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Mr. Joseph L. Andrus
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Re: Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*

Mr. Andrus,

Working Party No. 6 is applauded once again for its great undertaking to update and improve the Guidelines despite the many obstacles in achieving consensus on such challenging issues as intangibles. The *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Chapter VI of the *OECD Transfer Pricing Guidelines* and related provisions) ("Revised Discussion Draft") considerably expands the breadth and depth of the guidance provided in the current version of Chapter VI. Pursuant to the OECD invitation to comment, please find attached a non-comprehensive list of preliminary comments.

Please contact Sheena Bassani (514.982.2306; s.bassani@barsalou.ca) should the OECD desire further elaboration on these submissions or that these or related discussion items be presented at the meetings scheduled in November 2013.

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**Please take note that the attached comments have been submitted in the personal name of the undersigned and may not represent the views of Barsalou Lawson Rheault.*

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I. Introduction

The *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Chapter VI of the *OECD Transfer Pricing Guidelines* and related provisions) ("Revised Discussion Draft") contains two main sections: one for modifications to paragraphs in Chapters I-III and the other covering modifications to Chapter VI. Overall, the refinements that have been made to the Revised Discussion Draft have brought clarity and more coherence with the focus elsewhere in the guidelines on the functions, risks and assets of the parties. However, as highlighted within the Revised Discussion Draft itself, there remain some areas of ambiguity, notably how and when a profit split approach is to be applied, given its many deficiencies and difficulties in practice. Furthermore, there still appears to be a lack of consensus on treatment of hard to value intangibles (e.g., highly uncertain value). If special rules are in fact pursued for such hard to value intangibles, there is concern that this may not be in keeping with the arm's length principle.

The first two comments below relate to proposed modifications to Chapters I-III, notably Location savings / Other market features, as well as Synergies. The remaining comments relate to modifications proposed in Chapter VI, mainly regarding the Profit split and Hard to value intangibles, Discount factors, and some language suggestions for two of the examples.

II. Comments and Suggestions

A. Location Savings and Other Market Features

Location savings and other market features are not intangibles, and consequently have been addressed in the Revised Discussion Draft under the proposed amendments to Chapters I-III of the *Transfer Pricing Guidelines*.

Although it would not be practical to set out a comprehensive list of items for consideration under this section of the *Transfer Pricing Guidelines*, it would be beneficial to directly address at least one additional item in section D.6.2 *Other Local Market Features*, namely local R&D incentives (e.g., R&D tax credits).[1] Some tax authorities have taken the position that R&D tax credits earned by contract R&D

[1] In this regard, par. 6 could be modified as follows:
"Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to cost savings. For example, the comparability and

service providers cannot be netted (neither in part nor in their entirety) against the R&D expenses in the context of the financial analysis for transfer pricing purposes, even where the comparable R&D companies do not benefit from the same or similar tax credits.

More generally, it could be helpful to identify the categories of local market features that would normally over time be subject to erosion of the initial location-based advantage versus those that may be susceptible to retaining their location-based advantage. Erosion of this advantage is the natural and expected result of unhindered competition. The proposed identification of categories could be done by list or by way of example, such as a new paragraph following par. 10:

> "In yet other circumstances, it is possible that the comparability considerations change over time. For example, with respect to R&D tax credits in a market where only non-local comparables can be identified, which do not benefit from similar tax incentives, any initial location advantage may erode over time as a result of the operation of supply and demand. This may be the case where market supply can be expected to expand to meet new demand at competitive prices (e.g., if bids were opened up to third parties unrelated to the group), and where new third party suppliers of R&D services would benefit from the same R&D tax incentives as the tested party."

B. Synergies

Synergies have been addressed in the Revised Discussion Draft, under the proposed amendments to Chapters I-III of the *Transfer Pricing Guidelines*, notably because they are not considered intangibles.

Although the new section D.8 (Chapter I) on MNE Group Synergies contains very useful guidance (see par. 18 ff), it would be helpful to expand the focus beyond financial transactions and central purchasing and to address synergies in the context of acquisitions. In fact, the guidance as currently drafted appears to focus largely on (1) synergies that are considered incidental benefits (i.e., when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group), and (2) synergies that result from deliberate concerted action of group members.

In particular, the Revised Discussion Draft does not clearly address synergies associated with acquisitions, and in particular how to treat synergies that result principally from the functions, risks and assets assumed/deployed by only **one** entity (for example, the acquirer) to capture the value of those

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functional analysis conducted in connection with a particular matter may suggest that the size of the geographic market in which products are sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market, whether tax or other incentives are provided for the activity in question, and other similar factors affect prices and margins in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified." (emphasis added) synergies. This is in contrast to concerted action of the acquirer and the acquired company together, and possibly other group entities.

The Revised Discussion Draft would also do well to provide a more in-depth analysis and framework for financial transactions, although it is believed that this would be the next main area of study for WP6.

C. Profit Split Methods and "Hard to Value" Intangibles

In the footnote to par. 169, and at par. 199 it is stated that the BEPS Action Plan specifically calls for work to be undertaken on hard to value intangibles and on the application of profit split methods. Business comments on practical approaches to addressing issues related to partially developed intangibles have been encouraged.

1. Profit Split Methods

Profit split methods are notorious for their difficulties in practical application, and this has been recognized in the Revised Discussion Draft at par. 166 and elsewhere. This can be for any number of reasons. It is generally accepted that an objective measure should be sought to split the profits under any profit split method (e.g., R&D expenditures), rather than an arbitrary ratio (e.g., 50-50). In some instances the proposed measure may appear attractively objective (e.g., where the R&D expenditures are of the same type/nature, and are incurred over the same time period). In other instances, it may be impossible to put different types of expenditures on the same footing without introducing a significant element of subjectivity into the analysis. Another reason why the profit split may be difficult in practice would be difficulty in obtaining relevant data. Some profit split methodologies could warrant isolating expenses over many years, which could prove impractical or impossible if data from earlier years is no longer available or cannot be broken down as required. Given the many practical difficulties in applying a profit split approach, it is somewhat surprising that the method is proposed as an alternative in a number of the examples of the Revised Discussion Draft.

Of particular concern is the statement in par. 80 to the effect that, "Because it may be difficult to find comparable transactions involving the outsourcing of such important functions [referred to in par. 79], it may be necessary to utilise transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions."[2] However, there is no basis advanced as to why or how a profit split method would achieve a more reliable result if there are no comparable profit split transactions upon which to base the result.

[2] It is probably not serving the arm's length principle very well to attempt to prescribe "important" functions and generalize across businesses, as is done in current par. 79. However, there is further concern that this paragraph includes some functions that appear to be rather easily outsourced (e.g., decisions regarding defence and protection of intangibles, management of budgets, quality control). Par. 80 goes on to state that where "the legal owner outsources most or all of such important functions to other group members, the entitlement of the legal owner to retain any material portion of the return attributable to the intangibles after compensating other group members for their functions is highly doubtful." When read together, these two paragraphs do not appear to comply with the arm's length principle.

A more practical approach to overcome the difficulties in applying a profit split could include (1) developing examples that address the more common scenarios and challenges, and (2) achieving consensus from the member countries as to when they believe it would be appropriate to apply the profit split to the more common scenarios and when it would not be appropriate. However, to the extent that such a practical approach cannot be grounded in the arm's length principle, it will not be welcomed by the business community.

2. *Hard to Value Intangibles / Partially Developed Intangibles*

Regarding "partially developed" intangibles, difficult issues arise with respect to when pure ex ante approaches are allowed and what the documentation burden would be in those instances. It appears that there is still no consensus amongst the OECD members regarding this important aspect of when tax authorities would be permitted to make adjustments to the result based on the occurrence of subsequent events.

"Partially developed" or "hard to value" intangibles may not hold the same meaning for all readers and so a definition may be a good place to start. There is concern that too many intangibles could be captured by an overly-broad definition, especially if there are a different set of rules that will apply to such "hard to value" intangibles. Perhaps it could be helpful to develop some sort of bright line test to conclude that an intangible is in fact "hard to value" or "partially developed" and therefore subject to further rules. Realistic alternatives and also relative risk could both be further explored as possible bases for such a bright line test. However, again, if such further guidance or rules cannot be solidly grounded in the arm's length principle, it will not be welcomed by the business community. It would also be difficult to see how it could be accommodated by the current network of treaties without modification if the further rules go beyond the arm's length principle.

3. *Flip-Side Argument*

On another note, hard to value intangibles are sometimes in fact valued in the market place. Some tax authorities believe such transactions can be used to benchmark related party transactions where the intangibles are not in fact hard to value and are not unique and valuable. This, however, would not be an arm's length result. The Revised Discussion Draft could be improved by clarifying this flip-side argument.

D. Discount Factors

Par. 179 concludes that: "Valuations used by an MNE group in making operational business decisions may be more reliable than those prepared exclusively for purposes of a transfer pricing analysis." It is recommended that the following be added to that paragraph: <u>"However, the relatively riskier activities of a business could be expected to have a higher discount factor than the consolidated activities of the business or industry."</u> (emphasis added)

Similarly, par. 182 concludes that "It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis." The following statements could be added for further clarity: "However, such projections may account for consolidated functions and risks, not all of which may suit the purpose of the analysis which may be focussed on a more limited set of functions and risks. This may justify the use of different projections." (emphasis added)

E. Other Comments

1. Example 9

In par. 258 of Example 9, it is stated that: "it would not generally be expected that a royalty would be paid in arm's length transactions where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles other than the right to use such intangibles in distributing a branded product supplied by the entity entitled to the income attributable to such intangibles..." It is suggested that the following text be added, "except if the manufacturing and selling entities do not otherwise own or obtain the rights to market and distribute the product in Country Y."

2. Example 18

Par. 292 of Example 18 concludes that "It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring..." The following text could be added for further clarity: "although subsequent events could lead to value being lost." It would also be relevant to clarify how "value" would be defined for the purpose of this paragraph/example and under which circumstances any of that value could be attributable to the acquirer.

III. Conclusion

It is hoped that these submissions will assist Working Party No. 6 in their efforts to further refine the guidance offered in the revised chapter on intangibles.

Further and more in-depth discussions on these and other connected topics are always welcome.