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Via Email: TransferPricing@OECD.org

Comments on the "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles", 30 July 2013

Ladies and Gentlemen,

BDI (Federation of German Industries) is the umbrella organisation of German industry and industry-related service providers. It speaks on behalf of 38 sector associations and represents over 100,000 large, medium-sized and small enterprises with a good eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related services.

We refer to the "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles" and the opportunity to comment also on revised draft. BDI is very much interested in a sustainable international framework of definitions and regulations. We therefore very much appreciate your efforts in developing guidance in this highly relevant tax matter.

We are pleased to provide our comments on the draft and, hopefully, to contribute useful thoughts from a practical point of view. Our comments are laid out in the appendix to this letter, following the basic structure of the draft. The comments are not intended to be comprehensive but are focused on the key aspects of our concern.

We would be glad if we could elaborate on this during the session in November.

Yours faithfully,

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Comments on the Proposed Amendments to Chapters I – III of the Transfer Pricing Guidelines

The amendments to Chapter I mainly deal with the treatment of specific comparability factors. We appreciate the draft's attempt to clarify these practical important issues. Our comments are focusing the proposed treatment of an "assembled workforce":

- **Assembled Workforce (revised[1] paragraph 14 through 17)**

  – In our view, the treatment of an assembled workforce has been one of the most controversial issues in Section A. of the first discussion draft. The proposed solution therein did not convince the majority of the commentators (also critical e.g. *Silberztein/Bennett/Lemein*, Intertax 2013, p. 69).

  – The revised discussion draft (in the following: RDD) now addresses the "assembled workforce" in Chapter I of the Guidelines ("The Arm's length Principle"), instead of Chapter VI. It is not intuitive why this definitional problem has been outsourced to Chapter I as one would expect guidance in the Chapter VI (Section A.), where the issue is specifically addressed. Obviously, the issue on how to appropriately treat an "assembled workforce" for transfer pricing purposes cannot be resolved by a relocation to another chapter of the Guidelines (especially as Chapter I in this regard still refers to Chapter VI).

  – All in all, the new considerations on the treatment of an assembled workforce (revised paragraphs 14 et seq.) still leave considerable uncertainties. At first, the revised paragraph 15 indicates that an assembled workforce might be qualified as a "transferred asset"[2] in cases of "business transactions and similar transactions". The reader of the second draft would be interested, however, to learn the delineation between an "asset" and an "intangible", but no guidance is being provided in this respect.

  – Further on, the revised paragraph 16 contains a clarification that it "is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter". Accordingly, an assembled workforce seems not to be qualified as an intangible pursuant to Section A. of the RDD, but needs to be considered as a comparability factor.

  – While this appears to be a fair conclusion, the directly following paragraph 17 contains a very critical statement: "it should be noted that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how from one associated enterprise to

[1] "Revised paragraph" refers to the paragraphs of the second draft version, 30 July 2013.
[2] According to the wording of paragraph 15: "… the transfer of the assembled workforce along *with other transferred assets*" (emphasis added).

another. The further treatment of such "know-how" needs to be analysed in accordance with the principles, as set forth in Chapter VI.

– As "know-how" is basically subsumed under the definition of an intangible according to Section A. (revised paragraph 54; original paragraph 16), such a transfer or secondment might ultimately trigger an indirect transfer of an intangible which, in consequence, need to be compensated separately – although an assembled workforce as such is not regarded as an intangible.

– As we pointed out in our prior comment letter, such a consequence does not take into account modern business reality, but would severely harm consulting-based industries, for instance global software companies that increasingly focus on software-related services. Therefore, we still see the RDD's approach on "assembled workforces" as inappropriate. We believe the guidance should be clarified to state that "assembled workforces" neither directly nor indirectly lead to a transfer of an intangible for transfer pricing purposes triggering compensation payments.

Chapter VI: Special Considerations for Intangibles

A. Identifying Intangibles

- **Outline of revised Section A.**

– The revised Section A. still constitutes a wide interpretation of the term "intangible". It retains the basic definition of an intangible as proposed in the first draft version. Accounting or legal definitions are still regarded as not relevant.

– However, the basic definition has been amended by a new clause. The full definition of an intangible now reads as follows: "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstance".

– Moreover, in order to clarify the basic definition (revised paragraph 52 through 64) the illustrations have added a new category, namely "rights under contracts and government licenses". Those rights (and obligations) qualify as an intangible (revised paragraph 58).

- **Comments on revised Section A.**

– As the revised draft basically retains the extensive definition of an intangible in Section A., we refer to our comments as expressed in our first comment letter.

- We appreciate the new addendum (“and whose use…”) to the basic definition. It appears to be adequate as a first step to narrow the extensive basic definition towards a more practitioner-friendly extent. A further delineation of an intangible, however, is still required.

- We are surprised that the RDD still does not see the necessity “to establish a precise definition of goodwill or ongoing concern value” (revised paragraph 61), although the absence of a clear definition in the first draft version has been criticized by the majority of the commentators (cf. for instance Confédération Fiscal Européenne, European Taxation 2012, p. 591). Both are still “treated as intangibles” (revised paragraph 61).

- All in all, we still cannot follow the draft’s approach in defining an intangible. In particular, we do not share the need for developing a completely new and autonomous definition without any reference to existing accounting or legal concepts that are – from our point of view – well proven in their practical application. Also, the definition still appears too vague and not practitioner-friendly. As we pointed out in our prior comment letter, we particularly consider “separate transferability” as an adequate criterion for the recognition of an intangible for transfer pricing purposes.

B. Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles

- **Outline of revised Section B.**

  - Section B. has been substantially restructured in the draft’s second version. As regards its content, however, it still deals with the “Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles”. Apparently, the revised Section B. no longer refers to the term “intangible related return” (IRR). Nonetheless, the rationale behind the allocation concept remains the same as in the first draft version. The second draft also regards *functions*, *assets*, *risks and costs* in relation to *development*, *enhancement*, *maintenance*, and *protection* as determinative for the allocation of the respective “anticipated value” of the intangible to either the legal owner or any other associated or independent enterprise involved in the value chain. Consequently, the legal owner and other group members, respectively, need to be compensated according to the extent they perform functions, use or contribute assets and assume risk or costs related to the development, enhancement, maintenance and protection of the respective intangible.

  - With regard to **functions**, the RDD strictly distinguishes two categories, namely "more important functions" as well as "other functions" (revised paragraphs 75 et seq.), more than did the first discussion draft.

- In line with the first draft (paragraph 40), the following functions are deemed “more important” (among others): “design and control of research and marketing programs, management and control of budgets, control over strategic decisions regarding intangible development programs, important decisions regarding defense and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible” (revised paragraph 79).

- The distinction of these two function categories is crucial for the question as to whether the legal owner should be entitled to all (material) parts of the returns related to the intangible or not. While the previous draft merely stated that it is “*expected* (…) [emphasis added] that the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions”, without specifying the consequences in cases where this expectation is not met, the revised draft puts more emphasis on these “more important functions”.

- Unlike the previous draft, the revised draft makes it undoubtedly clear that a legal owner may only claim “the right ultimately to retain all or material parts of the return attributable to a given intangible on the basis of legal ownership”, if the legal owner performs and controls the more important functions by itself or “through its own employees”, respectively. The revised draft explicitly, and even stricter than the previous draft, postulates: “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 (emphasis added)”. Consequently, an **outsourcing** of any **important function** would be harmful to the legal owner’s entitlement to all (material) returns attributable to the intangible. This consequence is definite. No exception is granted.

- On the contrary, “other functions”, which are “less important”, may well be outsourced (to associated or an independent enterprises) as long as the outsourced functions remain under control of the legal owner (and are compensated at arm’s length). According to the logic of the RDD, “control” itself is a function. Consequently, if “control” is outsourced, an arm’s length compensation for this function is required.

- Furthermore, in order to be entitled to the material parts of the intangible-related returns, the legal owner also needs to provide “all assets necessary to the development, enhancement, maintenance, and protection of the intangibles” and moreover “to [b]ear and control(.) all of the risks and costs” (revised paragraph 89).

- **Assets** are (non-exhaustively) defined as “intangibles used in research, development or marketing (e.g. know-how, customer relationships, etc.), physical assets, or funding” (revised paragraph 82). The newly incorporated paragraphs 82 et seq. discuss the relevance of funding in more depth. In essence, the “pure” funding would not justify a compensation which is substantially higher than a “risk-adjusted” return on capital (revised paragraph 84).

- As regards **risks**, the second draft version considers “(i) risks related to development of intangibles, including the risk that costly research and development or marketing activities will prove to be unsuccessful; (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risk, including the risk that defense of intangible rights or defense against other persons’ claims of infringement may prove to be time consuming, costly and/or unavailing; and (iv) product liability and similar risks related to products and services based on the intangibles” as the most important ones.

- Against this background, the revised draft suggests the following “framework for analysing transactions involving intangibles (…)” (*six-step approach*):

  (i) identifying the legal owner of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, license agreements, other relevant contracts, and other indicia of legal ownership;
  (ii) identifying the parties performing functions (including specifically the important functions described in paragraph [79]), using assets, and assuming risks related to developing, enhancing, maintaining and protecting the intangibles by means of the functional analysis;
  (iii) confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis;
  (iv) identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles under relevant registrations and contracts and the relevant contributions of functions, assets, risks and other factors contributing to value;
  (v) where possible, determining arm’s length prices for these transactions consistent with each party’s contributions of functions performed, assets used, and risks assumed; and
  (vi) in the exceptional circumstances described in paragraphs 1.64 – 1.68, recharacterising transactions as necessary to reflect arm’s length conditions.”

- **Comments on revised Section B.**

  – First of all, the argumentation and wording in Section B. have become much more precise than in the first discussion draft. However, we (still) cannot follow the proposed allocation concept. According to our understanding, the allocation concept as proposed in the first draft has been principally retained in the second draft, although no longer referred to as "intangible related return" (IRR).

1. Remarks from a conceptual point of view

– When the OECD started the revision of Chapter VI in July 2010, the overall goal was a "development of clearer and consensus-based international guidance on the transfer pricing aspects of intangibles" in order to resolve "complex and monetarily-significant transfer pricing disputes".[3] In the meantime, however, the project has become part of the overall BEPS-project (see RDD, p. 1).

– As has been sufficiently reported, the most "abusive" or "aggressive" transfer pricing schemes are assumed to be based on artificial fragmentations of global intangible-related value chains and transfers of the legal ownership of intangibles. It is therefore the explicit goal of "Action 8 – Intangibles" to "ensur[e] that profits associated with the transfer and use of intangibles are appropriately allocated *in accordance with (rather than divorced from) value creation*" (p. 20 of the BEPS Action Plan).

– This approach is being exactly reflected in Section B. of the RDD: Each party involved in the value chain of the intangible should obtain its "fair" share according to the individual (anticipated) "value contribution". For this purpose, the RDD regards functions, risks and assets as appropriate keys for the allocation of the "anticipated value" to the contributing parties.

– At first sight, the allocation concept of Section B. might be perceived as economically well founded: Instead of just looking at the legal ownership of an intangible, the "economic" or "beneficial" ownership of the intangible should be determinative for the allocation of the cash flows associated with that intangible.

– Taking a closer look, however, one has to recall the fundamental economic insight that a profit (or loss) which has been generated in cooperation cannot be allocated on a "causal basis" to the respective contributors. This is mainly due to synergy effects. As ultimately any attempt to attribute income by means of key factors or "economic functions must be somewhat arbitrary (cf. *Schreiber*, International Company Taxation, Berlin/Heidelberg, 2013, p. 17-18), an objective economic measure to determine the individual "anticipated value", as

[3] See OECD, Transfer Pricing and Intangibles: Scope of the OECD Project, 25 January 2011, p. 2.

required by Section B., does not exist. One might therefore conclude that the reference to functions, assets and risks as appropriate keys to attribute a jointly generated intangible is in truth no more than another convention, not being based on a stringent economic theory. Put pointedly, the existing convention would be replaced by another but even more complex and less practitioner-friendly convention.

2. Remarks from a practical point of view

– As the RDD retains the allocation concept of the first draft (IRR), our concerns and criticism on its practical application, as expressed in the first comment letter, are equally applicable to the new Section B. In this regard, we are not able to note an improvement as compared to the first draft.

– From the perspective of legal owners of intangibles, Section B.'s allocation concept is too strict and even an aggravation as compared to the concept of "intangible related return" (IRR) according to the first draft. In particular, the RDD can hardly be followed in its assertiveness that "the outsourcing of such important functions would have not been undertaken by independent enterprises behaving in a commercially rational manner". This assumption may be true in cases of obvious abuse, but should not be generalized. Instead, the draft should at least grant the legal owner the possibility to provide evidence that the outsourcing is in fact economically driven. We note that the previous draft took a more liberal and reasonable view on the outsourcing of functions.

– The overall intention of this approach is to be found in paragraph 151 of Section D., which contains the following key statement: "it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the [legal; *authors' note*] owner of intangibles". Whereas we understand that group members other than the legal owner may claim a compensation exceeding a mere "routine compensation" depending on the concrete facts and circumstances, we are concerned that the draft is now supporting the extreme position, to let other group members participate in the entrepreneurial profit "in any case". But this might become the rule *de lege ferenda*.

– Even if the legal owner performs and controls the most important functions (and at least controls the less important ones), evidence is needed that "all" assets are provided and "all" risks are assumed. The requirements for a legal owner to be entitled to the material parts of the intangible-related return are too overly strict.

– We are particularly concerned with regard to the proposed treatment of "*research, development and process improvement arrangements*", as one of the "specific fact patterns" in paragraph 93 through 103. The conclusion drawn in paragraph 97 that a "[c]ompensation based on a reimbursement of cost plus a modest mark-up [would] not reflect the anticipated value or the arm's length price for the contributions of research team in all cases" might turn out as an argument to target the traditional and well-proven compensation of contract R&D on a cost-plus basis. Most MNEs have already experienced numerous disputes with local tax authorities on the "appropriate" compensation of domestic R&D providers. Those tax authorities might regard the allocation concept of Section B. as a conceptual "inspiration" or even "justification" to claim significant higher reimbursements than a so-called "routine compensations". The practical application of the proposed allocation concept is therefore likely to significantly increase the number of disputes with local tax authorities.

– To sum up, from a practical point of view we feel that Section B. of the RDD is too heavily influenced by the overall BEPS initiative and its ambition to counter abusive tax planning. In particular, the RDD fails to draw a clear line between abusive and non-abusive IP-structures. It does not respect the fact that most existing IP-structures are based on reasonable business management considerations, rather than tax saving goals. Often, IP does stay in the same territory where it has originally been created. We fail to understand why such historically-grown and non-migratory IP should now be considered "abusively allocated". Further, we do not share the need to deviate from the well-proven cost-plus compensation of "extended workbenches" which obviously do not serve an abusive re-allocation of IP to low tax jurisdictions. For the time being,[4] we strongly recommend retention of existing transfer pricing principles as laid down in OECD TP Guidelines. Chapter VI is certainly not the right place for the execution of the newly pursued anti-abusive tax policy. Any measures to counter "BEPS" should be reserved to general anti-abuse rules (GAARs) or special anti-abuse rules, such as Controlled Foreign Corporations (CFC) legislation.

C. Transactions involving the use or transfer of intangibles

- Section C. has not undergone material changes as compared to the first draft versions. For our remarks on Section C. we kindly refer to our prior comment letter.

D. Determining Arm's Length Conditions in Cases Involving Intangibles

- Since Section D. has not undergone fundamental changes as compared to the first draft versions, we refer to our previous comment letter. However, we would like to take the chance to highlight and comment the following points:

– While paragraph 154 confirms that "any of the five OECD transfer pricing methods described in Chapter II might constitute the most

[4] In long-term, at least with regard to the European Union, the introduction of Common Consolidated Corporate Tax Base (CCCTB) may be considered.

appropriate transfer pricing", paragraph 159, however, expresses a clear reluctance to "[o]ne sided methods, including resale price method and the TNMM" for "directly valuing intangibles" (revised paragraph 159).[5]

- As already stated in the first draft version, the comparable uncontrolled pricing method (CUP) as well as the transactional profit split method (PSM) are considered the most useful methods in the determining appropriate transfer prices for intangibles (revised paragraph 163). Paragraph 163, Section D., however, contains multiple implicit restrictions to the application of CUP. For instance, revised paragraph 148 generally challenges the "[u]se of comparables drawn from data bases". We interpret this paragraph as an additional formal restriction to the application of CUP. Indirectly, the application of PSM is further favored.

- In this regard it may be assumed that the newly forced promotion of the PSM is mainly driven by the BEPS action plan, in which the PSM seems to be acknowledged as the most promising method to prevent or counter BEPS as it would allow a re-allocation of main parts of the intangible-related return back to "high tax jurisdictions" in which the parent companies reside.

- All in all, we would (again) appreciate a more neutral and less biased approach. The OECD should stick to the most appropriate method approach, as introduced in the Guidelines after its main 2010 revision. The appropriateness of a method should not just be assessed under the sole aspect of preventing or countering "BEPS". Practical concerns need to be considered as well. We do not share the idea to promote profit split as the new default method. Rather, methodological flexibility needs to be kept.

[5] Obviously, the reason for rejecting one-sided approaches is they do not accord to the "options realistically available approach", as claimed in the paragraphs 129 et seq. of the revised draft.