BEPS MONITORING GROUP

Response to OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

This response is submitted by the BEPS Monitoring Group (BMG). The BMG is a group of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Tax Justice Network, Christian Aid, Action Aid, Oxfam, Tax Research UK and others. This response has not been approved in advance by these organisations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives.

This response has been prepared by Sol Picciotto, and reviewed by other members of the Group.

1. INTRODUCTION

1.1. This Discussion Draft is the latest in a process of revision, begun in 2010, of the provisions on Intangibles especially in Chapter 6 of the OECD Transfer Pricing Guidelines. The BMG has not previously commented on this or other consultations by the OECD-CFA, although some of its members have done so. The revision of the Intangibles chapter now also forms part of the BEPS project, which will be the primary focus of the work of the BMG. However, our responses and comments will not be confined only to the scope of the BEPS project. We regard this project as the result of a recognition of the limitations and failures of the international system as currently designed, which clearly calls for major reforms.

1.2. In our view, the test of the likely effectiveness of the proposals resulting from the BEPS Action Plan is whether they will help to create a sounder basis for international tax rules fit for the 21st century. We recognize that this Discussion Draft results from work begun prior to the BEPS project, and hence only partly addresses BEPS concerns, and that these aspects will be more fully dealt with in future documents arising more directly out of the BEPS work. Hence our comments at this stage will not be extensive, and will aim to suggest the direction in which we consider that the work on Intangibles should move in order to meet the objectives of the BEPS project.

2. Characterising Intangibles and Value Creation

2.1. The shift towards attributing profits from intangibles `in accordance with … value creation' proposed in the Draft is necessary, and indeed essential. It is inappropriate to continue to begin from the assumption that the legal owner or even the original developer of a specific intangible is entitled to all the profits which may be said to be attributable to it.

2.2. However, the notion of `value creation' needs more careful consideration. A firm's know-how develops organically and incrementally through its activities as a whole. Although basic research may be carried out in laboratories and research centres, the successful application of the knowledge produced depends to a great extent on the development stages in which saleable products are designed, tested, adapted and marketed. These stages are indeed generally more time-consuming and expensive than the primary research stage. They also involve repeated cycles of interaction involving many of the firm's employees, not only those normally considered to be engaged in research and development, but also those involved in production and marketing.

2.3. Increasingly also, contributions to this knowledge base come from the firm's customers and users of its products. A major feature of the digital economy or `cognitive capitalism' is the ability of a firm to collect data from and about its customers, as well as inputs from users which enhance its systems, services or products.[1] This has become a general feature of economic activity, which affects all businesses to some extent. Clearly some firms are particularly focused on information and communications technologies (ICT), and have been in the spotlight recently. Not long ago, similar concerns were expressed in relation to other sectors which are research-intensive, such as pharmaceuticals. However, ICT is not just an industry sector but also a pervasive feature of many if not all business sectors. This indicates the need for reform of the rules more generally, and not for special rules for a particular sector.

2.4. This understanding of the organic rather than discrete nature of the development of knowledge and technologies in a firm should also inform how `value added' is characterized. The Draft is right to move away from the concept of ownership of specific intellectual property rights. However, in our view the concept of `control' which seems central to the specification of the functions in para. 79 still seems problematic. The wording of the paragraph suggests that what is important is not necessarily the location of the actual activities of research and marketing or intangibles development but the location of the `control' of such programmes. This suggests that income could be attributed to an affiliate which could be said to `control' R&D programmes, although the actual R&D activities are conducted elsewhere. It seems to us that this would offer continued opportunities for BEPS, and/or it would create conflicts between tax authorities. R&D is generally conducted by teams, increasingly operating as networks. We doubt that it could be helpful to try to identify a `controlling mind' in such teams or networks, and even less to attribute income to it, rather than to the participants. No doubt some play a more important part than others in inspiring and directing the team effort. However, this could be reflected by using appropriate allocation keys (e.g. payroll costs) in applying profit-split, which we consider the most appropriate transfer pricing method in this context.

3. Which Method?

3.1. In our view, resolution of the difficult and often intractable problems posed by intangibles entails a recognition that transfer pricing rules must move away from transaction pricing towards the profit split method. This should be confronted directly, rather than obfuscating the issue by continued emphasis on the arm's length principle and the use of terms such as transactional profit methods.

3.2. The Discussion draft still continues to begin from the assumption of arm's length pricing of specific transactions, based as far as possible on comparables. Thus, it states that `[d]epending on the specific facts, any of the five OECD transfer pricing methods' may be appropriate. It even adds that `[t]he use of other alternatives may also be appropriate' (para. 154), although these are not specified. However, it also points to the `difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases' (para. 149). It explicitly rejects `one-sided methods' such as resale price and the TNMM as generally unreliable to be used directly (para. 159). It concludes that the most useful are likely to be the

[1] See N. Colin and P. Collin (2013) *Mission d'expertise sur la fiscalité de l'économie numérique*. Paris: Ministère des Finances et de l'Economie, section 2.2.

comparable uncontrolled price (CUP) and the transactional profit split methods (para. 163). Yet it immediately accepts that `[i]t should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible' (para. 164). Thus, the end-point, which seems to conclude that profit split is likely to be the most appropriate method, is very different from the starting assumption that all methods are relevant and comparables should be sought where possible.

3.3. This has several undesirable consequences. First, it seems to create a presumption that the optimal method is the CUP. This implies an obligation for tax authorities to search for possible comparables, evaluate them, and propose necessary adjustments. The considerable burden on tax administrations that this implies is hard to justify for OECD and G20 countries, let alone for developing countries. Although the OECD and other organizations have been putting resources into capacity development in relation to TP, it seems hard to justify such a use of scarce technical expertise, especially in poorer countries. We suggest that it would be much more effective to ensure that TP rules are designed to reflect economic reality, and to be administered as easily and simply as possible. Requiring tax authorities to engage in difficult, time-consuming and in most cases fruitless searches for comparables seems inappropriate.

3.4. Secondly, the reluctance of the Draft to recognize the importance and indeed the primacy of the profit split method means that this remains very imperfectly specified. Both firms and tax administrations are often, and understandably, reluctant to apply it, precisely because it has been treated as a last resort. Since there has been little attempt to systematize this method, it seems to involve little more than arbitrary bargaining over numbers. The solution is sometimes thought to lie in resort to MAP procedures, and indeed this seems implied in Action 14 of the BEPS Action Plan. However, once again it must be stressed that it is better to to ensure that the TP methodology is effective than to attempt to deal with this issue through a procedural solution such as strengthening the MAP.

3.5. Hence, we suggest that much more work is needed, especially within the BEPS project, to systematise and regularise the profit split method. At present, the Guidelines only refer vaguely to the need for the accounts of the related parties to be 'put on a common basis as to accounting practice and currency, and then combined'. They suggest that `financial accounting may provide the starting point for determining the profit to be split in the absence of harmonized tax accounting standards'. However, it is clear that much more focused and detailed attention will need to be devoted to this topic. Further comments are outlined in our separate submission on Documentation Requirements, and we will elaborate on these aspects more fully as the work develops.

3.6. An important issue also is the level of aggregation of the accounts to which the profit split method can be applied. The Guidelines currently assume that aggregation is only of the profits deriving from direct transactions between the parties concerned. However, the networks of relationships between members of a corporate group are often complex, and aggregation only of income from direct transactions is likely to be inappropriate. This is particularly the case for contributions to a firm's knowledge, which are not necessarily reflected in direct transactions.

3.7. The Guidelines also contain some discussion of the various allocation keys which may be used for allocating profits, but there is little attempt to formalise or systematise them. We suggest that the Intangibles chapter should include some discussion, and perhaps examples, of which allocation keys may be suitable for attributing value added. This relates to the point made in paragraph 2.4 above.

4. Conclusion

4.1 While we welcome the move away from ownership of intangibles to value added, in our view the work done so far is far too hesitant, The redraft still contains too much of the wording associated with the earlier adherence to a narrow view of arm's length and transaction based approaches. The result is a text that is highly obscure and contradictory. The Guidelines are widely treated as authoritative in relation to interpretation of the tax treaty provisions. If they are to be helpful, they need to be written much more simply and clearly, and with many fewer alternatives and contradictory statements. We hope that the BEPS project will provide the necessary impetus for a fresh approach to both the content and style of these important provisions.