September 15, 2010

Mr. Jeffrey Owens
Director
Organisation for Economic Co-operation and Development ("OECD")
Centre for Tax Policy and Administration
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Dear Mr. Owens,

True Partners Consulting, in cooperation with its global network of affiliates (collectively "True Partners International" or "TPI"), welcomes the opportunity to provide commentary to the OECD with respect to its undertaking of a possible revision of Chapters VI and VIII of the Transfer Pricing Guidelines ("TPG") concerning various aspects of Intangible Property ("IP").

Intangibles are clearly a very important topic within the transfer pricing realm and therefore we welcome the OECD's initiative to hopefully clarify certain issues pertaining to the transfer of IP. In the following sections, we share our ideas for the development of more cohesive international guidance.

Best Regards,

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1. Definition and identification of intangibles

One of the most important issues regarding IP within the context of transfer pricing, and is a critical first step in any such analysis, is the identification of the relevant IP. Therefore it is especially important in an international context that all jurisdictions have a common definition of what constitutes IP that is subject to transfer for tax purposes.

Generally, there are two categories of IP with regard to origin:

1. IP bought-in from independent parties; and
2. Internally-developed IP.

IP belonging to the first category could easily be identified in most cases. These assets are typically accounted for in the Taxpayer's financials through some sort of valuation or purchase price allocation exercise.

IP in the second category is more difficult to identify. Consider for example at what point an R&D activity actually yields a result that can be considered IP? Specifically, in the pharmaceutical industry one question that often arises is at what point in time is IP created; after the identification of a potentially active substance? After the preclinical trial? Or, not until the successful phase III of the clinical test (approval of the active substance)? It would be very helpful if the OECD TPG provide more clarity and guidance as to what constitutes IP and when internally-developed IP actually becomes a potentially valuable commodity.

Chapter VI of the TPG provides a list of items that can possibly be considered IP. Specifically, IP can include the rights to use industrial assets, for example, patents, trademarks, trade names, design or models. Literary and artistic property rights, know-how and trade secrets are also mentioned. Chapter VI also discusses business rights, including commercial activities, primarily marketing activities. This type of IP is referred to as commercial intangibles which are divided in two categories: marketing intangibles and trade intangibles. We believe that the examples provided in the TPG of what constitutes IP is too narrow in scope and not enough specific examples are provided.

Below we provide some specific examples that the OECD may wish to consider in terms of first, identifying an intangible asset:

- Legal existence and possibility of such protection
- Possibility of private ownership
- Ability to transfer

- Tangible evidence of the existence of the intangible asset (Registrations, contracts, codes, blueprints, etc.)

Furthermore we see potential in expanding the categorisation and examples for IP to include more specific categories like:

- Data related intangible assets (E.g. software, software copyrights, etc)
- Customer related intangible assets (E.g. customer lists, customer contracts, customer relationships, open purchase orders, etc.)
- Human capital-related intangible assets (E.g. trained workforce, employment agreements)
- Marketing-related intangible assets (E.g. trademarks, trade names, brand names, logos, etc.)
- Technology-related intangible assets (E.g. process patents, patent applications, technical documentation, etc.)
- Artistic-related intangible assets (E.g. Literary works, copyrights for music, movies, etc.)
- Engineering-related intangible assets (E.g. industrial design, product patents, trade secrets, engineering drawings, proprietary documentation, and know-how)
- Contract-related intangible assets (E.g. favourable supplier contract, license agreements, franchise agreements, non-compete agreements, etc.)

2. Transfer and Disposition of IP

There also appears to be a lack of international cohesion on the accounting treatment of IP that may be transferred or sold from one related party to another. For example, the sale of IP may trigger a capital gain in the jurisdiction of the seller, but inconsistent treatment from the perspective of the purchaser, e.g. amortization, deductibility, presents significant challenges to taxpayers in considering the appropriate action to undertake. Furthermore the treatment of goodwill, which by definition is not allocable to a specific intangible asset should also be considered, that is, how is goodwill treated when IP is transferred from one party to another, and where the transferor has significant goodwill on its balance sheet that is arguably related in part to the IP in question?

3. Management and Taxation of IP

The valuation of intangible property is critically important in determining how the IP is exploited and the benefits and consequences of doing so. There is, however, a conflict between commercial factors that may determine how the IP is exploited and the views of the various tax authorities who are concerned with ensuring that they receive the appropriate amount of tax resulting from the exploitation. This can have serious repercussions for a multinational group that wishes to retain ownership of the IP within the Group but, for a variety of reasons, may wish that the management of the Group's IP be in a different jurisdiction from that where it may have been initially created or purchased. Also, it is unlikely that internally-developed IP would have been created in one place within the Group and the transfer of it to one company that manages it will create tax issues. Thus, the OECD may want to give consideration to enabling multinational companies to transfer IP throughout the Group without any tax issues until such time as it is transferred externally. A considerable amount of time is wasted through having to agree values for IP with various tax authorities when it is only transferred internally within a Group.

It is accepted that tax authorities need to ensure that they obtain their share of tax *at some stage* but this should only be when the IP is sold externally by the Group and not on every internal transfer. The OECD should devise some form of allocation method or profit share that allocates the eventual profit on an external disposal of IP to each of the Group companies that were involved in the creation or purchase of that IP. As long as the IP can be identified throughout its life-cycle (as discussed above) it should be possible to determine an appropriate allocation, perhaps by a refined and expanded cost sharing arrangement that must recognise reductions in value as well as increases. Considering the position only on an external sale of the IP would simplify the tax position and prevent the need for agreeing to valuations of internal transfers solely for tax purposes. Tax authorities would admittedly "lose out" on the initial tax that would be negotiated at the time of transfer but if it was coupled with the removal of tax deductions for internal royalties or cost charges, there would be, hopefully adequate compensation until the ultimate profit is allocated among the Group companies for tax purposes.

4. Valuation of IP

Where a Group purchases IP, there is a value determined and this forms the basis of the initial cost. But in order to exploit that IP it may be necessary to make refinements or develop it further. There is thus a combination of purchased and internally generated IP that will have different valuations. The main difficulty concerns IP generated internally and how this is valued particularly where it is generated in different companies within the Group and/or used by other group companies. It is relatively simple to use cost as the basis of valuation but then what should be included in cost. The cost of research and development of the IP should obviously be included but what of that spent on the research and development of products and processes that do not produce defined IP but perhaps set the groundwork for that which does. Arguably all of these costs should be included. But what of marketing? The value of IP is dependent to a significant extent on how it is marketed, particularly to the end consumer, and it is acknowledged that a well known branded product will, at least initially, be more valuable than "the new kid on the block" but this, arguably, is because of the brand name behind the product rather than the actual product itself. Thus, the brand name is itself IP and consideration needs to be given to the components of IP and whether they can be unbundled for valuation purposes.

Additional guidance should be provided by the OECD with respect to methods that depend on the expected future benefit of exploiting the IP. In particular, the application of a method that utilizes the total expected returns resulting from the exploitation of the IP, i.e. returns that would arise from manufacturing capabilities, distribution network and other already-established intangibles, could give rise to a value independent parties would likely not pay.

It would also be helpful if the TPG provided additional guidance as to the application of market-based methods:

- Market oriented methods, like the CUP with possible adjustments
- Income oriented methods, like the discounted cash flow method or the relief-from royalty method

For each of the methods listed, guidance regarding the most important valuation factors should be given. For example, when considering an income-based approach such as the discounted cash flow method, guidance regarding the usage of an appropriate discount rate should be provided. For example, how should the Taxpayer calculate the risk premium on the risk free rate of return? Could the Weighted Average Cost of Capital of the selling company be used in the course of the valuation or it is necessary to calculate the discount rate on the basis of the Capital Asset Pricing Model tailored to the individual IP which will be transferred? Another important valuation factor is the economic life of the IP which determines the capitalization period. To use an indefinite capitalization period should be the exception.

Also, guidance should be provided as to what is the preferable valuation approach for a particular type of asset. For example would it be preferable to use a cost based method for IP which could be reproduced in the short to medium term?

Given that the valuation of IP can be a very complex process, The OECD may consider providing guidelines to facilitate and/or simplify the process for small and medium sized companies. For example, relief from documentation requirements can be granted to small or medium size Taxpayers that enter into IP transactions that are considered relatively small.

5. Cost Sharing

One of the key aspects under consideration relates to Cost Contribution Agreements or CCAs. CCA's have been part of some of the most controversial issues to analyze by both practitioners and tax authorities alike. Below we present our general suggestions and comments as to how, we believe, the Guidelines should be modified to address some of the issues that have arisen with regard to the implementation of CCAs by taxpayers.

A. Buy-in Payments

As the introduction to Chapter 8 (Paragraph 8.1) suggests, further guidance may be needed on measuring the value of contributions (defined as "Buy-in" payments) to CCAs. The determination of Buy-in payments presents a significant challenge to participants engaged in a CCA. In particular, the method should be applied and the assumptions and variables employed by practitioners and tax authorities alike, should be given special consideration. While the TPG in their current form do not provide much other than guidance, acceptable methods should be defined and examples examples of the application of such methods should be provided. However, the OECD should avoid the path taken by the Treasury Department of the United States in their recently modified temporary regulations (Reg. Sec. 1.482-7T) concerning Cost Sharing Agreements. We find that the U.S. regulations are too constricting in requiring taxpayers to apply a specific method in various situations. In particular, the "investor model" presented in the temporary regulations focuses too much on the fact that the initial developer of the intellectual property ("IP") may be entitled to compensation over and above the compensation due to a participant who only contributes funds or other assets. The purpose of the CCA is to equalize the burden of risk and therefore the value of the contributions should be assessed based on the risk and reward each party will anticipate to contribute and receive respectively. We recommend that specific valuation methods be prescribed with sufficient leeway provided to taxpayers to apply reasonable assumptions as to the various variables involved.

In addition, Paragraph 8.16 States:

"…It can be difficult to measure contributions that involve shared property or services, for example where a participant contributes the partial use of capital assets such as buildings and machines or performs supervisory, clerical, and administrative functions for the CCA and for its own business. It will be necessary to determine the proportion of the assets used or services that relate to the CCA activity in a commercially justifiable way with regard to recognized accounting principles and the actual facts, and adjustments…"

Further guidance and examples would be helpful in this area since taxpayers often do not consider such contributions in determining the contributions. However, once again, we caution the OECD to carefully consider the implications of this since it may not be appropriate to consider such contributions as anything more than a service provided by one or participants to the rest of the participants. For example, should all of the development activities be undertaken by one entity, this does not mean that, for example, its "workforce in place" or capital assets be necessarily considered a separate intangible that is contributed to the CCA. Consideration should be provided as to whether adequate compensation should include a markup on costs incurred. This may be particularly applicable if the method used to calculate the appropriate contribution is an income-based method rather than a cost-based method.

B. Adjustments

Paragraph 8.20 states:

"… It may be appropriate, particularly where benefits are expected to be realized in the future, for a CCA to provide for possible adjustments of proportionate shares of contributions over the term of the CCA on a prospective basis to reflect changes in relevant circumstances resulting in changes in shares of benefits. In situations where actual results differ markedly from projections, tax administrations might be prompted to inquire whether the projections made would have been considered acceptable by independent enterprises in comparable circumstances, taking into account all the developments that were reasonably foreseeable by the participants, without using hindsight."

While we agree that CCAs should provide for a means of dealing with cases where the economic circumstances of the transaction(s) result in benefits that are materially different than those originally contemplated at the outset of the agreement, we caution the OECD to consider how much latitude is provided to tax authorities to account for such differences. Though we note that the TPG suggest that hindsight should not be used, we suggest that more exacting language should be used in this regard and further discussion surrounding what may be concluded among arm's length parties facing similar circumstances. In our experience, arm's length parties do not simply adjust for the entire difference between anticipated and actual results but rather engage in a process of negotiation to "settle" the differences. This may vary from party to party and all reasonable approaches should be outlined. Otherwise, adjusting the results based only on the differences between anticipated and realized results removes the risk that each party agrees to undertake.

C. Characterization of Payments

Further guidance will also be helpful with regard to the tax characterization of contributions, balancing payments and buy-in/buy-out payments. In addition, clearer distinction should be provided between Buy-in payments and Balancing payments. While the TPG clearly state that the payments should not be considered royalties, there is no specific guidance provided as to how the payments should in fact be characterized.

1. Separate treatment of cost sharing for services versus intangible development (marketing as well as R&D)

The TPG in their current form do not clearly distinguish between cost sharing related to services, commonly referred to Shared Service Agreements ("SSAs") versus that related specifically to IP development. The distinction is important as an SSA is typically applied to centralized services that do not give rise to intangibles that can be exploited in the future and thus the benefit is merely the ability to reduce costs between and among the affiliates of a Multinational Company ("MNC"). We recommend that SSAs be treated specifically in the Chapter 7 – Special Consideration for Intra-Group Services.

2. Other Considerations

Paragraph 8.19 states:

> "There is no rule that could be universally applied to determine whether each participant's proportionate share of the overall contributions to a CCA activity is consistent with the participant's proportionate share of the overall benefits expected to be received under the arrangement. The goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate contributions in the same proportions…"

Further guidance on this issue would be helpful. While we agree with the TPG stated goal of the above statement, we consider this to be a fundamental consideration in determining the arm's length value of each party's historical and annual contributions, examples of how this is determined and applied by arm's length parties is paramount. We suggest that the TPG provide some practical guidance and parameters with respect to this issue.

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