

COMMENTS ON THE SCOPING OF OECD'S FUTURE PROJECT ON THE TRANSFER PRICING ASPECTS OF INTANGIBLES FROM THE CMS ALLIANCE

Introduction

As a foreword, we welcome the fact that the OECD invited the practitioners to comment on the scoping of its future project on the transfer pricing aspects of intangibles. We believe that intangibles have become one of the most challenging topics in the transfer pricing area from theoretical and practical perspectives.

Intangibles are now a key focus in the field of transfer pricing: the number and size of the transfer pricing disputes in relation to intangibles increased significantly in recent years while intra-group transactions in relation to intangibles are proliferating. We therefore believe that chapters VI and VIII of the OECD Transfer Pricing Guidelines approved in 1996 and 1997 do not fully address certain issues and that the OECD Committee on Fiscal Affairs should revise these chapters.

As per the invitation to comment, we will successively discuss the issues encountered in relation to the:

- Definition of intangibles;
- Transfer of intangibles; and
- Valuation of intangibles.

Definition of intangibles

The current version of the OECD Guidelines does not contain a detailed definition of intangibles for transfer pricing purposes but an illustrative list of typical intangibles. Given the various definitions of intangibles for legal, accounting and tax purposes, we believe that the OECD Guidelines should better assist tax payers and administrations in defining and recognising intangibles. We also believe that the OECD should especially address the conflicts between the various existing regulatory frameworks (legal, accounting and tax) regarding definition and identification of intangible assets, and how these conflicts should be solved from a transfer pricing standpoint.

An issue arising in this area is the definition of intangibles for transfer pricing purposes in comparison with the legal notions of protected intellectual property rights. Problems with transfer pricing of intangibles frequently can be traced to a lack of understanding of what intangibles are and who owns them. Intangibles are part of the commercial or property law of almost every country and this law could assist the taxpayer and practitioner in dealing with questions of whether something is an intangible, what right that confers and who owns those rights. Because the discussion is on intangibles, it seems only proper to consider rules and procedures under intellectual property law. Therefore, should indeed the definition of intangibles for transfer pricing purposes more closely be related to the definition of intangibles under intellectual property law?

Another approach in the field of transfer pricing is to consider intangibles as something that are not tangible assets and have the potential to create value for the parties. However, there are services which are unique and carry high added value and intangibles that are not unique or not highly valuable. Differentiating intangibles from value-added services could in this context become a controversial topic on which there is currently no guidance in the OECD Guidelines.

Rewarding intangibles could also be based on those situations where a process adds not only value but *abnormal and excess* value. This approach to the question of transfer pricing and intangibles

suggests that only on those situations is it expected that intangibles contribute value relevant for transfer pricing purposes and that determining the location and ownership of intangibles is only relevant when there is obvious and clear out-performance compared to the comparables. We therefore believe that the OECD Guidelines should be changed to clarify the concept of routine vs. non-routine intangibles and to address the question of whether an intangible should necessarily generate abnormal and excess profits.

We also believe that the OECD could do further work to determine if the existing list of typical intangibles should be extended to include assets such as unique organisation structure, human resources and workforce in place, databases, network, and/or to detail the typical intangibles already included in this list (know-how, models, etc.).

Finally, we believe that the OECD could provide more detailed guidance on the concept of “economic ownership” of an intangible, especially as regards situations where this concept significantly conflicts with the regulations included in the intellectual property law. More specifically, considering that this concept is by and large “unknown” in the legal regulatory framework applicable to intellectual property, the OECD should discuss what validity should be attached to this concept, from a transfer pricing standpoint, having due regard to the economic circumstances of the analysed transaction. Additional guidance could also be provided regarding how to determine, in a practical situation, how this concept would be used (or not used) by independent parties in conducting transactions on the open market. Besides, additional questions also related to: How and when is “economic ownership” created? What is the amount or nature of the activity necessary to create “economic” rights in intangible property returns? Who has the right to share in the future return of an intangible: the legal or economic owner of the intangible?

Transfer of intangibles

Many different approaches exist regarding intangibles. Not only as to what is included in the definition of intangibles, but also and fundamentally as to how transfers of intangibles are treated from a domestic law perspective. Given that differences in opinion and approach are likely to lead to double taxation, the OECD should work on the question of how avoidance of double taxation can be assured in relation to transfer of intangibles.

Firstly, when considering the transfer of intangibles, it has to be reiterated that transfer (through sale, disposal, licensing, etc.) routinely happens between independent enterprises and this is not an arbitrary concept invented for tax reasons.

We also believe that it will be useful for the OECD Guidelines to answer in more details the following questions:

- How is a transfer of intangibles established: from the perspective of the seller, buyer, both? If the answer is both, does that mean that two analyses need to be performed?
- Whether (and how) the notion of economic ownership should impact the analysis in case of transfer of an intangible, and possibly distinguish cases where the transfer takes the form of a license from those where it takes the form of a sale.
- Should issues with regard to the transfer of intangibles in specific industries very regularly affected by these questions (e.g. banking, pharmaceutical, information and entertainment industries) be addressed in the OECD Guidelines?
- Should other considerations (VAT, WHT, Customs value) be discussed within the OECD Guidelines?

Transfer of intangibles is also addressed in Chapter VIII of the OECD Guidelines relating to Cost Contribution Arrangements. However we believe that the current definition of buy-in / buy-out payments in these guidelines is very limitative and does not deal with the legal nature and characterisation of these payments.

The OECD could also consider whether the recommendations for structuring and documenting Cost Contribution Arrangements should be extended in a similar manner as the US regulations or other countries specific rules.

Moreover, with regard to Cost Contribution Arrangements, the OECD Guidelines neither provides explanations in relation to the similarities and differences between these arrangements and profit split agreements, nor address the case of a single entity incurring costs in a Cost Contribution Arrangement.

Valuation of intangibles

Under the OECD Guidelines, the intra-group sale and/or license of intangible assets should be priced in accordance with the arm's length principle. Current guidelines indicate that the methods for setting an arm's length price for goods and services will be of application for the purposes of intangibles transfer pricing. However, there are substantive differences in how intangibles add value to a business, compared to goods and services, and these must be taken into account in assessing how to approximate the arm's length price return for the transfer of an intangible.

The inherent characteristics of intangible assets mean that determining an arm's length price for transactions involving the sale or license of intangibles assets can be substantially more complex than determining an arm's length price for physical good transactions. Conversely, extensive databases of agreements between unrelated parties are publicly available, which is fairly unique when compared to other types of transactions.

We believe that it would be beneficial for multinationals enterprises and tax administrations if the applicability of the methods described in the OECD Guidelines was clarified in order to give more guidance on the circumstances in which methodologies in Chapters I to III are more likely to be applicable to intangibles.

Moreover, it would be useful to discuss whether certain attributes of an intangible or of the transfer of an intangible should be taken into account and how: relative bargaining position of the parties; alternative options realistically available to the parties, synergies, useful life, etc.?

As practitioners, we would also welcome the OECD's views on the following issues in relation to the valuation of intangibles:

- Many aspects could contribute to value creation and it could become difficult to draw a line between the respective intangible assets used in a business. Should a separate value be determined for each intangible, or could an aggregate value be ascertained for a combination of intangibles? How to determine the relative importance of combined intangibles over time?
- Benchmarking analyses regarding intangibles (especially license rates) differ from other benchmarking analyses. Should the OECD provide further guidance in relation to these analyses?

- In third parties situations, businesses value the transfer of intangibles using methods such as the market, income or cost approaches (including amongst others the DCF, multiples, relief-from-royalty, premium profits, or excess earnings methods). Some tax administrations including the IRS and the French Tax Administration also propose or impose certain methods for valuing businesses and/or intangibles. We believe that the OECD should not only allow for the use of other “non-specified” methods, as it is currently the case, but also consider providing guidance in this respect, defining these methods, and discussing the circumstances when these methods may be appropriate to determine an arm’s length price.
- In certain circumstances, more than one method will need to be undertaken to determine an appropriate return for the transfer of intangibles. We believe that the OECD Guidelines should be revised to include detailed explanations with regard to the use of an arm’s length range if more than one method is used or if several potential values arise from the use of different assumptions.

Experts of the CMS Alliance Transfer Pricing Group who contributed to these comments are:

Bruno Gibert: Head of Transfer Pricing Group, CMS Bureau Francis Lefebvre, Paris

Arnaud Le Boulanger: Chief Economist, CMS Bureau Francis Lefebvre, Paris

Stéphane Gelin: CMS Bureau Francis Lefebvre, Paris

Giovanni Cali: CMS Adonino Ascoli & Cavasola Scamoni, Roma

Nick Foster-Taylor: CMS Cameron McKenna, London