McDermott
Will&Emery

Boston Brussels Chicago Düsseldorf Frankfurt Houston London Los Angeles Miami
Milan Munich New York Orange County Paris Rome Seoul Silicon Valley Washington, D.C.

Strategic alliance with MWE China Law Offices (Shanghai)

Steven P. Hannes
Attorney at Law
shannes@mwe.com
+1 202 756 8218

October 1, 2013

VIA E-MAIL: Transferpricing@OECD.org

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit
Centre for Tax Policy and Administration
Organisation for Economic Co-Operation and Development

Re: July 30, 2013, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*

Dear Mr. Andrus:

I. <u>Introduction</u>

This letter is in response to the request of the Centre for Tax Policy and Administration of the Organisation for Economic Co-Operation and Development ("OECD") for comments on the July 30, 2013 *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles ("2013 Intangibles Discussion Draft")*.

This letter sets forth the comments of the Transfer Pricing Discussion Group ("TPDG") on the *2013 Intangibles Discussion Draft*. The TPDG consists of U.S. and foreign-based multinationals in various industries. These industries include automotive, chemicals, consumer durable goods, food and beverages, industrial equipment of different types, information gathering and dissemination, news, pharmaceuticals and technical information. Participants in the TPDG have a wide range of business activities directly relevant to intangibles, including registering and protecting patents, conducting research and development, hiring others to conduct research and development and licensing as well as other potentially related activities such as manufacturing, marketing, distribution and the acquisition and provision of services of various types.

While the principal activity of the TPDG is for the members to meet regularly to discuss amongst themselves matters directly and indirectly related to transfer pricing, the TPDG also submits comments on U.S. government proposals as well as those of the OECD related to transfer pricing.

As you may recall, the TPDG has previously commented to the OECD on its proposals related to transfer pricing for intangibles. In a letter dated September 13, 2012, the TPDG set forth its comments on the June 6, 2012 Discussion Draft entitled *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions ("2012 Intangibles Discussion Draft")*. Prior to that, in a letter dated September 14, 2010, the TPDG offered comments to the OECD in response to its request for suggestions for the scope of a then new project involving the transfer pricing aspects of intangible assets.

The OECD's efforts on transfer pricing for intangibles have been considerable. The TPDG recognizes that the G20 is supportive of the OECD efforts to address the topic, as part of a larger initiative. The TPDG appreciates the OECD's steps to involve the business community in its work on transfer pricing for intangibles. The TPDG is thankful, as indicated below, that the *2013 Intangibles Discussion Draft* has adopted some of the suggestions that the TPDG and others made in response to the *2012 Intangibles Discussion Draft*.

As is explained in the comments below, the TPDG believes strongly that the OECD should revise parts of the *2013 Intangibles Discussion Draft* before the OECD finalizes revisions to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration of July 2010 ("OECD Guidelines"),* makes any changes to the Commentary to Article 9 (Associated Enterprises) of the OECD's Model Tax Convention on Income and on Capital (the "Commentary" and the "OECD Model," respectively) or amends the OECD Model.

The TPDG recognizes, in this regard, that action number eight of the 2013 Action Plan on Base Erosion and Profit Shifting ("BEPS Action Plan") sets as a goal making final changes to the *OECD Guidelines* as early as September 2014 on this topic. Also, OECD representatives have stated publicly that this is the last opportunity for taxpayers to comment to the OECD on the Chapter VI subject (i.e., by way of comment letters such as this requested by October 1, 2013 and through the business consultations that the OECD intends to have in the months following the October 1, 2013 end of the comment period). Thus, the TPDG is once again submitting comments on this important topic.

Unfortunately, the schedule set for submitting comments is too tight to present comprehensive and detailed comments and suggestions for revisions. The TPDG focuses its comments in this letter on the most central aspects of a topic that overall is highly important to taxpayers and the global economy as well as to tax administrators.

II. Summary of Key TPDG Comments and Recommendations

The key comments and recommendations of the TPDG with respect to the *2013 Intangibles Discussion Draft* are summarized here.

First, the TPDG applauds the following positions taken by the *2013 Intangibles Discussion Draft*, some of which are changes from the *2012 Intangibles Discussion Draft*:

- An assembled workforce is properly not characterized as an intangible.

- The *2013 Intangibles Discussion Draft* appropriately omits the proposal made in 2012 to incorporate in Chapter VI a new category of intangibles: "section D1(vi) intangibles."

- The *2013 Intangibles Discussion Draft* correctly acknowledges that there is a class of items (e.g., market characteristics, group synergies) that is not properly characterized as intangibles but that can affect the determination of arm's length prices for a transaction as comparability factors. As is explained below, this approach could be expanded to address current concerns of tax administration about how to compensate affiliates having legal ownership, providing funding and taking risks, as well as those affiliates that carry out functions related to intangibles.

- The *2013 Intangibles Discussion Draft* usefully continues to illustrate the principles proposed for Chapter VI of the *OECD Guidelines* by way of multiple examples.

The TPDG notes, however, that unfortunately the *2013 Intangibles Discussion Draft* contains proposals that the TPDG and many others in the business community find problematic as detailed below.

- The *2013 Intangibles Discussion Draft's* proposed revisions to Chapter VI significantly increase the potential for confusion over the principle of respecting the contractual arrangements of related parties that are aligned with their conduct.   While affirming this well-established principle in certain paragraphs, the thrust of important portions of the *2013 Intangibles Discussion Draft* will likely allow tax administrators to undermine this principle almost at will in a variety of circumstances. The TPDG recommends revisions in this regard that are intended to address concerns of tax administrations about unduly rewarding "cash boxes" while avoiding the problems for both tax administrations and taxpayers inherent in various proposals in the *2013 Intangibles Discussion Draft*.

- The *2013 Intangibles Discussion Draft's* proposal to assign "intangible related returns" ("IRRs") is heavily biased toward rewarding functions (or controlling functions) rather than respecting contracts, funding and risk-bearing and inappropriately characterizes the compensation given to be given functions as intangible related returns.[1] This "shift" (some might use stronger characterizations) to increasing the compensation for functions by asserting that functions are entitled to intangible related returns, and at the expense of rewarding contractual ownership, funding and risk-bearing, is, with all due respect, not at all consistent with central tenets of transfer pricing statutes and judicial precedents, at least under U.S. tax law and, the TPDG suspects, under the tax laws of various other countries.[2]

- Although the "shift" is built on ignoring or de-emphasizing ownership, funding and risk bearing, does the affiliate performing functions to which the current proposals would assign intangible related returns have to bear risks? How would the OECD proposals accomplish the assignment of risks to a service provider carrying out the functions? For example, take a

[1] *2013 Intangibles Discussion Draft*, page 13, paragraphs 71, 79.

[2] The U.S. tax statute concerning transfer pricing, section 482 of the Internal Revenue Code, does not use the phrase "arm's length." However, the statute, as interpreted consistently by U.S. courts over many decades, embodies various principles two of which are central to this discussion: (1) the IRS cannot employ section 482 of the Internal Revenue Code to recharacterize or disrespect arrangements between taxpayers that are reflected in contracts and that are implemented consistent with the contracts; and (2) marketplace benchmarks, including "constructed" and "imperfect" ones, and whether they use financial results of companies or transactions, prevail under section 482 over theoretical approaches (e.g., formulas, including profit split) in determining for a related taxpayer "fees," "prices" or its financial results, such as "mark-ups."

situation where two related parties enter into an arrangement whereby one party performs all of the R&D, including planning, decision-making, etc. on behalf of a “cash-box” hiring party in exchange for a high but relatively low-risk compensation (i.e., reimbursement of value-added costs plus a large mark-up). If the project were to result in a loss, would the OECD IRR proposals mean that the arrangement would be recharacterized as a loan with the result that the service provider would suffer a loss and the hiring party would be repaid in full, plus appropriate risk-adjusted interest? Likewise, how would the IRR proposals address such an arrangement if the R&D project creates profits only after multiple years in which the hiring party bore all the project’s costs and had losses, while the service provider received service fees on a cost-plus basis and was consistently profitable? Also, would the IRR proposals assign intangible related returns to the service provider in these examples if it is not sufficiently capitalized to bear the risk associated with the project? TPDG members believe it is difficult to assign risk to a party after the fact, particularly as there can be five, ten or more years between when research begins and when it is clear whether the efforts have created profits.

- It should be noted that the *2013 Intangibles Discussion Draft* does not define "intangible related return" or use that phrase consistently.[3] As a consequence, there is far too much room for disagreement, uncertainty and double taxation. Unanswered questions about the phrase include the following. What does "related" mean? What are "returns?" Does the phrase mean: (a) income from intangibles (as the text and examples suggest); (b) income "related to intangibles activities" but not constituting income from intangibles; or (c) something other than (a) or (b)? Using such an undefined phrase increases the opportunities for extreme positions and controversy already introduced by the basics of the IRR concept currently being proposed for Chapter VI. It also gets in the way of the request in action eight of the BEPS Action Plan for "adoption of a broad and clearly delineated definition of intangibles."

- If the OECD member countries and others participating in the process continue to advocate "shifting" the *OECD Guidelines* to emphasize functions and de-emphasize contracts, funding and risks, as well as to claim that the former are entitled to intangible related returns, then the OECD should drop the pretense that these changes are consistent with the "arm's length standard" and should explicitly state that making this shift will

[3] Among the other phrases used are "*anticipated* return related to intangibles" (paragraph 78) and "return *attributable to* a given intangible" (paragraph 80). (Emphasis supplied.)

require various jurisdictions to adopt what the BEPS Action Plan calls "special measures" (e.g., new legislation).

- OECD recognition that IRR type proposals should be adopted by countries by way of special measures, rather than through a view of the arm's length standard that taxpayers (and some countries) perceive as distorted, if not a blatant misrepresentation, will help the overall BEPS project in a number of ways. One important consequence will be that taking this recommended course will avoid having contentious debates about semantics and history overshadow what is a serious tax and trade policy issue with implications for the future.

- The proposed shift of emphasis from contracts, funding and risk-bearing in transfer pricing, towards functions (or "control" of functions) in attempting to assign entitlement to income from intangibles will create both enormous uncertainty as indicated above and, contrary to the expectations of certain tax-revenue-driven countries participating in this OECD process, new tax planning opportunities.[4]

- Instead of distorting the "arm's length" standard and related, well-established tax principles, OECD member countries and other tax

[4] For example, one affiliate in a high tax country will be able to claim tax deductions by amortizing a patent it acquires and owns for tax purposes generally while its affiliated licensee in a low tax jurisdiction, will, under the *2013 Intangibles Discussion Draft*, be allowed to retain most or all of the intangible related returns.

authorities should focus, in the context of updating the *OECD Guidelines*, their energies on improving practices and rules relevant to the use and adjustment of transactional marketplace comparables under the *OECD Guidelines*. The introduction to the *OECD Guidelines* emphasizes that "'comparability analysis'…<u>is at the heart of the application of the arm's length principle</u>."[5] Likewise, Chapter VI would do well to state that comparability is at the heart of the application of the arm's length standard to transactions involving intangibles and should develop additional guidance for comparability analyses in the intangibles context.

- Future revisions to the *OECD Guidelines*, the OECD Model or the Commentary are an important part of the overall BEPS Action Plan. However, such revisions cannot address all the BEPS problems that countries perceive. The BEPS Action Plan envisions recommending, separately, "special measures" for intangibles transfer pricing, and the *2013 Intangibles Discussion Draft* can do more in that respect. Furthermore, the BEPS Action Plan envisages other types of possible solutions to the perceived "abuses" or "profit shifting" through intangibles pricing, including action step number three in the Plan. That step calls for strengthening the ("CFC") rules and making recommendations for the design of domestic CFC rules. Such CFC rules can, for example,

[5] *OECD Guidelines*, page 33, paragraph 1.6. (Emphasis supplied.)

discourage the use of an intermediary, tax-haven, shell company that claims inappropriate amounts of income from intangibles despite its status.

III. Entitlement to IRRs; Contracts, Funding and Risks Versus Functions

The TPDG believes that part "B" of the *2013 Intangibles Discussion Draft* improves upon the *2012 Intangibles Discussion Draft* somewhat. Among other things, the *2013 Intangibles Discussion Draft* will make clearer in the *OECD Guidelines* that tax authorities have no basis for challenging, under any circumstances, the assignment of intangible related returns as between two independent parties. Whether or not an unrelated hiring party is entitled to all of the income from intangibles or "related returns" depends heavily, if not entirely, upon the contractual arrangements, including claims to legal ownership, agreed to by it and the other unrelated parties it hires. Tax authorities must respect these arrangements.

On the other hand, the TPDG believes there is no commercial or legal basis, at least under current law in the United States, for the *OECD Guidelines* to require that in all cases a hiring party must control the activities of an *affiliated* service provider in order to retain or obtain its contractual claim of ownership to any portion of the benefits of any intangibles enhanced or created in whole or in part by the activities of the service provider. This and other problematic aspects of part "B" of proposed Chapter VI are discussed below.

The proposals for Chapter VI of the *OECD Guidelines* start by mentioning performing a comparability and functional analysis in order to determine arm's length "conditions" for the use or transfer of intangibles.[6] The TPDG believes Chapter VI should state that the prime role of the comparability and functional analyses in the context of pricing for intangibles is to determine the arm's length *consideration* that related parties should be receiving for the use or transfer of intangibles. Substituting the word *"consideration"* for the word "conditions" in this and other similar contexts in the *OECD Guidelines* will help eliminate erroneous impressions that the purpose of the comparability and functional analyses is to determine how the parties *should have* structured their intangibles transactions as opposed to what one would expect - evaluating what consideration the related parties should provide each other for the intangibles transactions *that they actually contracted for and undertook consistent with their contracts*.

Proposed Chapter VI starts to go astray on the subject of ownership and entitlement to intangible related returns when it states as follows:

> The right of other [non-legal or non-contractual owners] 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.[7]

[6] *2013 Intangibles Discussion Draft*, page 13, paragraph 38.
[7] *2013 Intangibles Discussion Draft*, page 20, paragraph 65.

It is neither accurate nor helpful to state that providing arm's length compensation due to non-owner members of an MNE group, in particular service providers, for their functions performed, assets used or contributed is related to or is in any way part of an "intangible related return." Service providers generally receive service fees, not ownership interests in intangibles, for their activities.

Depending upon the arrangements between the parties, compensation for the functions performed and assets used or contributed by these other members of the MNE group may mean, in some cases, that the income from an intangible is smaller. However, any such potential diminution is not because the non-owner "contributors" are receiving part or all of the intangible income belonging to the owner of the intangible asset. As is explained further below, the differences between these two approaches is very important in legal, economic and other respects.

The TPDG agrees with the thrust of a subsequent sentence in the proposals:

> When the relevant registrations and contractual agreements are consistent with the conduct of the parties…, the legal owner will generally be considered the sole owner of the intangible for transfer pricing purposes.[8]

It will be useful to add at the end of this sentence "and consequently will be entitled to all of the income from the intangibles it owns."

[8] *2013 Intangibles Discussion Draft*, page 21, paragraph 71.

The OECD proposals stray further when they state that the intangible related return ultimately retained by the legal owner depends upon:

> …the contributions it makes to the anticipated value of the intangibles through its functions performed, assets used and risks assumed and upon the contributions to the anticipated value of the intangibles made by other MNE group members through their functions performed, assets used and risks assumed. For example, where the legal owner makes no contributions that are anticipated to enhance the value of the intangible, the legal owner will not ultimately be entitled to retain any portion of the returns attributable to the intangible.[9]

These sentences and their underlying approach should be omitted from future OECD guidance for the reasons provided above as well as those that follow.

To restate the TPDG's comments above in a different way, whether or not other MNE members provide "contributions" that are "anticipated to enhance the value of the intangible" does not mean, either in marketplace transactions or under the tax law, that they have any claim whatsoever to income from intangibles or, for that matter, that they can be denied compensation if their activities do not in fact "enhance the value of the intangible" belonging to the legal owner. Third parties that are under contract as service providers and that are compensated as such for their services are in many, if not most, cases entitled to their returns solely as service providers and regardless of the success or failure of any resulting intangibles.

[9] *2013 Intangibles Discussion Draft*, page 21, paragraph 73.

In any case, there are numerous third party contracts and results from companies that provide R&D services typically available to measure the "arm's length" compensation due to related parties in a variety of contractual arrangements. A new Chapter VI can and should re-emphasize the importance of searching for such marketplace or "transactional" situations, examining their details and making comparability adjustments to them when necessary. A new Chapter VI should also provide more guidance to improve the processes of searching for and making adjustments to such marketplace transactions.

The proposals for Chapter VI continue to stray from commercial reality, tax law principles and the arm's length standard when they describe a legal owner's ability to retain the return attributable to its intangible as follows:

> …it will either perform the functions related to development, enhancement, maintenance and protection of the intangibles, or arrange to have functions performed *under its control* by independent enterprises or by associated enterprises. … In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. A member of an MNE group that is the legal owner of an intangibles could similarly be expected to retain either independent enterprises or associated enterprises, transacting on an arm's length basis, to perform functions related to the development, enhancement, maintenance and protection of intangibles. *In such cases, however, the party performing the outsourced functions should operate under the control of the legal owner.*[10]

[10] *2013 Intangibles Discussion Draft*, page 22, paragraph 76. (Emphasis supplied.)

For the reasons explained in the following paragraphs, TPDG members believe that the next version of this part of the proposed *OECD Guidelines* should omit the italicized sentence and the concepts it advocates. The next version should also delete the phrase *"under its control"* in the first sentence above.

Taxpayers who are heavily engaged in the creation and development, both internally and externally, as well as use of intangibles are mystified by this misplaced OECD emphasis on "control" and its linkage to being entitled to IRRs. First of all, they report that there are many circumstances in which *unrelated* parties hired to provide R&D or other services designed to help create or contribute to the value of an intangible where the hiring party does not have control over how the third party service provider conducts its activities and where the third party is compensated as a service provider with no rights to any resulting intangibles or their returns.

Of course, one can reasonably expect that the unrelated hiring party typically has the capacity to execute the services contract, to set a budget therefore, and to provide funding (or have a reasonable expectation thereof) as agreed in the contract. The contract will typically also set a goal, and perhaps milestones, formulated by the hiring party or service provider or both. Even though the hiring party may require or negotiate with the unrelated service provider protocols or guidelines for the contracted services, the hiring party does not, in the experience of TPDG members, usually or necessarily have "control" over how that work is conducted by the unrelated service provider.

The following examples of publicly available contracts between hiring parties and unrelated parties engaged in research and development activities illustrate the TPDG views about "control" and rights to intangibles expressed above:[11]

Research and development:

- Researcher "shall perform R&D work…in accordance with [written] specifications." R&D work includes, but is not limited to, "technical consultancy, engineering and related services." All rights and modifications are property of the hiring party.

Development:

- The "budget for the Study…will be signed by both" parties. Researcher "will be responsible for the direction and supervision of all Study efforts in accordance with the [Researcher's] policies, the Protocol and the Agreement." Project monitors have the rights to "examine and inspect," but there are no formal requirements or timetables for monitoring. Hiring party retains all rights to data and results.

Research:

- Researcher "shall have the primary responsibility for decision making with respect to the implementation of the Research Plan." The Research Plan and associated budget are jointly determined. Hiring party "shall own all rights, title and interests" in research results.

Development:

- "Developer shall prepare a development plan for the Software" and "Customer shall have 5 days to review the Development Plan." "Developer has the sole right to control and direct the means, manner and method by which the services required by this Agreement will be performed." Developer assigns all rights to "anything created or developed…under this Agreement."

[11] Examples provided by Edgeworth Economics.

Marketing:

- Company A entered into an agreement to enlist Company B to market products in the United States for which A held patents and trademarks.
- Both parties were to "devote substantially equal efforts and internal resources to the marketing, promotion and detailing of the Products" and would have equal representation on key marketing committees, activities that would presumably contribute equally to the development of the trademark.
- Company A retained all rights to the trademark and patents for the products marketed by Company B.

In brief, the above five contracts, which are not unusual, illustrate that there is no empirical support for the proposition that third parties uniformly "control" the unrelated service providers they hire. The commercial reality is that third parties hire each other to conduct research, development, marketing and so forth under many different arrangements. In each of the above examples, and notwithstanding a range of responsibilities for the service provider, the hiring party retained all rights to the intangibles. In no case did the hiring party "control" the service provider.

Even if the OECD "IRR" views mentioned above or others were uniformly consistent with commercial reality, the TPDG believes that the *OECD Guidelines* is not the forum in which to prescribe the details of what are or are not the most relevant, let alone "uniform," commercial practices (nor can the *OECD Guidelines* appropriately provide service providers with returns that belong to owners of intangibles).[12] The

[12] Different industries and companies within an industry may take different views of when and how to use third party services and expertise for activities such as: gathering market information; setting objectives,

existing *OECD Guidelines* take a much more limited, appropriate and commercially realistic approach to providing guidance relevant to this topic when they discuss factors that can assist a pricing analysis. For example, they state that the hiring party should have:

> …the capacity to make decisions to take on the risk…and decisions on whether and how to manage the risk, *internally or using an external provider*. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk…is not sufficient to transfer the risk to the other party.[13]

Likewise, and as is explained elsewhere in this letter, the fact that one party hires another unrelated or related party to "make contributions" to the development, enhancement, maintenance or protection of intangibles does not mean that the contributor receives rights to the intangibles. Whether or not that occurs depends on the rights and obligations of the parties as defined under their contract as implemented consistent with its terms.

The current *OECD Guidelines* illustrate the statement quoted above by way of a description of an outsourcing arrangement for research. The example accepts that the hiring party is considered by contract to be "the owner of the outcome of the research"

---

goals and performance metrics; selecting products or services to sell; defining the specifications therefor; conducting research and development; creating prototypes; testing and proving the end product; marketing; manufacturing; maintaining and protecting intangible property rights; etc. Such diversity of commercial behavior reinforces the TPDG's view that it is neither appropriate nor helpful for the *OECD Guidelines* to attempt to provide generalized descriptions of "common" (let alone "uniform") commercial behavior as between unrelated parties or to prescribe what is "acceptable" behavior between related parties.

[13] *OECD Guidelines,* paragraph 9.23. (Emphasis supplied.)

even though it outsources the research and neither manages nor performs the relevant functions. The hiring party retains ownership of the outcome for tax purposes if it can make the decision to hire the party (or can terminate the contract) and can decide on the type of research and its objectives as well as the benefit for the project. In other words, the principles of these paragraphs in the current *OECD Guidelines* accept ownership of intangible assets returns generated by way of outsourcing by what might be referred to as an "informed hiring party." This is a commercially realistic, non-dogmatic view that new *OECD Guidelines* should embrace, not abandon.

In brief, the assumption in the *2013 Intangibles Discussion Draft* that unrelated hiring parties uniformly have the type of control described, and that it is exercised by its own employees, is demonstrably incorrect. In any case, it should not be the function of transfer pricing rules, at least not under the arm's length standard as taxpayers and tax authorities have long known it, to make generalized judgments about the details of how unrelated parties organize their commercial arrangements on matters such as oversight, management or supervision nor to prescribe how related parties must structure such commercial details of their related party transactions, whether involving intangibles or otherwise, in order to achieve specific pricing results.

Of course, if, in a particular case, a tax authority could present third party contracts or other empirical evidence demonstrating, for example, that when similar unrelated R&D service providers control their own activities they are *uniformly* compensated with a portion of the income from the intangibles, as opposed to, for example, receiving a cost plus mark-up (even with a high mark-up), then that would raise serious concerns.[14] It might even provide a basis for a proposed reallocation of income from the intangibles to the service provider under the arm's length standard.

This comment letter does not identify all of the similarly problematic statements about the IRR concept that should be omitted from a new Chapter VI. However, one more inappropriate commercial generalization that should be excised from the current proposals reads as follows:

> When assessing the appropriate return to funding…it should be recognized that in arm's length transactions, a party that provides funding, but that does not control the risks or perform other functions associated with the funded activity, generally does not receive returns equivalent to those received by an otherwise similarly-situated investor who also performs and controls important functions and bears and controls important risks associated with the funded activity.[15]

By way of contrast, the proposed Chapter VI takes a more even-handed, appropriate and non-prescriptive approach in certain aspects of its discussion of commercial risk taking where it states that:

> There is no standard set of risks assumed in the funding of intangible development, enhancement, maintenance or protection. Rather, the risks assumed will vary based, for example, on contractual terms and the conduct and solvency of the relevant group members, and must be determined

[14] The TPDG members believe, based on their collective business experiences, that this hypothetical uniformity among third party R&D service agreements does not exist in reality.
[15] *2013 Intangibles Discussion Draft*, page 23, paragraph 82.

> considering all of the facts and circumstances of the relationship among such group members.[16]

The TPDG suggests that an expanded statement for the *OECD Guidelines* on the topic of "control" and the conduct of functions, *et. al.* would be as follows:

> There is no one standard in marketplace transactions for how unrelated parties address their functions, risks and other factors when engaged in intangible development, enhancement, maintenance or protection. Rather, how these topics are addressed will vary based on contractual terms and the financial and business circumstances of the third parties. Likewise, there are many ways in which related parties can address their functions, risks and other factors when engaged in intangible development, enhancement, maintenance or protection.

The issues of the appropriate amount of compensation for conducting or "controlling" functions and taking risks can be appropriately viewed and addressed as comparability factors, either by using different types of comparables or by making adjustments to the comparables. For example, assume there are two types of third party R&D service providers, with "type one" acting with little input and no oversight from the hiring party and "type two" taking regular direction and oversight as well as technical and other input from the hiring party. Also assume that type one receives xxx percent operating profit on its value-added costs in its third party transactions while type two earns x percent profit on its valued-added costs in its third party transactions.

Depending upon the terms of the contract and other facts of a related party contract R&D service relationship, it may be more reliable and appropriate to use type

[16] *2013 Intangibles Discussion Draft*, page 24, paragraph 83.

one rather than type two as the comparables and to set the arm's length consideration for the R&D service provider. However, there is no foundation in law, fact, or logic for asserting that a related service provider that bears none of the risk that its contracted R&D services will produce anything of value, even one that receives little or no oversight or input beyond the terms of the contract, automatically owns the resulting intangibles and their returns.

In the United States, the authority for the Internal Revenue Service ("IRS") to propose transfer pricing adjustments is part of a tax law that generally allows taxpayers to structure their transactions as they choose and respects those transactions if implemented consistent with their form. The U.S. transfer pricing statute has been consistently interpreted by the courts as being subject to these same legal principles. The current U.S. transfer pricing statute (and probably those of many other countries) does not, for example, allow, as the OECD proposes, treating a provider of R&D services as if it acquired rights to the resulting intangibles while the rest of the tax law, such as the source of income, withholding tax or amortization statutes, respect the transaction as the provision of services and not as the acquisition of intangibles.

In preparing new *OECD Guidelines*, it should be recognized that pricing statutes and their principles do not reside in an economic treatise or in a legal vacuum. The same can be said for income tax treaties containing language like that of Article 9 (Associated Enterprises) of the OECD Model.

Interestingly, in 2012 the Supreme Court of Canada interpreted the (prior) Canadian transfer pricing statute, which in the relevant years contained the words "arm's length" and which the CRA had for years said followed the *OECD Guidelines* and the "arm's length standard." The Court held that the statutory language did not allow the CRA to ignore contractual commitments the parties made to each other or the facts as to which party was bearing the financial risks of certain activities or had originated intellectual property rights.

> [51]…Because the prices paid to Adechsa were set, in part, as compensation to Glaxo Group for the rights and benefits conferred on Glaxo Canada under the License Agreement, the License Agreement could not be ignored in determining the reasonable amount paid to Adechsa under s. 69(2), which applies not only to payment for goods but also to payment for services.
>
> [52]…Considering the License and Supply Agreements together offers a realistic picture of the profits of Glaxo Canada. It cannot be irrelevant that Glaxo Canada's function was primarily as a secondary manufacturer and marketer. *It did not originate new products and the intellectual property rights associated with them. Nor did it undertake the investment and risk involved with originating new products. Nor did it have the other risks and investment costs which Glaxo Group undertook under the License Agreement*.
>
> [62]…the respective roles and functions of Glaxo Canada and the Glaxo Group should be kept in mind. Glaxo Canada engaged in the secondary manufacturing and marketing of Zantac. Glaxo Group is the owner of the intellectual property and provided other rights and benefits to Glaxo Canada. Transfer pricing should not result in a misallocation of those different functions and the resources and risks inherent in each.
>
> [63]…prices between parties dealing at arm's length will be established having regard to the *independent interests of*

> *each party to the transaction*. .... An appropriate determination under the arm's length test of s. 69(2) should reflect these realities. [17]

To be sure, this is one high court's interpretation of the words "arm's length" under one country's domestic statute. Nonetheless, the OECD should carefully consider this and other case law interpretations of transfer pricing statutes, especially those containing the words "arm's length," before continuing further with the claim that the abstract arm's length standard that has been interpreted in one way by the OECD for many years can now take on a very different meaning.

IF, for example, the U.S. Treasury took the view that it was appropriate as a matter of tax and trade policy for the United States to implement the *2013 Intangibles Discussion Draft's* proposed shift, or something similar in regards to IRRs, then it would have to address whether the IRS has the authority under the existing statute to do so or whether, instead, legislation is necessary. Most other countries will be in the same situation.

Whether or not the tax authorities of certain OECD member countries or others participating in the OECD process share the above private sector view of the scope of the current transfer pricing law in their own jurisdictions, the ministers to which they report should recognize that the proposed shift is dramatic, extremely controversial and highly debatable as a matter of sound tax and economic (e.g., trade) policy.

[17] *Canada v. GlaxoSmithKline Inc.*, 2012 GCC 52 [2012], page 30.

If, despite all the sound legal and policy arguments as well as factual support provided by taxpayers, the next OECD document on intangibles continues to support the proposed IRR “shift,” or even a modified version, then it would be, with all due respect, inadvisable, if not counter-productive, for OECD documents to continue with the pretense that this proposed “shift” is within the scope of the abstract concept of the "arm’s length standard” or consistent with existing U.S. and other income tax treaties that contain language in Article 9 (Associated Enterprises) like that of the OECD Model. Taking that stance will, among other things, allow a public debate about semantics or the legitimacy of the proposed solutions to overshadow and interfere with a constructive public vetting of the merits of the proposed solutions. Instead, any such future OECD documents should view this sort of proposed shift as sufficiently different and important that it should be adopted by way of special measures, including new legislation and the negotiation of new provisions in tax treaties.

An open acknowledgement that the OECD’s proposed shift should involve the adoption of special measures will improve the quality of the ensuing public discussion on the pros and cons of the merits of a proposed IRR “shift,” should the OECD or countries continue to advocate its adoption. Ultimately, the legislative processes in countries will improve any resulting changes in pricing approaches considered and adopted by countries. Among other things, these processes will allow countries to reconcile and coordinate the principles inherent in the “shift” with different legal standards used under the other provisions of their law that generally respect the structure of a taxpayer's transactions if they are implemented consistent with their form.

The arm's length "standard" that the OECD is attempting to (re)define in new *OECD Guidelines* is an abstraction. There is no specific Model OECD transfer pricing statutory language that countries can adopt domestically if they choose or that the *OECD Guidelines* can periodically interpret (hopefully as a judge would) or revise. (Perhaps the OECD should propose model statutory language.) In any case, it is hard to imagine a judge, at least in a common law jurisdiction, interpreting the language of the current Article 9 of the OECD Model Treaty as allowing the new approach to contractual ownership, funding and risks and entitlement to IRRs that the *2013 Intangibles Discussion Draft* proposes for the *OECD Guidelines*.

Even as an abstraction, the arm's length "standard" has over many years had certain meanings and principles consistently attributed to it by the OECD and others. The *2013 Intangibles Discussion Draft* proposes in part to adopt principles that are fundamentally different from those the OECD has even very recently claimed are consistent with the arm's length "standard."

At the same time, it is a totally legitimate and constructive aspect of the OECD's work to reconsider old guidance in the *OECD Guidelines* and publish new guidance therein on which the member states have reached consensus as being within the "arm's length standard." However, it is offensive to TPDG members and industry that the *2013*

Intangibles Discussion Draft does not acknowledge that the "shift" discussed in this section is both fundamental and not consistent with the arm's length standard that the OECD has described and advocated over so many years. These "shift" IRR-related proposals represent a new and very different approach to what has been called the arm's length standard, and the OECD and member states should acknowledge this. As indicated above, doing so will benefit all involved, including the countries that are proponents of the "shift."

IV. Profit Split and the Arm's Length Standard Versus Formulary Apportionment

The *2013 Intangibles Discussion Draft* states with vigor that the arm's length standard is reliable and sustainable and far preferable to formulary apportionment, which the OECD rejects. The TPDG endorses these views.

Unfortunately, the *2013 Intangibles Discussion Draft* gives the impression that the OECD's continued rejection of formulary apportionment has become largely a matter of semantics. This is because the *2013 Intangibles Discussion Draft* explicitly opens, as illustrated by Examples 13 and 14, many opportunities for tax administrators to assert, at times at will, that profit split should be used to assign or divide intangible related returns rather than relying on marketplace benchmarks to determine an affiliate's entitlement to a certain amount of compensation. This proposed change to the *OECD Guidelines* is neither necessary nor advisable.

U.S. courts addressing difficult transfer pricing matters have for decades preferred even “imperfect” or "constructed" comparables to reach what they believe are reliable results rather than endorse the IRS proposed use of formulas or theories, such as profit splits, that are not based on marketplace benchmarks.[18] Around the world there are no commonly held principles, "rules" or even formulas as to how profits are supposed to be reliably split.

Perhaps in part because of this lack of guidance, aggressive tax authorities find profit splits convenient to quickly assert the tax collection results to which they believe they "should" be entitled. Encouraging such tax administration behavior cannot be good for the international tax system or cross border trade. It will in many cases force taxpayers into the courts, in which by the way, they have been very successful. Is that what the OECD and tax administrators want?

Tax administrators that favor the use of profit split are underestimating the uncertainty, conflict and double taxation that greater endorsement and use of profit split will create. Tax administrators and the OECD are also overstating the challenges of working with even “imperfect” and “constructed” comparables to reach reasonable and reliable pricing outcomes involving intangibles.

[18] The IRS views two sets of cases, referred to frequently as *Lilly* and *Searle*, as endorsing profit split. Putting aside questions about whether that is the best or most accurate view of these decisions, the TPDG would like to point out that these cases are anomalies, and, at the trial level, are both the product of the same judge.

In the view of the TPDG, the proposed Chapter VI could easily be revised to reduce the dangers described above. The TPDG would be pleased to offer specific drafting changes at the OECD's request.

V. Additional Suggestions

- Move the comments remaining in Chapter VI on group synergies to Chapter I.

- Omit continued and multiple references to what unrelated parties "would have" done and instead emphasize careful comparisons with actual unrelated party transactions, what they actually earned, and the manner in which different comparability adjustments can and should be made given the relevant contract, business activities, risks, etc. of the related parties as actually structured and implemented.

- Omit the phrase "unique and valuable" intangibles from future guidance. The phrase is problematic, particularly as defined.[19] The second part of the definition of such intangibles is as follows:

> …(ii) whose use in business operations…is expected to yield greater future economic benefits than would be expected in the absence of the intangibles.

[19] *2013 Intangibles Discussion Draft*, paragraph 51.

This would seem to apply to all intangibles, such as ordinary customer lists and relationships as well as patents and trademarks. Thus, it is unclear what this part of the definition adds. The first part of the definition states as follows:

> …those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions…

This part of the definition is vulnerable to subjective judgments and consequently, abuse, particularly by tax administrations (or taxpayers) seeking to routinely use profit splits rather than relying on marketplace benchmarks or analyses based on business-based cash flow projections. If the definition cannot be refined and made substantially more objective, then the phrase should not be utilized. In any event, the TPDG wonders why the phrase “unique and valuable intangibles” is necessary or what it could usefully add to future guidance even if defined objectively. The OECD took the right course in omitting the previously proposed category of “section D1(vi) intangibles,” and it should follow that course here as well.

VI. Conclusion

The TPDG believes the OECD can and should, through revisions to Chapter VI of the *OECD Guidelines*, add clarity and appropriate guidance to the treatment of certain situations involving intangibles and transfer pricing consistent with the well-established principles of the arm's length standard. (Positive examples and suggestions are provided in Parts II-V of this letter.) The TPDG believes that the OECD has at the moment a remarkable opportunity to make constructive contributions to the public debates about BEPS and intangibles transfer pricing given the involvement of the G20 and the recent BEPS Action Plan. This is part of why the TPDG believes it is so important for it (and others) to participate in the OECD process and welcomes the opportunity to do so through these comments and the upcoming OECD Business Consultations.

At the same time, and as the TPDG understands it, the mandate to the OECD at hand is to address intangibles pricing issues under the "arm's length standard" by, in particular, revising the *OECD Guidelines*. The TPDG believes the *2013 Intangibles Discussion Draft* has, on the key points so identified in this letter, gone well beyond this mandate. Even if, contrary to the views of the TPDG and other taxpayers, there is a consensus among the participating countries that the IRR statements and certain related parts of the *2013 Intangibles Discussion Draft* represent sound tax and trade policy, are practical, and can be implemented without creating the double taxation and other problems identified, then the OECD should recognize and acknowledge, for the reasons provided above, that these parts of the proposals should only move forward under BEPS as "special measures" (i.e., legislation). The BEPS Action Plan understandably envisions the need for "special measures" and proposals for them are to be expected.

Please contact the undersigned with any questions or comments. We look forward to a constructive dialogue at the November OECD Business Consultation.

Sincerely,

Steven P. Hannes

Cc: TPDG Members