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VIA E-MAIL

Mr. Joseph L. Andrus
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Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
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Re: TPWG Comments on Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Mr. Andrus,

We are writing to share the views of the Treaty Policy Working Group on the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, released by the OECD for comment on July 30, 2013.

The Treaty Policy Working Group is an informal association of large global companies based throughout the world, which represent a broad spectrum of industry sectors. The Treaty Policy Working Group has been working since 2005 with the OECD, and more recently with the UN, to analyze and address tax policy and administration concerns regarding transfer pricing, profit attribution, permanent establishment, and related issues that are critical to the avoidance of double taxation and the conduct of cross-border trade and investment. We appreciate the OECD's continued leadership in developing guidance on these important issues.

We recognize that the Revised Discussion Draft (RDD) reflects many changes and improvements to the initial Discussion Draft of June 6, 2012. Our comments here are directed at acknowledging those improvements as well as suggesting further consideration of areas that may conflict with the arm's-length standard, as set forth in the OECD Transfer Pricing Guidelines (TPG), or otherwise create ambiguity and heighten the risk of unrelieved double taxation.

Improvements to the RDD

We applaud the clarifications and modifications in the RDD in several areas, including:

- Confirmation that location savings, local market features and synergies are not intangibles, but are more properly thought of as comparability factors;
- Amendment to the definition of intangibles subject to transfer pricing as something "whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances";
- Clarification that not all intangibles deserve compensation separate from the payment for goods or services or generate premium returns;
- Further clarification that not all R&D or marketing expenditures produce or enhance intangibles; and
- Requirement that a transfer pricing analysis focus on whether unrelated parties would compensate the specified intangibles in comparable circumstances.

Remaining Areas for Improvement

Notwithstanding the progress reflected in the RDD, we remain concerned about a number of points. This letter focuses on our main areas of concern.

1. ***The RDD is overly prescriptive and should be rebalanced to provide more guidance based on general principles.***

We strongly endorse the arm's-length standard as the core principle to be applied in transfer pricing matters. Our overarching concern is that, while the RDD, in some cases, acknowledges the highly factual nature of the transfer pricing exercise under the arm's-length standard and allows for judgment to be applied, it does not do so consistently. In fact, in numerous areas, the RDD is prescriptive in setting out expected results and preferred methods, or disqualifying certain methods. To address these concerns, we recommend modifying the language throughout to provide a balanced approach that allows both the taxpayer and the tax authority to gather the relevant facts, weigh the available approaches, and make judgments as to the most appropriate method for establishing and documenting arm's-length transactions. It could also be useful to add a new introductory paragraph stating this intention explicitly. We believe this would tighten the link between a new Chapter VI and the arm's-length principle.

We understand that what most concerns tax authorities is a transfer pricing approach to one or a series of transactions involving the use of an intangible, in which:

- the sales, support, contract R&D, contract manufacturing and related "routine" functions are compensated with a modest return (perhaps based on an application of TNMM);
- all residual from intangibles, entrepreneurial success/failure and business risk flows to the legal owner and/or funder;

- especially if that legal owner/funder is a company that is light on functions, assets, and risks ("a man and a dog").

We acknowledge this concern and can endorse appropriate revisions to the Transfer Pricing Guidelines to address such situations. Our reading of the RDD, however, suggests that there is too much focus on limiting the intangible related returns which could flow to the legal owner in inappropriate cases. It appears to us that in trying to craft guidelines to address or prevent inappropriate outcomes in the "man and a dog" case, the RDD has:

- emphasized prescriptive approaches seeking to engineer the desired results;
- relied largely on negative guidance; and
- lost sight of the larger need for guidance that is applicable in a wide range of circumstances, many or most of which do not involve the "man and a dog" fact pattern.

For example, paragraph 73 is entirely negative in approach, setting out a mandate that the legal owner may not earn any of the residual if it does not perform and/or control functions, assets, and risks at or above a very high functional threshold. However, we note that there is no parallel discussion stating that other parties to the transaction may earn the residual profit only if they perform and/or control functions, assets, or risks at or exceeding that same threshold. As a result, we read the RDD to mandate that the residual profit should be awarded to entities other than the legal owner and/or funder, even if those entities themselves might not meet each of the criteria imposed on the owner/funder. In so doing, the RDD sets up a one-sided test, apparently for the sole purpose of prescribing the desired result: denial of residual profit to a legal owner/funder. This appears to us to be inconsistent with statements elsewhere in the RDD (*e.g.*, paragraph 159) in which one-sided approaches are criticized. This language creates a double standard, and could result in an inappropriate result, particularly for MNEs with dispersed functions, assets and risks. For example, the legal owner / funder could be denied any intangible-related residual because it did not perform all of the important functions / assets / risks described in paragraph 73, only to find that other related parties were assigned the intangible-related residual even if such party performed no more than a small part of the listed important functions / assets / risks.

We submit that the wiser course is to seek a way to express a more principled approach that is applicable to the full range of taxpayer situations, as opposed to the current prescriptive language focused on the "man and a dog" scenario.

The solution we propose is as follows:

- The RDD's remarks concerning the application of profit split methods should be revised to maintain neutrality with respect to the application of the OECD's methods in general. Moreover, discussions of specific situations in which the application of profit split methods may be more appropriate or preferred should include situations in which the participants' contributions are materially different from one another and/or are of materially different contributed value.
- The RDD should provide more guidance on comparability factors and appropriate adjustments that will help both taxpayers and tax authorities to establish when a TNMM or other one-sided

method is or is not reliable or appropriate. Doing so will also clarify when adjustments are required to avoid inappropriate results, such as disproportionately small or large remuneration relative to the value-creating contributions of the entity.

- If it is the consensus position, retain the principle implied by the combined reading of paragraph 73 and Example 1, in which a legal owner with only a nominal financial contribution is not entitled to earn the residual, but clarify that the absence of funding by the legal owner is the reason for the result in Example 1.
- The RDD should acknowledge that funding and its associated risk-bearing is part of the chain of value creation of intangibles. Correspondingly, funding should be weighed along with the other intangible value creating activities in an analysis of the appropriate arm's-length remuneration to be awarded to each party contributing to intangible value creation.
- Otherwise, the RDD should provide that the legal owner/funder is entitled to a portion of any residual return from the intangible according to the facts and circumstances of the case (including the contractual arrangements and the actual behavior of the parties). Guidance could be supplemented to provide that the amount of the residual may be greater or lesser in a particular case, depending on the relative amount and significance of the functions, assets, and risks of the entity(ies) that contribute to the value of the intangibles. This principle would appropriately distinguish a "man and a dog" case from cases where the legal owner / funder in fact has other functions, assets or risks. Such further guidance should indicate that there is no pre-defined level of contribution to the creation of value from intangibles that shifts all the residual to another party if that level is not reached. Said differently, the claim to residual profit should be thought of as a sliding scale, and not an "all or nothing" result except in the case of a legal owner whose only contribution is a nominal financial one.

2. ***The guidance on accounting goodwill and valuation of transferred intangibles should be refocused and clarified to ensure that the RDD is consistent with the Transfer Pricing Guidelines.***

In a similar fashion, we understand the Delegates' concern about ensuring that the term "intangibles" is defined broadly enough so that elements that, for accounting purposes, might be counted in "goodwill" are not automatically excluded from consideration in a transfer pricing analysis. We also understand that tax authorities are concerned about situations in which the value of intangibles obtained through acquisitions may be understated in business restructuring transactions.

We believe that the RDD again has attempted to address this concern through a prescriptive, results-oriented approach, rather than by articulating principles and considerations that taxpayers and tax authorities alike should apply. Example 18 is the principal source of our concern. We believe that Example 18 is inconsistent in several respects with other principles embraced by the RDD and the Transfer Pricing Guidelines:

- While the RDD endorses the general principle that the Transfer Pricing Guidelines should be followed and the most appropriate method should be applied (RDD paragraph 37; TPG paragraphs 2.1 through 2.11), Example 18 effectively mandates the use of the CUP/Acquisition Price method, without regard to the facts and circumstances of the case.

- Whereas the RDD generally endorses the need to apply comparability standards and to make adjustments where appropriate (*e.g.*, RDD paragraphs 147, 155; TPG paragraphs 3.47-3.54), Example 18 mandates a result that implies that no adjustments shall be made.

- Whereas the RDD states that purchase price allocations and measures of accounting goodwill are not determinative for transfer pricing (paragraphs 62, 173), Example 18 mandates that the accounting values control.

Further, the RDD, by sending mixed messages with respect to accounting goodwill, is not consistent in providing guidance for companies with self-developed intangibles and those with acquired intangibles. Many self-developed intangibles are not reflected on a company's balance sheet (paragraph 41), but the arm's length principle still requires that these assets be valued if they are transferred. Acquired intangibles do appear on the balance sheet in different ways (sometimes as separately identified assets, and sometimes within accounting goodwill). An even-handed approach would treat these situations equally and would require valuations for transferred intangibles based on the fundamental principles of the TPG, and without particular regard for accounting conventions.

Our proposal is to amend the RDD to state the following:

- Confirm the position that income-generating intangible assets should not be transferred without arm's-length compensation.

- Confirm that accounting values should not control for transfer pricing purposes, whether these accounting values arise in the context of self-developed intangibles or acquired intangibles.

- Confirm that the value of transferred assets should be determined based on the application of the most appropriate method.

- Confirm that methods which link asset(s) with the income they are expected to produce likely will be more meaningful and more consistent with other guidance in the Transfer Pricing Guidelines and the RDD (such as considerations regarding "profit potential" (paragraph 134)), and will be more likely to capture the "goodwill and ongoing concern value" of the assets in question, because they connect the assets with the actual income the assets are expected to earn.

- Acknowledge that the acquisition price for an acquired business may be a relevant data point concerning the value of acquired assets that are subsequently transferred within the acquiring business, but acknowledge that adjustments are likely to be necessary to reflect the facts and circumstances of each case.

- Modify Example 18 to eliminate the statements that "[t]he full value of that business [Company T] should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T", and "[i]t should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring." The Example also should acknowledge that a review of methods should be undertaken to determine which is the most appropriate method under the circumstances, including in light of the income actually expected to be earned from the intangible.

3. ***The RDD should acknowledge that residual profit may arise from elements other than intangibles.***

It is our observation that the RDD's discussion which addresses residual profits is not limited to intangible property. Instead, to the extent that what is analyzed is "residual profit," this residual is driven by intangibles, as well as many other factors, such as efficiencies and inefficiencies, market differences, management skill or error, successful or failed business decisions, and anything else that affects the profitability of a related party during the period examined. For this reason, we believe that guidance truly focused on intangibles should acknowledge that direct methods of valuation, such as the CUP method, rather than indirect methods, may be the more appropriate methods in many cases. Moreover, to the extent that indirect methods focused on residual profit are applied, we believe the RDD should:

- Acknowledge the potential effect these other factors can have on the amount of residual profit;
- Confirm that these factors are not themselves intangibles (as it does with location savings and synergies, for example);
- Require that these factors be addressed and neutralized in the analytical approach so as to carefully isolate the profit relating to the intangible property transferred between related parties; and
- Note that the effect of these other factors in any particular transaction will be determined by the application of the general TPG principles to the transactions at issue.

4. ***The RDD is too prescriptive as to methods and inordinately favors profit splits.***

We believe that, while the RDD has introduced a more balanced and fact-based approach to the selection and application of methods, it still puts a "thumb on the scale" in favor of profit split methods to an unwarranted extent. As we and other commenters have noted, while profit splits have their place among transfer pricing methods, the Transfer Pricing Guidelines should remain neutral, as they have established common criteria for the selection and application of any method. We see the "most appropriate method" test (RDD paragraph 149; TPG paragraph 2.2) as the common criterion for this purpose. Applying that standard, taxpayers and tax authorities alike are free to evaluate each relevant method under the facts and circumstances of each case to determine which is "most appropriate."

One way in which we believe the RDD leans toward profit splits is based on the frequent use of the term "allocate." For instance, paragraph 65 refers explicitly to the notion of allocation:

> "The right of other members of the MNE group to receive compensation for their functions performed, assets used or contributed, and risks assumed may be conceptually framed as an *allocation* to those other members of all or part of the return attributable to the intangible". (Emphasis added.)

An "allocation" of profit has the connotation of a proportional division based on one or more metrics. While we understand that an "allocation of profit" might be seen as simply the result of any pricing exercise, and does not necessarily imply the application of a profit split method, we recommend selecting other terminology that is neutral and has no particular connotation as to method. We further note that in some places, the RDD uses more neutral terminology, such as "remunerate." We believe that more consistent, neutral wording throughout will improve the draft.

Similarly, on the theme of neutrality, we find throughout the RDD comments that call into question the use of certain methods. For example, paragraph 164 states: "It should be recognized that the identification of reliable [CUP] comparables in many cases involving intangibles may be difficult or impossible…" Further, paragraph 159 questions the validity of one-sided methods. Since the RDD cites to the general principles and comparability factors in the existing Transfer Pricing Guidelines, we see no reason to express prejudice against the CUP, TNMM or any other method. Equally, the RDD should not appear to advocate in favor of certain methods. As a result, we recommend that the RDD include a paragraph specifically confirming that the most appropriate method be selected and applied in every case.

5. ***The circumstances in which any "special measures" may be applied should be clearly identified and there should be consensus on their use in lieu of the arm's-length principle.***

We acknowledge that WP6 may identify situations in which it seeks to diverge from the arm's-length standard and apply "special measures." If this is the case, we submit that it is essential that the specific circumstances in which special measures might apply are clearly identified, and further, that there is complete consensus on the limited circumstances in which special measures may be used instead of the arm's-length standard. With the situations for the appropriate application of special measures clearly identified, then the RDD should further confirm that the arm's-length standard applies in all other cases.

In the absence of clear and specific identification and consensus, we believe the RDD as currently drafted will increase dispute and controversy. Without clarity on which situations are subject to special measures, taxpayers and tax authorities are increasingly likely to apply conflicting approaches, leading to contentious disputes. Without a broad international consensus, dispute resolution mechanisms such as the mutual agreement procedure are unlikely to operate as intended, resulting in unrelieved double taxation.

6. ***The use of "anticipated value" to determine profit entitlement is fundamentally at odds with the arm's-length principle and should be reconsidered.***

We note with concern that the RDD now contains many references to remuneration based on the "*anticipated value*" of the intangibles or of the parties' contributions (in paragraphs 65, 73, 74, 77, and 78, among others). We believe this is not a correct reflection of how unrelated parties are compensated. If a party is rendering a service, it is compensated for the value in the market at that moment of the services it renders. If a party is an entrepreneurial risk-taker, then by definition, such a party is not rewarded based on anticipated value; it is rewarded based on actual value as it may happen to emerge over time. It may be true that an entrepreneurial risk-taker will decide on the investment it is willing to make and the funds it is willing to put at risk based on the return it anticipates receiving, but once committed, it will receive compensation based on actual outcomes.

The pharmaceutical industry is an excellent example. In order to bring a new drug to market, a pharmaceutical company may have an at-risk co-development partner. In addition, these co-developers may need to involve a contract research organization (CRO) to run clinical trials. The CRO, while being a "contributor" to the development of the intangibles, is not an at-risk partner in the endeavor. Instead, its contribution is remunerated through a fee structure. This fee structure relates to the nature and extent of the services rendered, but it is *not* based on the "anticipated value" of anything, least of all on the ultimate value of the drug, if it ever is commercialized. Further, the co-developers, being the at-risk parties, are only rewarded based on actual results, not on "anticipated value." If the drug is never commercialized, the co-developers cannot remunerate themselves based on an earlier "anticipation" of commercial success.

Software development is another example. Companies frequently contract out software development to unrelated companies and/or individuals. Operating system and applications development is often contracted out based on paying the contract developer for time spent at an agreed hourly rate, or may be priced based on a fixed fee. In either case, the contract developer is paid on this basis, and is not remunerated based on the "anticipated value" of the software it develops.[1] Other forms of software development may be agreed on a co-development basis, such as is often done with the development of computer games. In these contracts, the co-developer may be remunerated with a revenue-based royalty. In this case, as well, the co-developer is not compensated based on the "anticipated value" of its contributions. Rather, whatever royalties the co-developer ultimately receives – as a risk-taker -- are entirely dependent on the revenues *actually* earned on the game.

By definition, risk takers realize the *actual* results, and anticipated results are irrelevant to ultimate compensation. We believe that it would be more consistent with the arm's-length principle to direct taxpayers and tax administrations to determine the profit entitlement to legal ownership and IP development based on the contractual relationships between the related parties, their investments in IP rights and IP development, their actual behavior, and market evidence.

7. The location savings discussion could benefit from an additional clarification.

We agree with the RDD's continued recognition that location savings may be a comparability factor, but are not, themselves, intangibles. In fact, we do not believe that location savings is a comparability factor related to intangibles as much as it is a comparability factor for the application of the TNMM, RPM, and similar methods applicable to transfer pricing analyses and tangible goods and services, and we recommend clarifying this.

We are puzzled however, by Example 24, in which one of the alternatives involves manufacturing in a lower cost jurisdiction. This example deals with Pervichnyi, which owns an intangible that it uses in its own manufacturing. The example derives the value of the intangible as the entire residual after manufacturing and distribution routine returns are subtracted. When Pervichnyi uses the intangible itself,

[1] It may be difficult to determine the value of internal use software, in any case, and the RDD acknowledges that such software may be valued based on cost (paragraph 161), which is consistent with our comments and clearly diverges from the notion of "anticipated value."

it generates 601 in residual profit over a 5 year period. An alternative arrangement that Pervichnyi could consider would involve manufacturing in a lower cost jurisdiction. In that setting, the total residual generated is 853; the entire difference between 853 and 601 relates to lower costs of manufacturing. The text of the example concludes that Pervichnyi should not sell the intangible for less than 853, based on the assumption that Pervichnyi can "capture the production cost savings." Thus, the example assumes that the value of the intangible is directly and dollar for dollar affected by the value of location savings.

Therefore, while paragraph 64 states that location savings are not an intangible, Example 24 reaches a conclusion that has the effect of assigning 100 percent of the location savings to the value of Pervichnyi's intangible. We find these statements fundamentally contradictory. Location savings cannot *directly* affect the value of an intangible without, in effect, being treated in the same manner as an intangible. In fact, in this example, the location savings is related to the manufacturing activities, not to the exploitation of the intangible. Thus, it is incorrect to assign any portion of the location savings to the intangible value.

More broadly, Example 24 points out the dangers and potential inaccuracies of valuing an intangible solely based on a residual profit concept, be it the application of the TNMM, a profit split, or other similar methods. As we have stated under point 3 of this letter, many different factors affect the profitability of a given business operation. Applying an unadjusted residual method to valuing intangibles necessarily results in ascribing the financial effects of those many factors to the intangible itself, which is a valuation error. The location savings quantified in Example 24 should be seen as relating to the manufacturing activity and the price that would be agreed between Pervichnyi and the lower-cost manufacturer, Company S, for the manufactured goods. The relative ability of these parties to capture the location savings would affect the price for these goods. But the RDD errs by conflating this with the value of intangibles. As we further commented in point 3 of this letter, these location savings (regardless of which party captures them), along with any other factors affecting profitability that are not related to the intangibles themselves, should be neutralized via adjustment to the residual profit, thus isolating the value of the subject intangibles.

We recommend that Example 24 be deleted unless it can be clarified to address these issues and inconsistencies.

* * *

The Treaty Policy Working Group hopes that these comments will be helpful as the Working Party as it continues its deliberations on these important issues. Please let us know if you have any questions.

Sincerely yours,

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On behalf of the Treaty Policy Working Group