the charge for the transfer of intangibles is set to an arm's length value, there should be no need to resort to non-recognition arguments.

With respect to the second question, I cannot see any rationale for allocating residual profits to the subsidiary in this case. The arm's length charge for the transfer of intangibles from the parent company to the subsidiary should be set to an amount that would only allow the subsidiary to make a market return on its risky financial investment. Para 278 does not seem to share this view, as it is stated that the subsidiary should not be entitled to "*all of the returns attributable to the intangibles*" and that it may be necessary to "*apply profit split*" method. This view entails that the subsidiary is allocated a portion of the residual profits from the intangibles.

In my view, an analysis of the functions performed, assets used and risks incurred by the parent and subsidiary company in relation to Product M does not support the allocation of any residual profits to the subsidiary. In this case the subsidiary has no technical personnel; in essence it merely finances on-going R&D. For this financial risk it should receive an arm's length return, but not a part of the residual profits. The intangible related returns should be allocated to the party that provided the necessary unique contributions, e.g. blue sky research, R&D design, quality control etc.

Alternatively, if the pricing of the transfer of intangibles from the parent to the subsidiary was to be based on a profit split between the two companies, it should be clear and supported by a functional analysis, that the subsidiary did in fact contribute to the creation and value of the intangibles connected to Product M. In my view, this is not the case in Example 14 as it currently stands.

Further, as it stands now, the transfer pricing solution of Example 14 does not seem consistent with Example 2.

4.9 Example 16

In this business restructuring example,[24] there are several transactions. First, subsidiary S transfers tangibles to the new subsidiaries T and U. Second, subsidiary S's distribution rights in country C and D are terminated without compensation. Third, and in connection with the second transaction, new long term license agreements are entered into between the parent and subsidiaries T and U for countries C and D respectively. Combined, the three groups of transactions deploy value from subsidiary S to the new subsidiaries T and U.

The combination of the termination of the old distribution agreement and the entering into of new licensing agreements effectively transfers from subsidiary S to the new subsidiaries:

- the goodwill of subsidiary S related to its sales in country C and D, and

[24] The example illustrates Para 113 of the Draft.

- previously exclusive licenses for Product Q patents, trademarks and other marketing intangibles.

With respect to determining the arm's length charge for the transfer of the package of intangibles (goodwill, licenses previously enjoyed by subsidiary S) Para 284 does not suggest any particular premises or methods. In my view, the example should indicate whether the residual profits connected to the values created (goodwill) or enjoyed (exclusive licenses for countries C and D) by subsidiary S, through the determination of an arm's length charge for the transfer, should be allocated only to subsidiary S (TNMM-based) or split between it at the recipient subsidiaries (profit split based).

4.10 Example 18

In this example,[25] the parent company acquires unrelated company T for 100. The value of the acquired company is derived from two factors; i) the partially developed and promising intangibles (technology) and ii) the potential of the personnel of T. Subsequent to the acquisition, the intangibles are transferred from subsidiary T to subsidiary S. Also, the talented workforce of subsidiary T is made available to subsidiary S through a contract research agreement. Thus, subsidiary S will own all future intangibles developed under the research arrangement and will effectively fund the R&D efforts through the contract research agreement. Subsidiary S has a large R&D staff that approves and develops plans etc.

The example prescribes a transfer pricing assessment of the transfer of intangibles from subsidiary T to subsidiary S. In this respect, it is stated in Para 292 that "*a substantial portion of the value … may have been transferred*" and that subsidiary T should be compensated for this.

My comment pertains to the reservation that "*some portion of the value … may … have been retained*". This reservation indicates that the Draft in deed is willing to allocate a portion of the residual profits connected to the transferred intangibles to subsidiary T, by way of not demanding consideration for the part of the value that purportedly is retained by the company. I question whether it is realistic and useful to view any of the residual value to be retained by subsidiary T in this case. Para 291 makes it clear that all rights to existing intangibles are transferred to subsidiary S, which will also own future intangibles, and that "*all company T research personnel … will be devoted exclusively*" to providing R&D for subsidiary S under the control of the latter.

Under these circumstances, it is not immediately apparent what value may have been retained by subsidiary T.

First, the pricing of the transfer of existing intangibles from subsidiary T to subsidiary S should, in my opinion, fundamentally be based on the premise that all value connected to the existing intangibles has been transferred.

Second, the next question should be whether the existing intangibles should also attract income from future intangibles developed based on the transferred intangibles. Para 291 states that "*T workforce will continue to work exclusively on the development of the transferred technologies*…". If the existing intangibles will be the core of the value of also future developments, this will be a strong argument for including the residual profit from such future developments in the value of the existing intangibles when determining the price that subsidiary T is entitled to. As subsidiary T developed the existing intangibles, and will continue to develop the technology, the transfer pricing should as a starting point allocate all residual profits connected to the transfer to subsidiary T. Only if it can be demonstrated that the functions performed by subsidiary S has contributed to the

[25] Example 18 illustrates Para 116 and 165 of the Draft.

value of the future developments of the transferred existing intangibles, should a profit split be allowed.

Income resulting from intangibles from work performed under the contract research agreement connected to completely new technology, i.e. work that was not commenced at the time of the transfer and not related to the existing intangibles, should be allocated solely to subsidiary S.

4.11 Example 19

In this example, existing software technology was transferred from group company Zhu to group company S. The transferred technology "*was utilised as the foundation*" for the new technology developed by company S.[26] Also here, the question should be whether the existing intangibles should attract income from future intangibles developed based on the transferred intangibles. In my opinion, that should be the case. As the point of departure, all residual profits connected to the software system delivered to Bank B by company S should be allocated to Zhu. To the degree that company S did provide valuable modifications to the software, a profit split could be applied. However, as Para 294 states that the code in the Bank A and Bank B programs was so similar that it would "*justify a claim of copyright infringement*", it seems likely that if a profit split approach was applied, only a marginal part would be allocated to company S.

4.12 Example 22

In this example, subsidiary B transfers product M patents to parent company A for a lump-sum. The Draft only prescribes that "*valuation techniques represents the most appropriate transfer pricing method*" to determine whether the charged price conforms to the arm's length principle.

In my opinion, the draft should be more specific, as valuation per se cannot be regarded as a transfer pricing method. DCF-valuation should be regarded as a technique that may be useful in certain circumstances to operationalize - primarily profit-based - transfer pricing methods, such as the TNMM or profit split method, when determining the arm's length price for a transfer of intangibles. For example, it could be stated whether the valuation should be based on allocation of residual profits pursuant to the TNMM or the profit split method. As the manufacturing know-how and marketing intangibles are left with subsidiary B, a profit split approach based on the pricing of the entire product M business would likely be useful.

4.13 Example 23

Also here intangibles are transferred for a lump-sum. The example should give some guidance on the allocation of intangible related profits from the transferred intangibles. As it reads now, it does not. Certainly the residual profits from the existing and transferred intangibles should be allocated to subsidiary B. If the functions performed by subsidiary C in further developing the intangibles are sufficiently significant, a profit split may arguably be more suitable for allocating the residual profits from future versions of the transferred intangibles.

4.14 Example 25

This example presents 3 scenarios in order to illustrate the determination of an arm's length consideration for the transfer of intangibles connected to product F.

In the first scenario, the parent company manufactures product F based on manufacturing and marketing intangibles it has developed. The products are sold directly to local distribution subsidiaries. The parent reaps a normal return of 5% of COGS on its manufacturing function, as

[26] Id., Para. 295.

well as all residual profit related to the intangibles. The NPV for the parent is 601. The distribution subsidiaries get a normal return for their distribution functions, set to 2% of sales.

In the second scenario, the manufacturing and marketing intangibles are transferred from the parent to subsidiary S. The parent has no role in the value chain of product F in this scenario. The latter company manufactures product F and sells it on to the local distribution subsidiaries. Subsidiary S is allocated a normal return of 5% of COGS on its manufacturing functions, and reaps all residual profit connected to the transferred intangibles. As above, the local distribution subsidiaries get a normal return for their distribution functions, set to 2% of sales.

In the third scenario, the parent does not transfer the intangibles, but places the manufacturing function for product F with subsidiary S. The parent reaps all residual profits from the intangibles. The NPV for the parent is 853. Subsidiary S is allocated a normal return of 5% of COGS on its manufacturing functions, and the local distribution subsidiaries get a normal return for their distribution functions, set to 2% of sales.

Para 317 of the Draft clarifies that the realistically available options for the parent should be taken into consideration for the purpose of pricing the transfer of intangibles from the parent to subsidiary S. It is stated that the price should be set at a level that will allow the parent to reap the entire residual profit connected to the transferred intangibles. Thus, if the parent performs manufacturing functions itself, the price should be no less than an amount that would yield a NPV of 601, or a NPV of 853 if the parent places the manufacturing function with subsidiary S. The guidance in Para 317 is clear.

The language in Para 318 however is not entirely clear. The only result that will be compatible with Para 317 is a price for the transfer of intangibles which leaves subsidiary S with no part of the residual profits connected to the intangibles. It should be clarified that subsidiary S will only be entitled to a normal return on its manufacturing function. This normal profit is calculated on the basis of COGS and should be allocable solely to subsidiary S.

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Respectfully yours

Oddleif Torvik