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By E-Mail

www.richterconsulting.com

Direct Line: (514) 934-3552
E-mail: jrhee@richterconsulting.com

Mr. Jeffrey Owens
Director
OECD Centre for
Tax Policy & Administration

Re: Public Comments on the Transfer Pricing Aspects of Intangibles

Dear Mr. Owens,

Thank you for the opportunity to provide comments on the Transfer Pricing Aspects of Intangibles of the OECD Transfer Pricing Guidelines. Please find herewith our comments and suggestions of issues to address.

Comments on the Transfer Pricing Aspects of Intangibles

- I. *What are the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles?*
 1. Transfer of an intangible asset
 - 1.1. One of the most significant issues that have been encountered in recent years is the question of whether something of value has been transferred when a Multi-National Enterprise ("MNE") restructures its business. This issue was touched on in the last OECD Discussion Draft on Business Restructurings and it raises fundamental issues that should be further explored to adequately respond to it.
 - 1.2. Some of the issues that arise in trying to answer this question include:
 - 1.2.1. What is an intangible asset (definitional exercise)?
 - 1.2.2. Are there differences in the definition of intangible assets for transfer pricing, accounting and legal purposes?



- 1.2.3. Is there a difference between an intangible asset and a “value driver”¹ such that an intangible asset can be transferred while a value driver cannot be transferred separately from the entire business?
- 1.3. When an MNE closes down one location and replaces it with another location in another jurisdiction, has it transferred something of value to the new site?
 - 1.3.1. For instance, assume MNE has a manufacturing facility (Subsidiary A) in Country A which has been in existence for 20 years. Subsidiary A was treated as a contract manufacturer, supplying MNE and other subsidiaries and has consistently earned a net cost plus return for its activities. However, Subsidiary A’s facilities are aging, inefficient and the cost of production in Country A has been steadily increasing in the last years. As a result, MNE closes down the manufacturing activities of Subsidiary A and opens a new state of the art facility in Country B. Subsidiary B replaces Subsidiary A as the global supply chain manufacturer under a contract manufacturing arrangement, with a cost plus return.
 - 1.3.2. This example raises a number of questions including the following:
 - 1.3.2.1. Does MNE’s termination of the contract manufacturing arrangement result in the transfer of intangible assets away from Subsidiary A to the new manufacturing subsidiary?
 - 1.3.2.2. If so, what are those intangible assets that have been transferred or would it be argued that the whole business, including its goodwill, has been transferred?
 - 1.3.2.3. If something of value has been transferred, how is it valued?
 - 1.3.2.4. Does a captive subsidiary have goodwill?
- 1.4. Another situation in which it may be argued that a transfer of an intangible asset arises is in the context of one company providing R&D services to another. Certain jurisdictions have argued that notwithstanding a “contract R&D” service arrangement, that in certain cases the party that provides the service has created an intangible asset and has effectively transferred the intangible to the other party.
 - 1.4.1. Questions raised in this example are:
 - 1.4.1.1. What type of activities or what are the facts of such cases which would lead to the conclusion that intangible assets have been transferred despite the legal arrangement for one party to provide an R&D service?
 - 1.4.1.2. Is that a recharacterization of the transaction and should tax authorities be permitted to do so?

¹ A “value driver” would be for example, a workforce or customer relationships that may lend value to the business but cannot be transferred between parties dealing at arm’s length as a separate asset.



2. Valuation of intangibles

- 2.1. If an intangible asset has been transferred, what are the appropriate valuation methodologies that should be used?
- 2.2. The standard transfer pricing methodologies would likely not apply in these circumstances and it may be useful to consider valuation methodologies such as a Discounted Cash Flow (DCF) method or the market capitalization method.

3. The effect of intangible assets or “value drivers” on functional and comparability analyses

- 3.1. The presence of intangible assets or significant value drivers will affect the transfer pricing methodology used and the determination of the tested party if a one-sided transfer pricing methodology is used.
- 3.2. The main issue in this regard is how to value or quantify the effect of the intangible asset or value driver. For instance, it may be argued that a sales and distribution subsidiary (Subco) has a large market share in a particular country because of its longtime presence in that country and the strong customer relationships it has cultivated over the years. The questions that arise are:
 - 3.2.1. Whether this competitive edge is an intangible asset or a value driver;
 - 3.2.2. Whether this value outweighs the value of the products purchased from the other party to the related party transaction and therefore, which party should be the tested party;
 - 3.2.3. Whether the market share and customer relationship are elements that other companies have in the comparability analysis and even if they do, whether Subco’s value is somehow different from the comparable companies’ values?
 - 3.2.4. Whether any adjustments could be made to the comparables’ profit level indicators to recognize Subco’s competitive advantage.

II. What shortfalls exist in OECD guidance on intangibles?

4. Identifying the existence of an intangible asset

- 4.1. A fundamental question is whether an intangible asset exists separate and apart from the business. This is an important question for transfer pricing purposes in performing a proper functional analysis (determining functions performed, assets owned, including intangible assets, and risks assumed by each party) and in determining whether a transaction involving a transfer of an intangible asset has occurred.
- 4.2. An intangible asset, that is identifiable and transferable, separate and apart from the business should be distinguished from general “goodwill” and value drivers that are inherently tied to the entire business. For instance, patents, trademarks, technical know-how or the design of a product are identifiable intangible



assets that can be separated from the entire business and transferred between arm's length parties, while goodwill cannot be separated from the whole business and would not be sold by itself to a third party.

- 4.3. What has confused matters is the accounting practice of itemizing components that make up goodwill. For example, workforce and client relationships are components of goodwill that for accounting purposes have been separately identified and valued in the context of a purchase price allocation. While these "assets" may be separately identified for accounting purposes in the context of a purchase price allocation, they are not intangible assets that would be sold to a third party separately from the entire business. They are in fact, "value drivers" of a business.
- 4.4. It may be useful to provide criteria in determining whether an intangible asset exists. The criteria could include whether the asset is legally registered and protected and the presence of any other legal agreement indicating ownership of an intangible asset (such as a licensing agreement). In fact, one proposition is that legal ownership is a key criterion that distinguishes an intangible asset from a value driver. However, other factors may be considered in distinguishing an intangible asset from a value driver for intangibles that are not legally protected (e.g. unregistered designs, know-how). The bottom line is that an intangible asset cannot be transferred to an arm's length party if there is no ownership of the asset. A value driver is not an asset that is legally owned (e.g. the company does not "own" a workforce or a client relationship).
- 4.5. Addressing the existence of intangible assets will also provide guidance for the definition of intangible assets for transfer pricing purposes (as opposed to a legal or accounting definition of intangible asset).

5. Ownership of intangible assets

- 5.1. It has been suggested that there are three tests which should be applied to determine the ownership of an intangible:
 - 5.1.1. Who is the legal owner of the intangible (i.e. the party which has the legal claim to the intangible or to intellectual property);
 - 5.1.2. Who is the economic owner of the intangible (i.e. the party which bears the costs and risks with respect to the development of the intangible and is therefore entitled to the income attributable to the intangible); and
 - 5.1.3. Who is the party that exercises practical control of the intangible through its use in the business activities²?
- 5.2. This test may be insufficient for transfer pricing purposes depending on how the question of identifying the existence of an intangible asset is answered. For instance, if legal existence is not a prerequisite in

² "Transfer Pricing and Intangibles: Summary of Discussions at the 61st IFA Congress in Kyoto", International Transfer Pricing Journal, IBFD, January/February 2008.



recognizing the existence of an intangible asset, then legal ownership cannot be determined for those intangibles that are not legally protected.

- 5.3. Moreover, there is a suggestion that somehow there can be more than one owner of an intangible asset; a legal owner and an “economic” owner. In some cases, the legal owner of an intangible asset is ignored where the intangible asset has been licensed to a related company on the basis that the licensee is the “economic owner” of the intangible asset. It would be useful for the OECD to provide guidance on such a separation (if indeed there should be such a separation) and the significance of this distinction.
 - 5.4. The question of which party “exercises practical control” of the intangible should also be addressed and clarified. Again, in the context of a licensing arrangement, it is common to see both the licensor and licensee sharing in the responsibilities relating to the exercise of control over the intangible asset. For instance, it is common to see a clause in arm’s length licensing arrangements that require the licensee to inform the licensor of any infringement on the use of the asset and to take appropriate action to stop such infringement, in addition to any action taken by the licensor. In these cases, the application of this test would not be helpful in determining the ownership of the intangible asset.
6. Quantifying the effects of intangible assets in a comparability analysis
- 6.1. Once an intangible asset has been identified and the ownership of the asset has been determined, the next step is to evaluate what effect, if any, such intangible asset has in a transfer pricing analysis. In other words, there are two possible effects the existence of an intangible asset can have in a functional analysis.
 - 6.2. First, the presence of intangible assets may affect the determination of the party that is selected as the tested party and/or the appropriate transfer pricing methodology to be used.
 - 6.3. Secondly, the presence of intangible assets may influence the choice of comparables or any adjustments that should be made to the financial results of the comparables. The issue in this case is whether there is sufficient available information to determine:
 - 6.3.1. Whether the comparables have intangible assets (as opposed to simply value drivers);
 - 6.3.2. If these intangible assets are similar to the intangible assets that would be expected to be owned by other comparable companies (sometimes referred to as “routine” and “non-routine” intangible assets); and
 - 6.3.3. How to measure the impact that the intangible assets have on the profit level indicators of the comparables.



III. *What are the areas in which the OECD could usefully do further work?*

7. Consider other methodologies for determining arm's length amount for transfer or use of intangibles
 - 7.1. The traditional transfer pricing methodologies are not always suitable for determining an arm's length amount for the transfer or use of an intangible asset. Other valuation methods, such as a Discounted Cash Flow, Market Capitalization or Relief from Royalty should be considered by the OECD for transfer pricing purposes as they may be more appropriate methods to determine arm's length amounts in the context of intangibles.
 - 7.2. In the valuations discipline, the 25/75 rule of thumb is often used in verifying the reasonability of a royalty rate. We would ask the OECD to comment on the validity of using such rule of thumb, which is commonly used for valuations purposes.
 - 7.3. In some cases we have seen a net margin analysis applied to test an intercompany royalty rate. In other words, the licensee's profit was tested against comparable fully-fledged companies and the profit in excess of these comparables was considered to be an appropriate royalty to be paid to the intangible owner. We would ask the OECD to consider and comment on this approach.
8. Clarification of terminology used in the context of intangibles
 - 8.1. Since the 1995 version of the OECD Guidelines, the transfer pricing lexicon has evolved, including terminology used in the context of intangible assets. It would be useful to have a clear and consistent definition of terminology and concepts including the following:
 - 8.1.1. Routine versus non-routine intangibles
 - 8.1.2. Legal versus economic owner of intangibles
 - 8.1.3. "Unique" intangibles
 - 8.1.4. Marketing intangibles
 - 8.1.5. Assister/Developer versus legal owner concept

IV. *What should be the format of the final output of the OECD work?*

9. Our suggestion for the format of the final output of the OECD work is as follows:
 - 9.1. Discuss relevance of intangible assets to transfer pricing (effects on the functional analysis, determination of transfer pricing methodology to use, determination of tested party, and recognition of whether an intangible asset was transferred or licensed).



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- 9.2. Methods to determine arm's length amounts for transactions involving intangible assets.
- 9.3. Methods to determine adjustments to comparables to take into consideration the effect of intangible assets on comparables' or the tested party's PLI.
- 9.4. Examples to illustrate under what conditions a license arrangement would be considered as a transfer of the intangible asset instead of a licensing arrangement.
- 9.5. Examples to illustrate when a transfer of an intangible has occurred in the context of a business restructuring.
- 9.6. Connection and tie-in to Chapters I-III, Chapter VIII and Chapter IX of the OECD Guidelines.

Conclusion

Thank you again for the opportunity to share our concerns, ideas and issues with the OECD on transfer pricing matters. As always, we encourage guidance from the OECD to facilitate the application of transfer pricing concepts for both tax administrations and taxpayers.

Yours very truly,

Richter Consulting, Inc.

Jennifer Rhee, CA	jrhee@richterconsulting.com
Ihor Soroka, M.A.	isoroka@richterconsulting.com
Irina Oks, M.A.	ioks@richterconsulting.com
Vladimir Zivkovic, M.A.	vzivkovic@richterconsulting.com
Linda Argalji	largagli@richterconsulting.com