OECD (TransferPricing@oecd.org)

Comment on "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" (July 30, 2013)

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## Executive Summary

We highly appreciate the importance and difficulties of intangibles in transfer pricing, especially in light of recent significant concern on BEPS, as well as efforts being made by the OECD. We understand that OECD is more emphasizing importance of comprehensive understanding of value creation of a multinational company given increasing importance of intangibles and digital economy. While we generally agree with the direction, the care has to be given to actual workloads for companies, particularly not very large yet doing business in multi countries.

Thus, for realistic application of the guideline, it is highly desirable if further guideline is provided as to distinction of important transactions which requires total value chain analysis and not that important so that one-sided analysis is still valid. For these purposes, further discussion should be developed to assess importance of intangibles owned by tested party and by comparables so that there will not be confusion between taxpayers and tax authorities as to when one-sided approach such as TNMM is appropriate or not. We also expect that further guideline would be provided as to an attribution of excess profits due to location savings and other market specific factors.

We also highly appreciate the efforts to made to provide extended numbers of examples to clarify the points made in main paragraphs.

## Specific Comments

D6 Location Saving and other local market features

1. We think it is very important to make clear distinction between location savings and other factors which affect intercompany pricing. Although the draft does a good job, we think it is possible to more clearly define other factors than location savings. In most cases, less competition in the given market results in higher profit for companies who are in the market. In these cases, the excess profit is attributable to first mover advantage as well as entry to barrier which the first movers may have created. It is not necessarily true that 100% of excess profit due to such market factors are attributable to local companies in the market. Another affiliate may contribute to give an access to such market with excess profit potential. Therefore, very careful analysis needs to be made to determine attribution of the excess profits due to location savings and other factors.

D.6.1 Location Saving

3 The order of consideration appears to be strange. If the relevant location savings are passed on to customers or suppliers, we do not need to make any further special analysis in transfer pricing study. Therefore, the consideration of (iii) "the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers" should come first and the analysis for any further consideration is not required if the location savings are completely passed on to independent customers or suppliers.

4 "Specific comparability adjustments for location savings" should be explained with examples here or in another appropriate section.

D.6.2 Other Local Market Features

12. As explained in the example of special license, it is important to emphasize contribution from more than one party. However, unless specific guidance as to how multiple contributions from different parties should be analyzed and quantified, the explanation may result only in confusion. The discussion can include relative size of expenditures spent on developing different types of intangibles, economic nature of developed intangibles including economic useful life, as well as quantified risks associated with developing and owning intangibles.

D.7 Assembled Workforce

14. It is not clear whether and how the "Assembled Workforce" should be analyzed in transfer pricing study. It has been always argued that compensations companies pay to employees are at "arm's length" thus companies are not better or worse off by having a specific workforce. Things may not be that straightforward and companies may in fact attract and retain "special" workforce through making special efforts and more expense. However the next difficulty would be that hiring and retaining a "special" workforce is not necessarily distinctively "expensive" compared to hiring and retaining a "not so special" workforce for the similar qualifications and the numbers of workforce. Thus if a company does not assume additional significant financial obligation and risks for assembling "special" workforce, it is hard to justify the view that the company developed and maintained intangibles. Finally, if a transfer pricing analysis already involves quantifying valuable intangibles such as R&D and marketing, and if relevant HR costs are capitalized in order to value such intangibles, it is likely that at least compensation for "special workforce" in these areas are already captured as capitalizable expenditures. Therefore, it is not necessary to separately consider intangibles of "Assembled Workforce", and doing so may result in double-counting.

Even if the criteria above are satisfied, making objective evaluation on "assembled workforce" may be extremely difficult. It can easily fall into subjective discussion and difficult disputes between tax authorities and tax payers.

Therefore, we do not recommend giving unwarranted weight on Assembled Workforce in intangibles valuation. If one can take a view that "assembled workforce" is more or less replaceable at market place, compensation to individual should be considered at reasonable level. Although it is possible that a seconded individual can make significant contribution to the value of intangibles (as described in para17), it is possible that another new hire may also make similar contribution. At least, working hypothesis should be that "assembled workforce" should be viewed as tentative, and not determinative, compared to more established categories of intangibles such as patents and corporate or product brands in transfer pricing analysis. Although the draft may imply the paragraph 17 as exception, we think it is more reasonable to delete it altogether.

18. Although it is true that MNE Group Synergies are important reasons why companies go multinationals, they are very hard to quantify in transfer pricing analysis. In fact, excessive emphasis on MNE Group Synergies may result in total rejection of

one-sided test such as TNMM and may always require two (or more)- sided tests such as profit split. MNE Group synergy may be appropriately incorporated with relatively simple scale adjustments if the advantage of larger scale is major component of the synergy, and the relationship between scale and profitability is observed.
Profit split analysis can be the best method under certain conditions but it should not be over-emphasized. Either as long as any group synergies are considered to be immaterial, similar synergy is available in comparables (for example, due to the size of a comparable), or not attributable to tested party, it can be ignored in the analysis. Unless group synergy can be objectively quantified vis a vis comparables, a separate analysis should not be required.

37. It is good to emphasize the importance of "an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across <u>the entire supply chain</u>." (Underline added) However, it should be noted that it would be very difficult to gain such "understanding" at the level of local subsidiary (as opposed to at global headquarters) if functions and risks of the local subsidiary is limited. It should be further discussed whether such holistic analysis involving the entire supply chain is necessary, if so in which situation . If it is deemed not necessary, one-sided approach such as TNMM would be sufficient as long as reasonable comparables are applied. If not, more comprehensive analysis including profit split is necessary. Practically how we draw the line between the two has been controversial for both tax authorities and tax payers. Any clear guideline as to when such "understanding" is required as well as how such "understanding" can be obtained if it is necessary should be highly appreciated.

38. Similarly, it is very useful if the guideline mentioned "when" the separate analysis on intangibles is required. If it is required, it should be noted real (as opposed to superficial) funding relationship, or financial risk, of developing the intangibles should be clearly identified as necessary task to be analyzed before the remuneration is discussed. It is often the case that "superficial" funding or financial risk analysis can produce misleading result. For example, if a manufacturing subsidiary MS is investing in development of a new product but if the cost is always passed onto a distribution subsidiary DS, through cost plus pricing arrangement, which sells the products MS produced to third parties, true financial risk is borne by DS, not by MS. Attention needs to be paid, under intercompany arrangement, which entity ultimately assumes financial risk. On the other hand, if the outcome of the new product development is critical for

MS even if MS is not really paying for the investment, and the failure in development would significantly affect future performance of MS, by significantly lower utilization of the factory, for example, argument that MS bears economic risks can be valid.

39-42 We fully support the view in the draft that definition of intangibles should not be too narrow or too broad and it should not be solely determined by the information for accounting or for legal purposes. In another word, it should be based on information in economic analysis.

43-44 We also fully support the view that distinction of intangibles from market conditions or other circumstances that are not capable of being owned or controlled by a single enterprise is quite important (para 43) and that not all intangibles are valuable enough to warrant specific compensation (para 44). In fact, we believe that such distinction to identify "valuable" intangibles which require a separate analysis should be discussed at the beginning of the section. Again, if analyzed intangibles are determined as "not valuable", no further separate transfer pricing analysis is required.

In judging materiality or relative importance of the intangibles, it is sometimes useful to discuss relative size of financial resources spent to develop intangibles. For example, R&D to sales ratio may be a useful indicator to determine if a company owns "valuable" intangibles. Although it may differ by industry, by country or by specific situation, any investment larger than x %of sales may be regarded as valuable intangibles, and any investment smaller than y% to sales may be regarded as routine intangibles, which do not require a separate analysis. Although such numerical approach may not always be accurate, it is assuring if the draft includes the possibilities of such approach.

47 As a practical matter, characterization and determination of (the rate or amount of) royalty is extremely important in intangibles transactions. It should be more clearly defined that intercompany transaction of goodwill should be determined based on an appropriate discounted value of royalty stream. It is also important that royalty payment should be clearly distinguished from investment in developing intangibles. Sometimes, we hear that tax authorities may argue that royalty payment should constitute investment in intangibles. The distinction should be clearly made between the two, as well as with cost-sharing to avoid disputes between the tax authorities and tax payers.

51 The definition of “unique and valuable” intangibles should be further refined. “Unique” aspect of intangible is not well defined. It is not clear if “valuable” but “not unique” intangible may exist or not. We are not sure if “not so unique” intangible can be valuable. How should we interpret oligopoly situation where only two firms in a relevant market provide “similar” or “not so unique” developed products yet both are immensely profitable, even though the market restrictions are not imposed by the relevant government, or any other special market characteristics can be observed.

71 It is important to recognize “control” aspect of decisions concerning the use and transfer of the intangibles and the practical capacity to restrict others from using the intangibles. Control aspect is again very difficult to objectively analyze, thus certain guideline needs to be developed. For example, important decisions can be made at “global” business meetings or “global” board meetings. How is the owner of the intangibles should be determined in such cases? Sometimes, it is impossible to align “control” with only one entity, where some sort of profit split may be necessary.

73. The clear distinction of legal ownership and true (economic ?) ownership of intangibles can be viewed as appropriate responses to BEPS issues.

74. While we agree that a comprehensive analysis covering functions, funding (and other assets) as well as control over the risks is good practice to follow, it is difficult in practice unless clearer guidance on “control” is provided.

76. While it can be useful to refer para 9.23 through 9.28 to analyze “control”, it should be noted, under related party context, relationship between decision making on control and capabilities to assume relevant risks can be very ambiguous and sometimes can be arbitrary. Suppose an important decision is made at a corporate board meeting where one of the board member lead the discussion and the person represents certain business line but not necessarily specific legal entity. In such cases, it is extremely difficult to align control to transfer pricing analysis as to which affiliate bears relevant risks. It may be more appropriate to analyze pricing arrangements among affiliates to find out which entity is determined to absorb larger financial risks (and return) relative to other affiliates. On the other hand, if such pricing arrangement needs to be determined based on functional analysis, the functional analysis should include the discussion as to other aspects of intangibles such as functions perfomed and true funding, then the economic ownership, either by a single entity or shared by more than one affiliates, without too

much dependence on notional “risk” analysis.

77. It is important point to examine who is “controlling” outsourced functions for development of intangibles. Again, further clarification of the definition of control is desirable.

80. Not sure if it is appropriate to mention “profit split methods” and “valuation techniques” in parallel. These two are not mutually exclusive. It may be more important, when discussing valuation of intangibles, to discuss distinction between one-sided method and multiple-sided methods, such as profit split. A profit split is clearly one of the “valuation techniques”.

81. It should be emphasized, in conjunction with available comparables, that one-sided method does not generally provide reliable results in valuing an affiliate with “important” functions. However, it should also be emphasized that there are possibility that one-sided method, with appropriate adjustments for “important” functions, may still work.

82. The discussion over funding and return appears to be close to “investor model” discussion in the US cost-sharing regulation. It makes sense not to put too much weight on financial risk in intercompany situation, given that a troubled affiliate may ultimately be rescued by other affiliates, as long as keeping the affiliate makes economic sense.

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Another important point is distinction between assigning “functional profit” and residual or excess profit attributable to certain function in a business process related with intangibles. It is extremely important to describe clearly defined threshold where attribution of residual or excess profit is warranted, and possible residual profits. Arguably, there are cases where “adjusted” cost-plus markup would be appropriate for a member.

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The discussion of enhanced value of “combined” intangibles is really good one but it may be difficult to find practical solution. It is not clear whether the “enhanced” value due to combination can be reliably calculated. This discussion may be interpreted as promotion of profit split method, by implying difficulty in valuing each separate intangible.

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Similarly, the discussion of "reputational value" and "goodwill" also highlight the complex nature of intangibles valuation but may be interpreted with the bias toward profit split analysis.

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It is highly recommended to expand the discussion of materiality test for intangibles analysis. In case of IP litigations, it is often discussed that the value of patents is not normally distributed and more than 99% of patents analyzed has only nominal value[1]. Likewise, it should be emphasized that a separate analysis on intangibles is required only in exceptional cases, and it would be valuable if the discussion includes how to determine the borderline between the norm and exception.

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The paragraph may be interpreted that the use of TNMM as one-sided method cannot be used at all in valuing intangibles. We believe that it is not the case. It is a matter of facts and circumstances, where there may still be many cases where TNMM can be the best method.

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The term "profit potential" has been used in many places as one of the factors to be considered to assess comparability. Realistically, it is extremely difficult to find acceptable comparables when "profit potential" is defined in terms of absolute amount, including present value of cash flow associated with the intangible at issue. On the other hand, it may be relatively feasible, if "profit potential" is defined in relative manners such as return on investment or simply relative share between the parties assuming different roles (e.g. developer v.s. marketer).

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Regarding the risks described in the paragraph, one important element of the risks appears to be missing. We may call it as market risk where developed intangibles,

[1] Mark Schankerman "How Valuable is Patent Protection? Estimates by Technology Field" The Rand Journal of Economics 29, no.1 (Spring 1988)

either product or marketing for example, does not perform as planned simply because of the change in market including economic environment, competition and consumer/buyer preferences. Such risk also significantly affect value of the intangibles.
On the other hand, we think that the discussion on infringement should be expanded. Even in non-infringe situation, if a competitor comes up similar project faster, then the competitor may achieve significant first-mover advantage and any company which comes to the market later would suffer.

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We do not agree the proposition that large size of adjustments is automatically not reliable. The proposition may discourage both use of comparables and economic adjustments which are still potentially reasonable. As long as the adjustment is logical, objective and economically sound, along with the use of other "valuation techniques" which were endorsed in para 80 , the application of such adjustment should not be discouraged.

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The paragraph contains very important message that "not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. It is understandable, given importance of BEPS issue, that both the appropriate calculation of residual profit, i.e. appropriately capturing total profit minus functional profit, and appropriate identification of true owner of intangible are included in major objectives of the Revised Draft. While we agree that totality of value creation process needs to be analyzed in principle, it may also make relatively easy case more complex and burdensome. It is not very clear why we now have to analyze not only "intangibles and routine functions" but also "all of the relevant factors materially contributing to the creation of value". While we infer that such "relevant factors" may include such items as location savings and other local market features", unless clearer guidelines are provided, it may only increase the confusion and conflicts.

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As described in our comment on para 130, "general" rejection of one-sided method does not appear to be reasonable given recognition of the fact that not all the intangibles is "valuable" in para 120.

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It is reasonable to discourage cost-based method to value intangibles. On the other hand, sometimes we see that many MNCs implement "minimum" royalty based on cost, including as amortization expense of capitalized relevant costs. If there is third-party evidence in such practice, it should be considered to be potentially one of the arm's length methods

We also have seen an example where relative contribution of multiple parties is measured based on relevant cost spent for development of intangibles or on capitalized such costs, thus under profit split context, cost information may still provide valuable and objective (and certainly available) information to measure relative contribution. The possibility of using such method, as more practical more as theoretically perfect way, should be mentioned.

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We strongly agree the view that rule of thumb does not provide reliable outcome. It should perhaps be emphasized that usual "industry standard" royalty rates are not reliable comparable either unless there is strong evidence that tested transaction is no different from average value of the intangibles in the industry, which is inherently difficult to prove.

164 The paragraph appears to put very high hurdle for the use of CUP method. On the other hand, the Revised Draft repeatedly discourages the use of TNMM method. As a consequence, use of profit split may be encouraged but profit split has not been welcomed in many instances due to complicated nature to develop, implement and monitor. There need to be some counter-measurement introduced so that tax payers can comply with relevant regulations within reasonable efforts and costs. For example, the use of CUP, in fact as long as it is not wrong, should be encouraged by including possibility of adjustments after which the use of CUP can be justified

166 In this context, application of profit split methods needs to be discussed in more detailed and in more practical perspectives. In reality, the use of profit split methods is not very frequent. Many consider profit splits as complicated, difficult to manage thus not practical. It is true that more information and workload is required for profit split

compared to those for TNMM, for example, it can still be a method for material and complex intercompany transactions where intangibles are used at both ends.

167 The meaning of paragraph is somewhat misleading. We thought that "a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties is essential element of the analysis" no matter which methodology is eventually applied. If the Revised Draft emphasizes more burdensome work required for profit splits relative to other methods, it is not productive.

Of course, it is advisable if more rigorous profit split analysis is required for large scale transactions of intangibles, which recently have been discussed in the context of BEPS.

We think that it is practically important to provide different level of acceptable profit split analysis depending on materiality of transactions.

205 It should be noted that price adjustment clause is hard to find, and is difficult to implement even if it exits, as evidenced by numerous litigation or arbitration as to how the clause should be applied. Tax payers are encouraged to update intercompany pricing arrangements depending on the change of economic and business circumstances.

206 It is very important to recognize how tax audit is conducted, which covers past many years. In rare occasions, tax auditors use "hindsight" and make adjustments with information only available after the fact (ex-post), thus it is not consistent with arm's length standard. On the other hand, taxpayers should prepare rigorous analysis as to how valuable intangibles were valued when transactions happened without mixing up information available only after the transactions. In many cases, taxpayers do not have such information. Re-creating information many years after the relevant transactions happened is extremely difficult task.

209-223 One of the critical points in transfer pricing analysis for intangibles is comparability. As indicated in the paragraphs, comparability should be evaluated in relative terms between potential comparables and tested party, thus, for example comparables with certain intangibles can still be applicable if tested party use similar intangibles (para 211). However, it should be noted that the argument for comparability of intangibles used by comparables and by tested party does not likely to satisfy all the comparability criteria including profit potential (para xx). Thus it is highly desirable, depending on the case, if the guideline is provided as to how strictly the comparability should be interpreted for each case. For example, a framework below might be helpful.

**<u>Intangibles comparabilty matrix</u>**

| | Intangibles used by | |
|---|---|---|
| Importance of intangibles | Tested Party | Comparables Parties |
| High O | | |
| Medium △ | | |
| Low/No × | | |

In the situation of x-x where both tested party and comparables do not own intangibles (or only very low value intangibles), one-sided test does not produce problem, at least due to the intangibles. On the other hand, it would be almost unthinkable in o-o situation, valuable intangibles owned by both tested party and by comparables parties are "comparable" so that one-sided test can still be reliable. Other than these two clear -cut extreme situations, there may be many situations where other combination of kinds of intangibles used by tested party and by comparables is observed. It should make sense to develop this framework to give more detailed guideline for the possible one-sided tests in the situation where intangibles are used or transacted either directly or indirectly, where one-sided tests can still be appropriate depending on relative importance of comparables as well as on the level of comparability between the two. While such discussion is occasionally observed (for example in para 212), it is extremely helpful if the guideline describes comprehensive framework for the use of comparables in one-sided tests.

210 It is also helpful to define intangibles in relatively clear manner as in this paragraph, including for "marketing", "logistical know-how" and software. While these are implied as valuable intangibles, in actual cases, the importance likely varies a lot by case and different TPM can be selected depending on the importance as well as by the degree of available comparables.

252 Although all the examples after para 224 are great means to communicate important points the draft intends to make, we thought that Example 8 is too unrealistic. We can not think of situation where related parties agree on distribution agreement for

limited periods without option to renew. We think that one of the reasons why companies go multinational is to make long-term investment for geographic as well as functional expansion. We cannot think of economic justification for short term distribution agreement without option to renew, unless automatic extension is implied (but we understand that the example does not imply automatic extension.) We think it is better to make the point Example 8 is trying to make, by assuming comparables with distribution agreement without option to renew, while tested party is assumed to have long term intercompany relationship.

(End)