Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles by the Confederation of Netherlands Industry and Employers (VNO-NCW)

We are pleased to see the significant progress which has been made since the previous draft, with improvements around the concept of legal ownership particularly appreciated. Given that there is much value associated with intangibles, we continue to believe that it is vitally important for the OECD Transfer Pricing Guidelines to provide as much certainty as possible on the subject. Further, we welcome consensus wherever possible between member states and the OECD on definitions, interpretations and implementation of the Guidelines. In general, we urge the OECD to focus on simplicity and efficiency in relation to this Chapter. It should be made clear that the arm's length principle is the leading principle in selecting the most appropriate method. More specifically, we feel that the application of the profit split method should be revised to maintain more neutrality with respect to the application of the OECD's methods

Our commentary focuses on five main issues. Supplementary comments relating to specific paragraphs or issues are provided in the appendix.

1. **Reliance on the profit split method and the difficulties associated with applying it in practice**

   We believe that parts of the Draft can be interpreted as placing more reliance on the profit split method. While we welcome this as an acceptable method, we suggest highlighting the application of the most appropriate method. Following a thorough functional analysis we feel that in case of the use of intangibles also other methods than the profit split method, including the use of TNMM, may be applicable and we suggest the Draft to be more balanced in its approach.

   Additionally, regarding the use of the split method, we caution the controversy that could follow the application of this method, in terms of difficulties for the tax payer to practically apply the methodology, the compliance burden, the risk that the methodology as applied will not reach international consensus thereby risking double taxation, and the lack of comparables due to the fact that profit splits are rarely encountered in third party situations. One particular difficulty relates to defining which transactions fall within the ring fence in which the profit is split i.e. allocating costs and revenue which relate to the shared business.

   The Draft should provide more guidance on applying the profit split method in the often highly complex Intangibles cases, whereby ultimately profits or losses may occur.

2. **Contracted out services such as Research & Development**

   In many industries, outsourcing R&D is common practice. We suggest that it is crucial to establish the value drivers of an MNE to understand the relative value that should be attributed to functions, risks and assets, both performed within the MNE, and bought from third parties. A functional analysis, supported by an industry and market analysis, will indicate whether or not it is considered regular third party behavior to outsource parts of the value chain, R&D being a good example.

Furthermore, for the purpose of clarity, it would help if the Draft imposes a more rigid threshold for an entity being entitled to earn or lose more than a routine return vis-a-vis a related party when they are engaged to undertake activities for a project which could lead to the creation of an intangible. We believe that the Draft could be revised to restrict the return for providers of contracted out services that lead to the creation of intangibles, to the extent that such transactions would only lead to the entitlement of an intangible related return (profit or loss) consistent with equivalent third party transactions.

3. **Employees or groups of employees as an intangible**

It is important to clarify whether employees, or groups of employees, fall within the definition of an intangible, or whether they are a comparability factor. The current Draft at times appears contradictory, for example when comparing paragraphs 15 and 17 to paragraphs 40 and 43. Our view is that employees, or groups of employees, should only be assessed as a comparability factor, and strictly not extended to potentially include as an intangible. This is for a number in reasons, but principally; that third parties do not agree intellectual property values based on groups of employees alone, employers only ever have a limited level of control over their employees and employee contractual arrangements with employers are often limited in respect to 'control' (e.g. it is common an employee contract includes a one-month/three-month termination clause).

4. **Interaction between intangibles**

We welcome the recognition of the broader brand concept in Paragraph 57, and that a brand has more aspects (separable IP or not) in addition to trademarks. We would recommend that these other items (such as goodwill and reputational aspects) can be valued separately for TP purposes. It is possible, for example, that a licensee remunerates the licensors or economic owners of the trademarks and brands separately for the trademark license and separately for access to the wider brand, much like the franchise arrangement concept which often has multiple remuneration components, that is trademark and know-how as separate items. The economic outcome of the remuneration structure is most important – not necessarily the legal labels placed on the individual or collection of items.

For example consider a franchise agreement. This often has a separate remuneration for trademarks, such as the McDonalds golden arches, and separate remuneration for the know-how like store lay-out, menu set-up etc. We suggest this paragraph is revised to reflect the commercial realities of licensing arrangements in so much that there is not one approach for all industries and all fact patterns.

5. **Group membership benefits (synergies)**

   It is crucial to understand how far reaching the concept of MNE group synergies, otherwise interpreted as ‘passive association’, is intended to extend. Paragraphs 18-27 introduce some important implications for tax payers and tax administrations.

   An illustrative example is welcome; however, we would suggest that Example 1 in paragraphs 24-27 illustrates the concept of passive association in respect to financial transactions, and seems out of place when group synergy benefits are considered. For reasons outlined in more detail in our comments below, we recommend to remove the example.

Summary

We have highlighted five points which we feel could particularly benefit from additional clarity and guidance on application. In the appendix to this letter, we provide further detailed comments on all sections of the draft.

We understand that the complexity surrounding many of the concepts under consideration means that certainty and consensus among the OECD member states are difficult to achieve, which once again highlights the need for an effective arbitration regime, like e.g. in the EU, as also addressed in the BEPS action plan. We believe that the reward of easier international trade makes the effort worthwhile.

We would be very happy to further engage with you on the subject or to elaborate, with you or in consultation, on any of the topics covered. Should you have any questions regarding the attached, please feel free to contact us.

Appendix: detailed comments

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

- Paragraph 23: The entitled party or parties in this respect (whether the saving is due to the hub entity or all the participants for example) largely depends on the results of careful functional analysis applying arm's length principles. Overall, we consider this paragraph is confusing in parts; we suggest more fulsome consideration of synergies needs to be explored and clearly linked back to the arm's length principle, such that the correct recipient or recipients of 'group savings' is identified based on accurate functional analysis.

- Paragraph 33: We consider this paragraph fails to take into account negotiation expertise of personnel in Country D which may exist, and for which the expertise of those individuals have generated the discount, rather than simply the discount arising from being a bulk order absent valuable negotiations. We suggest that in order for the Draft to be balanced, it should offer guidance on how to calculate Country D's share on the saving.

Comments on Sections A-D and Related Examples in the Draft

Section A: Identifying Intangibles

- The example in paragraphs 24-27: Financial transactions have not yet been fully considered and embedded within the current OECD Transfer Pricing Guidelines ("the Guidelines"), which is also an action to address in the OECD's forthcoming project on Base Erosion and Profit Shifting ("BEPS"). Hence, we feel including this example is premature.

- Apart from whether it applies to financial transactions or to illustrate group synergies, the example leaves some unclarities. For example it could be read as to suggest that an uplift in credit rating (and hence decrease in interest cost) is warranted in all cases, which we feel is a generality that does not fit reality.

- Finally, this example could be interpreted to not provide sufficiently consistent guidance following Chapter IX of the Guidelines regarding risk transfer and control concepts. If this approach was followed for financial transactions, then we feel it should be applied consistently across all related party dealings, which would likely impose constraints in terms of the level of compliance effort required and finding reliable data to make accurate comparability adjustments.

- Paragraph 37: We suggest that a clarification is required to ensure that this paragraph is not interpreted to mean that an MNE has to disclose their entire supply chain. Further, it is necessary to ensure that the guidance is clear that every entity need not be allocated a larger piece of the profit simply by being part of a valuable supply chain. We suggest that the following words are embedded in the last line of the paragraph such as: *'creates value at appropriate point in the supply chain'*.

- Paragraph 45: We support and welcome the wording of this paragraph.

- Paragraph 50: We suggest that this paragraph is clarified to ensure that this revised definition of a marketing intangible cannot be interpreted to mean that every distributor has marketing intangibles of some sort. Further, we would challenge the possibility to find reliable benchmarks with sufficient functional comparability to the tested party. There is a risk that this broader definition of marketing intangibles could unreasonably increase the compliance burden on tax payers, even if reliable comparables could be found, which is in our view, doubtful, even for a simple distribution function.

- Paragraph 53: We recommend that this paragraph is extended to provide the counter explanation. That is, expenditure of large amounts of risky and costly R&D does not necessarily result in the development of valuable, or indeed any, IP. As it stands, the guidance provides only the counter outcome.

- Paragraph 54: We recommend that this paragraph includes a comment that specifically excludes the knowledge of individual employees as possibly falling under the definition of an intangible.

- Paragraph 55: We welcome the second last comment in this paragraph. We agree that trademarks do more often than not, carry intangible and commercial value, outside direct end-customer facing market levels (such as retail for example).

- Paragraph 58: We suggest that the wording in the last sentence "government licences and concessions are intangibles", should read, for example, as "government licences and concessions may be intangibles".

- We suggest that Paragraph 61 contradicts Paragraph 57 in so much it suggests that the value of a trademark should also take into account the reputational value in total. We disagree with the contents of this paragraph by reference to the above comment. We believe these items can be separable, and are often separated in third party situations.

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

- Paragraph 73: We suggest that this paragraph could be interpreted to indicate that a legal owner needs to perform certain activities to retain any return attributable to an intangible. However, there are cases such as buying an intangible like a formulation/recipe that simply allows you to make premium returns without any additional activity. We suggest that the revised chapter make allowances for this nuance. This example may be confusing as the know-how to buy the right formulation/recipe will be in the legal owner which could be qualified as an activity.

- Paragraph 74: We suggest that this paragraph is unnecessarily restrictive because it assumes that one entity performs all the functions which are listed. What happens if five different entities undertake development, maintenance, enhancement, protection and funding? Are they all entitled to one fifth of the return? This seems unrealistic and overly burdensome for an MNE tax payer to manage globally.

- Paragraph 76: We welcome this paragraph, as it clearly sets out that the entities entitled to the intangible return need not have their own employees physically carrying out all of the key activities, but we agree however, that those entities need to exercise control over those activities.

- We note that the wording of Paragraph 77 could be interpreted to suggest that a legal owner might not be entitled to benefit from routine services performed on behalf of the legal owner of the intangible. In reality, many third party vendors would agree to perform the functions listed for a routine return. We therefore recommend that the wording 'for the intangible value anticipated to be created through such functions' should be deleted to avoid the possibility of this unsuitable interpretation.

- Paragraph 80 states that an entity's own employees should perform the more important functions in order to be entitled to the intangible return. However, in third party transactions this may not happen as certain important intangible generating functions may be outsourced for which that contracted entity's remuneration is limited to a routine related return. Furthermore, such guidance as currently drafted appears to be inconsistent with Chapter IX of the OECD Transfer Pricing Guidelines ("TPG") i.e. if an entity appoints the service provider, controls the scope, controls the budget, and has the capacity to judge the outcomes – this qualifies that entity as having the control and therefore the entitlement and ownership to the intangible.

- Paragraph 83. This paragraph appears to provide confusion; first it suggests that funding and risks are integrated, but then goes on to conclude both must be analyzed separately. We suggest keeping the integrated items together.

- Paragraph 96. We suggest that this paragraph could be interpreted to mean that when a distributor actually bears the cost of its marketing activities (i.e. does not receive a reimbursement) then it is assumed the distributor should share in the potential benefits. Generally such a distributor should receive a TNMM return, whereby effectively the supplier bears the costs of the marketing activities. Only where there is actually an intangible created or enhanced through the activity of the distributor, the distributor should earn an additional return. We suggested this is clarified.

Section C: Transactions Involving the Use or Transfer of Intangibles

- Paragraphs 113 and 114 present a similar issue. We suggest that it is potentially harmful and misleading to include wording such as "any license fee required should consider both the trademark and the associated reputational value".

- Paragraph 117: We would welcome clear examples are included in order to explain instances when disaggregating would be appropriate and examples when disaggregating would not be appropriate. This would help with contextualising the appropriate approach to the guidance for both tax payers and tax administrations.

- Paragraph 120: We welcome this paragraph as it provides the necessary flexibility on the appropriate selection of TP method. Although, some standardisation in usual cases should be encouraged, for example cost plus for service transactions, CUPs for financial transactions, etc.

Section D: Determining Arm's Length Conditions in Cases Involving Intangibles

- As mentioned in comments to earlier drafts, we continue to note that there should not be a requirement to undertake two-sided TP analyses in every case. When a simple intra-group transaction involving an entrepreneur and a limited risk entity (like a limited risk service provider), it is reasonable and commercially practical to only test the arm's length nature of the remuneration to the limited risk entity, and assume that the residual profit hence is attributable to the entrepreneurial entity. A one-sided analysis should be considered appropriate, provided that an accurate functional analysis is completed, such that each entity is accurately characterised to allow for such remuneration structure.

- Paragraph 132: We are concerned that this paragraph may encourage tax administrations to inappropriately examine the quality of business decisions, sometimes with the benefit of hindsight. We suggest this paragraph is revisited and amended. We also suggest that guidance on how to assess realistically available options from an economic perspective is included in the Draft. This will ensure tax payers and tax administrations will address options realistically available in a consistent manner.

- Paragraph 134: We consider that the first section of this paragraph is reasonable; that is care should be taken when a CUP methodology is used to ensure sufficient comparability exists. However, the last sentence is confusing. The CUP methodology examines comparable prices and so by adding an additional layer of comparability at a profit level is in our view inappropriate. The theme of this paragraph can be achieved by correctly applying the concepts of a CUP method to be the most appropriate method, such that it is used only when a genuine CUP exists.

- Paragraph 157: We suggest that the intended meaning of this paragraph needs to be clarified. This will help to avoid ambiguity regarding whether or not an assembled workforce is a comparability factor or an intangible. This paragraph appears to suggest that an assembled workforce is a comparability factor, whereas paragraphs 15 and 17 seem to indicate the opposite. We strongly consider an assembled workforce to be a comparability factor only and we encourage this clarification is made by the OECD.

- Paragraph 160: It should be noted that R&D in the begin phases of a project, for example, does not always lead to valuable intangibles. These costs are therefore best remunerated on a costs basis. Refer also to our comments at paragraph 53.

- The implication of Paragraph 170 is potentially that the use of the TNMM is no longer appropriate where intangibles are involved. We suggest this is reconsidered, as the most appropriate method should follow a thorough functional analysis, and could include the TNMM.

- Paragraph 171: This Paragraph appears to favour a methodology adopting an NPV of future cash flows valuation approach. We agree with this guidance, and consider it to be beneficial since it removes unnecessary uncertainty with tax payers in particular regarding the most appropriate valuation approach. Although, we consider that a comment is also added to suggest that other techniques, like earnings multiples, may also be appropriate, depending on the facts and circumstances.

- Paragraph 205: We suggest that a comment is added that the use of price adjustment clauses is very much facts and circumstances driven, and to reiterate that the use of hindsight should be avoided in all circumstances.

Examples to Illustrate the Guidance

- We welcome the review and expansion of the Examples section which we know considers a considerable improvement compared the original Draft. The examples are more transparent and easier to follow and apply to a specific case. In particular, because we consider that since each example adds only one factual change from the previous example, it is easier to follow the set of Examples.
- Examples 1 to 5: We welcome the drafting and conclusions to examples 1 to 5.
- Example 6: We broadly agree with this example. However, should Company S not be described as an entrepreneur, or 'an entrepreneur for its section of the value chain'?
- Example 7: We broadly agree with this example, although it is difficult to imagine that the accurate comparable data would exist to distinguish between the scenarios in examples 6 and 7. Instead, it may be best to characterise Company S as an entrepreneur for its section of the value chain; then the question becomes 'would a third party enter into the agreement with Company P?'
- Example 10: This example fails to reward Primair for owning the R trademark originally. The reward earned by Company S is as if they founded an entirely new brand in year 1. Why did they not choose to establish a new brand? The answer must be because it was easier for them to take brand R and begin marketing it in Country Y. Primair does not seem to be getting any reward under this example for being the original trademark owner which has not immaterial value as the founder and we would expect at least some founder return for such IP exploitation.
- Example 13: We welcome the drafting of this example and consider it to be a very important example since it recognises that valuation techniques are often necessary when comparable data does not exist.
- Example 14: We agree with this example, given that Company S does not have employees with R&D expertise. However, it does not address the more important question of what return Company S is entitled to, should they employ 1 or 2 people with high level oversight and sign-off duties. Another example could explain that Company S remains the entrepreneur if they maintain strategic oversight duties.