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Dear Mr Owens

This is Ernst & Young's response to the OECD's invitation to contribute to defining the scope of its project on the Transfer Pricing Aspects of Intangibles.

The invitation sought comments on:

- ▶ the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles;
- ▶ shortfalls, if any, in the existing OECD guidance;
- ▶ areas in which the OECD could usefully do further work; and
- ▶ the format of the final output of the OECD work.

We have attempted to distinguish these questions; but they are closely related.

### **Question 1 - What are the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles?**

The most significant issues involving intangibles include:

- ▶ What arm's length method should be used, particularly for non-routine intangibles for which it is highly unlikely that there will be publicly available data that could be used as a comparable?
- ▶ How to divide the returns of the exploitation of licensed intangibles between the licensor and licensee;
- ▶ Whether there are "intangibles" for which it is not appropriate to make some form of payment;
- ▶ How should services be priced that include the use of intangible assets?
- ▶ Ownership of intangibles from a legal, economic and functional perspective; both in relation to remuneration of functions making use of the intangible and in relation to any change of the ownership and the associated valuation;
- ▶ What entity(ies) own(s) co-developed or other network intangibles?

- ▶ Treatment of expenses incurred by a licensee for the (further) development of the intangibles;
- ▶ Recognition of cost contribution arrangements and the valuation of contributions of the participants.

### **Question 2 - What shortfalls, if any, are there in the existing OECD guidance?**

Our comments below are approximately listed in order of importance.

- ▶ There is a lack of clear guidance that comparable transfers of intangibles are NOT required to apply the arm's length standard for transfer pricing purposes. The mere fact that similar transfers of intangibles do not occur among unrelated parties should not have as a consequence that the transaction may not be recognized. The issue here is the same as that in relation to restructurings, which is addressed well in new Chapter IX.
- ▶ The Guidelines lack guidance on the role of legal ownership. It should be clarified what the role of legal ownership should be; how this relates to economic (co)ownership or functional ownership; and how the reward for the various ownership forms should be determined.
- ▶ Closely related to this, further guidance on the “ownership” of intangibles which are not legally protected may be useful.
- ▶ The distinction between the definition of intangibles for transfer pricing purposes and the definition used for financial accounting purposes should be clarified.
- ▶ The Guidelines presently do not provide guidance on how to handle certain synergies from a global operation, such as network intangible effects of volume or scale or location savings.

### **Question 3 - In what areas can OECD usefully do further work?**

#### ***Definition of intangibles***

While the definition of property rights is typically a domestic law issue which may not be subject to the provisions of a double tax treaty, defining what intangibles are subject, and - maybe even more – are not subject to transfer pricing is within the purview of the transfer pricing guidelines and double tax treaties. Examples of attributes of a business which it may be claimed should be treated as intangibles for which an arm's length remuneration should be paid/received include:

- ▶ First mover advantage
- ▶ Scale
- ▶ Barriers to entry
- ▶ Superior management
- ▶ Future profit potential
- ▶ Risk bearing activities
- ▶ Goodwill

- ▶ Going concern
- ▶ Workforce-in-place
- ▶ Network intangibles
- ▶ Development of subsequent generations of intangibles to the extent the original developer did not develop
- ▶ Creation of derivative works related to licensed intangibles (as compared to development of next generation intangibles)

### ***Use of hindsight***

It would be useful to consider whether additional guidance can be provided on how to deal with the inherent difficulty of forecasting the profits arising from intangibles in order to discourage the application of hindsight. Ideas for consideration include:

- ▶ Provision of partial safe harbors on certain types of transactions;
- ▶ Provision of increased deference to taxpayer approaches if defined criteria or processes have been followed
- ▶ Provision of more examples of where unforeseen results would be consistent with the arm's length standard.

### ***Valuation of intangibles***

It would be useful to provide more guidance on valuation methods including current transfer pricing methods in the guidelines. Frequently used methods and their characteristics should be addressed, and the acceptability from the perspective of the arm's length principle should be discussed. For example:

- ▶ The discounted cash flow method, including elements such as the discount rate, useful life, exclusion of future income unrelated to the licensed or transferred intangible
- ▶ Profit split method
- ▶ Capitalized cost approach
- ▶ Relief-from-royalty method/approach
- ▶ The "Investor Model"
- ▶ The acquisition price or market capitalization approach.

In addition, guidance on specific issues with regard to the comparability analysis appropriate to a particular method may be useful. For example, when using a discounted cash flow method, what steps should be taken in the comparability analysis to determine the discount rate to be applied?

In applying the often used methods for valuing intangibles, the decision to use pre - or post tax valuations can have a significant impact. It would be helpful to have guidance on this issue.

### **Aggregation and bundling**

Issues here include the pricing of service transactions which may be seen as reliant on “embedded” intangibles and the bundling of services and intangibles. A specific point for consideration here is the “franchise model”.

### **Information asymmetry**

An issue that is relevant for the application of the arm’s length principle in general but, with regard to intangibles specifically, is the question whether in related party transactions information asymmetry should be the starting point. Obviously, third parties transacting have to deal with information asymmetry. This asymmetry will influence the valuation of intangibles. The question is whether this should be the starting point when evaluating transactions between related parties.

### **Cost contribution arrangements (CCA’s)**

Although in final form Chapter IX is not absolute on this point, it may be difficult to reconcile the assumption of risk by a number of parties to a CCA with the notion that the party bearing a risk should “control” that risk. The necessary nature and degree of participants’ participation in the governance of a CCA if it is to be accepted should therefore be clarified.

Closely related to this is the question of balancing financial and “in-kind” contributions to CCA’s.

### **Question 4 - Format of the final output of the OECD project**

Ernst & Young believes the final output should be in the form of a revised Chapter of the Guidelines. We think the provision of examples would be extremely helpful, either as part of the Guidelines, or as an appendix.

### **Closing remarks**

Ernst & Young hopes that these suggestions are of assistance in defining the scope of this important project.

Ernst & Young would welcome the opportunity to contribute further through participation in the consultation meeting on 9 November. In the meantime please let me know if we can be of further assistance.

Yours sincerely



Robert Miall  
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