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1 October 2013
Our reference:
Dz/amü 848624v4.DOC

Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Sir or Madam,

Thank you very much for the opportunity to comment on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. We are firmly committed to the success of this project and are pleased to assist in its development and would like to share a few thoughts that are based on our practical experience in advising multi-national enterprises in matters of transfer pricing and intangibles.

We have recognized the comprehensive comments on the Discussion Draft on the Proposed Revision of Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions. Thus, we have limited our comments below to certain additions made by the Revised Discussion Draft for which further clarification might be helpful.

Chapter I: The Arm's Length Principle

D.7. Assembled Workforce

Proposed paragraph 14 points out that the existence of a uniquely qualified group of employees should be taken into account in a transfer pricing comparability analysis and its impact on arm's length prices for goods and services may be reflected by comparability adjustments, if "it is possible to determine the benefits or detriments of a unique assembled workforce". In our view, it is questionable how it can be assessed that a given employee group is uniquely qualified and how this can be established through a comparability analysis. We would welcome more clarity and examples from the OECD as to what is, and is not, a unique workforce.

In fact, businesses constantly strive to hire and train a group of employees in commercial reality. However, market participants cannot clearly identify the value of an assembled workforce from other assembled productive resources related to the value of the goods or services provided. Hence, it is hard to assert the uniqueness of a workforce compared to the workforce of enterprises engaging in comparable transactions. Moreover, and as the proposed paragraph 15 indicates, any (possibly clearly identifiable) benefit of a unique assembled workforce considered on its own may often be limited to savings in time and expenses of hiring and training employees, i.e. any benefit of the assembled workforce is limited to cost savings. But as benefits related to cost savings are already remunerated by an arm's length price for the goods or services provided, we believe that these benefits should not be compensated a second time. This would not accord with commercial reality, in our view. Nevertheless, we are aware of any other benefits resulting from know-how and trade secrets (and not from a workforce), which should be taken into account in a transfer pricing comparability analysis.

Proposed paragraph 17 explains that "in some situations, the transfer or secondment of one or more employees may (…) result in the transfer of valuable know-how". Consequently, this transferred know-how should be separately analyzed and must be priced at arm's length. We regret that the OECD does not clarify in Chapter VI that the mere presence of an assembled (uniquely qualified) workforce does not create an intangible, because a workforce itself cannot be owned or controlled for use in commercial activities by enterprises. The OECD only states in proposed paragraph 16 that there is no intention "to suggest that transfers or secondments of individual employees (…) should be separately compensated as a general matter" and that "in many cases the (…) compensation for the services (…) will be the only payment required." We recommend to include in Chapter VI that the mere presence of an assembled workforce itself is not considered as an intangible.

In addition, the OECD explicitly mentions that "in some situations" transferred know-how related to transferred or seconded employees is considered as an intangible. However, further guidance is needed how to analyze in which situations, i.e. under which preconditions, "transferred know-how related to transferred or seconded employees" can be regarded as a valuable intangible. In our experience, such know-how is only priced in an arm's length situation, if it provides a material economic benefit or burden that can be clearly identified, measured and documented. As long as the transfer or secondment of employees does not go along with a concrete granting of (separately identifiable) rights or legally protected positions like formulas, samples, technical plans etc., such making available of know-how would neither be remunerated separately between unrelated parties nor give rise to premium returns. Hence, we believe that proposed paragraph 17 in its current form leaves room for controversy and, thus, for double taxation risks.

D.8. MNE Group Synergies

Proposed paragraph 18 sets out that in some circumstances associated enterprises may benefit from synergies amongst these enterprises that would not generally be available to similarly situated independent enterprises. In our view, however, group synergies, such as streamlined management or purchasing power, should be regarded as mere opportunities, which are characterized by an substantial degree of uncertainty. Such synergetic potential is based on mere expectations of creating value, which largely depends on external and internal influencing factors. It is – in itself – not a concrete granting of rights or legally protected positions. Hence, group synergies do neither have an established value nor qualify as concretely realizable "business opportunities", which would be remunerated between unrelated parties. In support of this view, we believe that group synergies are already part of an enterprise's goodwill. In such case, unrelated parties would not agree upon a separate remuneration for group synergies. Group synergies may only be regarded as uncertain future "value drivers", as they are "reflex effects" stemming from modifications of the intra-group organization and, thus, cannot be controlled for use in commercial activities by enterprises.

While proposed paragraph 63 of Chapter VI appropriately excludes group synergies from the definition of intangibles as synergies are not capable of being owned or controlled, proposed paragraphs 18 and 20 indicate that group synergies should be taken into account as comparability factors. In our view, however, the identification of reliable comparable uncontrolled transactions and the determination of appropriate comparability adjustments may be difficult in practice, as comparable independent enterprises are not able to realize group synergies. We believe that group synergies may be considered as value building factors, if, and only if, they are concrete and specific enough to materialize.

Proposed paragraph 19 states that synergetic benefits arising solely by virtue of group affiliation and in the absence of specific actions to that benefits need not be separately compensated or specifically allocated among associated enterprises. We agree that in the absence of deliberated concerted actions of associated enterprises no separate compensation is made in an arm's length situation. Thus, we also agree with the examples 1 and 2 presented in the proposed paragraphs 24-27. In our view, each associated enterprise contributes to synergetic benefits arising by group membership only in proportion to its benefits from the creation of these benefits. Therefore, a comparison between contribution to and benefits from these benefits can be neglected. In addition, we believe that synergetic benefits arising solely by virtue of group membership cannot be clearly identified, measured and documented. Further, we doubt that these benefits fulfill the requirement of "commercial or financial relations" stated in Art. 9 OECD Model, since group membership leads already to the association of enterprises. Hence, we welcome the statement of proposed paragraph 19.

Proposed paragraph 23 suggests that benefits of group synergies, if they materialize and can be attributed to deliberate concerted group actions, should generally be shared by associated enterprises in proportion to their contribution to the creation of the synergy. We disagree with this statement to the extent that, based on our experience, synergetic benefits (even if they materialize) cannot be allocated to a specific associated enterprise, since they are dependent on each other and mutually complementary. In support of this concern, it is, in practice, often the case that the ultimate parent company of group members has a significant influence on generating group synergies, as it is responsible for strategic management framework conditions within a group. Thus, generating group synergies may also depend on the activities of the ultimate parent company (and not only on other associated enterprises). However, an allocation of synergetic benefits between the ultimate parent company and other associated enterprises is hardly feasible and extremely controversial, because a clear identification and quantification would be required.

Furthermore, we submit that proposed paragraph 23 does not clarify the exceptions of the above discussed general OECD approach ("generally"). For example, from a perspective of German tax authorities, the associated enterprise which could or should use for its benefit in a fictitious price negotiation should always derive synergetic benefits. Hereby, German tax authorities consider which alternatives of action an associated enterprise has. Against this background, it could also be argued that the associated enterprise which has more advantageous alternatives of action will likely use this position in price negotiations. Hence, the associated enterprise which has more negotiation power should ultimately benefit from group synergies, once they materialize, even though the key question remains still unsolved under this approach how to determine and to quantify these potential benefits in practice. However, it is not unlikely that other tax authorities disagree with the aforementioned approach possibly used as a pretended exception to the general OECD approach. Given this, we believe that lack of clarity in this regard may result in controversy between different tax authorities and, thus, in double taxation risks.

Chapter VI: Special Considerations for Intangibles

A. Identifying Intangibles

A.3. Categories of intangibles

Proposed paragraph 49 appropriately asserts that there are no classes or categories of intangibles. We agree that this is consistent with the modern commercial reality, as the split of the intangible definition into the subdivisions "marketing intangible" and "trade intangible" and, thus, the differentiation between producing and distributing goods in the market seem to be largely based upon the theory of classical industrial production.

However, we note that the OECD uses the term "marketing intangible" to "facilitate discussions". We propose that the OECD expand on the discussion on the necessity of this differentiation for facilitation reasons. We believe that the continued use of the term "marketing intangible" – being shaped by its use in the past – could be (mis-)used as a justification by tax authorities and/or taxpayers for different approaches being applied in determining arm's length conditions for transactions that involve such kind of intangibles. We recommend to replace the term "marketing intangible" by "customer-facing intangible".

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

B.4. Application of the foregoing principles in specific fact patterns

(c) Payments for use of the company name

Proposed paragraph 99 states that no payment should be recognized for transfer pricing purposes for the use of the group name merely to reflect the fact of group membership. As explained above, we agree that group membership alone does not justify any separate compensation in an arm's length situation.

However, proposed paragraph 100 sets out that a payment for use of the group name would have been made in an arm's length situation, where use provides a financial benefit to group members other than the member legally owning a trademark for this name. In this regard, proposed paragraph 101 mentions that it is important for the determination of the arm's length price to consider the financial benefit to the user of the name attributable to use of that name as well as the costs and benefits associated with other alternatives.

We agree with the statement of the OECD that in the aforementioned controlled transaction a financial benefit must be remunerated. In our observation, it is one of the key statements in the discussion that intangibles are – in the majority of cases – characterized by their uniqueness, which makes it difficult to value intangibles in controlled transactions. The OECD therefore lays emphasis on a hypothetical arm's length test that comes very close to the "prudent business manager standard" which is used to reflect what unrelated parties by means of "two prudent business managers" would potentially agree. In our experience, the hypothetical arm's length test raises a variety of questions. At first, the financial benefit analysis must take into account the field of use of the intangibles and their assumed contribution to the value chain. Hence, the use of a trademark that is identical to the company name is only priced in an arm's length situation, if the trademark has a genuine economic value that can be separately used, e.g. enhancing sales potential in the market. Otherwise, the use of the group name would not be remunerated separately between unrelated parties, in our view.

Furthermore, the assessment of the economic benefit requires a comprehensive analysis of the underlying economic circumstances. This analysis has to consider what alternative business transactions might have come into consideration instead of the use of the group name as stated in the proposed paragraph 129. In our experience, the question whether other “realistically available options” are available to the user of the name is difficult to handle in practice. It leads back to a “commercial rationality behavior test”, which also touches the debate about “non-recognition” of controlled transactions, whereas in the view of the OECD, the term “commercial rationality” will be measured on the basis of the “options realistically available” to a taxpayer.

The principle of “options realistically available” is – from an economic point of view – nothing but tantamount to a “make-or-buy decision”, i.e. it is a business decision that considers the costs and benefits of alternative business strategies. However, that does not answer what exactly can be regarded as “realistically available”: Does that mean that only the particular economic and commercial circumstances of the taxpayer’s situation (e.g. his market position, his financial resources, the human resources available and his willingness to take risks) have to be considered? Moreover, it remains unclear at what point in time such evaluation has to be conducted. Does “realistically available” mean that only the information available at the time the controlled transaction is entered into has to be considered or does that mean that the tax authorities may also be entitled to use “hindsight knowledge” which emerges in later years? Thus, we would welcome more clarity regarding the “commercial rationality behavior test”.

Furthermore, proposed paragraph 101 also stresses the importance of the relative contributions to the value of the name made by both the legal owner and the user in the form of functions performed, assets used and risks assumed. In general, we agree with this statement. However, we wish to point out that it is questionable whether the concept of the “necessity of important functions performed by own employees” laid down in the proposed paragraphs 79 to 81 (which is – by itself – highly doubtful considering modern commercial reality as being emphasized by many comments regarding the first discussion draft) applies in this regard as well. We would welcome more clarity and examples from the OECD as to what are, and are not, the relevant (important) functions performed and to their interaction with the assets used in the context of the determination of the arm’s length price regarding the financial benefit to the user of the group name.

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

D.2. Supplemental guidance regarding transfers of intangibles or rights in intangibles

(vi) Supplemental guidance on transfer pricing methods in matters involving the transfer of intangibles or rights in intangibles

Proposed paragraph 162 states that "the application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis" and, thus, this rule "cannot be used to evidence that a price or apportionment is arm's length". We agree with the points that rules of thumb are no substitute for a functional and comparability analysis and in the absence, and only in the absence, of a functional analysis rules of thumb may not be useful.

However, we believe that the application of a rule of thumb can be helpful to both taxpayers and tax authorities when serving as an additional plausibility check, i.e. in cases a functional and comparability analysis has been applied. Empirical studies have shown that a large percentage of royalty negotiations arrived at a royalty rate that was equal to approximately one-quarter to one-third of the licensee's anticipated (pre-tax) profits derived from the use of the underlying technology ("Goldscheider Rule"). Moreover, in terms of determining royalty rates, many industries' negotiations between unrelated parties frequently yield a royalty rate of around 5 % of net sales (which is extensively discussed in the relevant economic literature). Given this, and in our view, rules of thumb can – as long as no exceptional situation arises that would cause unrelated parties to determine different pricing ranges – provide for a reasonableness test that might enhance the tax authorities' comfort that a price is arm's length. Thus, we suggest to include that the application of a general rule of thumb can serve as a plausibility check whether a price or apportionment is arm's length.

We are looking forward to the further process and trust that these brief remarks may serve the further discussion.

Yours sincerely,

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