INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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VIA E-MAIL

Mr. Joseph L. Andrus
Head of Transfer Pricing Unit
Tax Treaty, Transfer Pricing & Financial Transactions Division
Centre for Tax Policy & Administration
Organisation for Economic Co-operation and Development
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Re: Comments on Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Mr. Andrus:

The International Alliance for Principled Taxation (IAPT or Alliance) is a group of about two dozen major multinational corporations based throughout the world, and representing business sectors as diverse as consumer products, media, mining, telecommunications, oilfield services, transportation, medical equipment, food products, luxury goods, computer technology, energy, pharmaceuticals, entertainment, software, beverages, automotive, IT systems, publishing, and electronics. The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally.

The IAPT thanks the OECD for providing this opportunity to comment on the revised discussion draft. We congratulate the Working Party for its timely production of a new revised discussion draft with improved clarity on a number of topics.

Process

We note that this document is still a work in progress which may be amended to reflect BEPS work. We understand that countries have legitimate concerns with BEPS, but we would be concerned if the revision to the Transfer Pricing Guidelines (TPG) was outcome-oriented rather than principled. Policy objectives may differ among countries and over time. We believe that the credibility and sustainability of OECD instruments such as the TPG as well as the global consensus on them lies in their principled approach, neutrality, and technical superiority.

The Revised Discussion Draft is still not complete. It does not contain the revised section on hard-to-value intangibles and the amendments considered to be made to Chapter VIII on cost contribution arrangements. These are two important areas for companies, and we urge the OECD to provide sufficient time to consult with business broadly before finalizing revisions to the Revised Discussion Draft.

The TPG are a consensus document, and we think that it would be helpful to have a clearer indication of the consensus status of the revised Chapter VI. We hope that the final product will be a consensus one. If this is not the case, the question arises whether to clearly identify the countries that have a minority view on some discrete issues.

The Revised Discussion Draft, on a number of occasions, sets prescriptive guidance which is not necessarily grounded in the arm's length principle. Our strong preference would be for all of the TPG guidance including the new Chapter VI to be solidly grounded in the arm's length principle. The IAPT is of the view that most of the transfer pricing aspects of intangibles can be satisfactorily dealt with within the arm's length principle, including in relation to the policy concerns expressed by the OECD and its member countries as part of the BEPS action plan.

However, should the OECD decide to deviate in some exceptional instances from the principle, we urge the OECD to ensure that such deviations are clearly defined, narrowly focused, and consensus-based. Otherwise, this would create conflicts between those jurisdictions deciding based on the arm's length principle and those jurisdictions deciding based on the guidance in the TPG, with major uncertainty for all parties involved. We would also recommend that the OECD provide a technical explanation of the reasons for its conclusion that deviations from the arm's length principle are needed in special circumstances or in some areas of the guidance.

We look forward to participating in the November consultation, which we expect will make it possible for all parties involved to better understand the intention behind the revised draft and the practical and policy difficulties around it.

Main points of agreement

IAPT supports a number of statements in the Revised Discussion Draft, in particular:

- Clarification that synergies, location savings and other market features are comparability factors, not intangibles.
- Addition to the definition of transfer pricing intangibles of the words "whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances".
- That "not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances" (para. 44).
- That not all R&D expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible (para. 45).
- That it is important to identify the relevant intangibles with specificity and that it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions (para. 46).
- That the transfer pricing analysis should consider whether independent enterprises would provide compensation for intangibles in comparable circumstances (para. 62).

- References to arm's length arrangements between independent parties (e.g. at para. 82).
- Clearer and more consistent references throughout the Revised Discussion Draft to the existing guidance in Chapter IX of the TPG on business restructurings than was the case in the June 2012 draft (e.g. at para. 85).
- That it is appropriate for both taxpayers and tax administrations to exercise restraint in rejecting potential comparables based on the use of intangibles by either the parties to potentially comparable transactions or by the tested party. Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill. If identified transactions or companies are otherwise comparable, they may provide the best available indication of arm's length pricing notwithstanding the existence and use by either the tested party or the parties to the potentially comparable transactions of relatively insignificant intangibles. Potentially comparable transactions should be disregarded on the basis of the existence and use of non-comparable intangibles only where the intangibles in question can be clearly and distinctly identified and where the intangibles are manifestly unique and valuable intangibles (para. 213).

You will find below more detailed comments on key sections of the Revised Discussion Draft.

Proposed amendments to Chapter I

D.6 Location savings and other local market features

Paras. 1-13: The IAPT strongly agrees that location savings and other local market features are comparability factors, not intangibles. Accordingly, we wonder what the rationale is for the proposal to insert the new language in a new Section D.6 of the TPG rather than in existing Section D.1.2.4 of the TPG which already deals with economic circumstances and in particular with market comparability. [1]

Paras. 4-5: The IAPT supports the notion expressed at para. 4 that "where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required." We note that a reasonable application of the comparability standard is needed in this respect. Our members encounter cases where some tax administrations apply an unrealistic comparability standard and reject all independent comparables in order to select a profit split method in cases where that method is not appropriate to the functional analysis of the parties. We expect disputes to arise increasingly as to whether local comparables are reliable enough and accordingly whether comparability adjustments should be performed to account for location savings. We suggest that the reference to "reasonably reliable local market comparables" which is found in para. 8 be also added to paras. 4 and 5.

Para. 3: The analytical steps proposed at para. 3 can prove extremely burdensome from a compliance perspective and there is no proposed guidance in the Revised Discussion Draft as to how to apply them. For instance, by reference to what theoretical costs should location savings be determined (next best option)? In what circumstances (e.g. relocation of plant)? For how many years? What if the

[1] See for instance TPG 1.55: "Economic circumstances that may be relevant to determining market comparability include the geographic location; the ***size of the markets***; the ***extent of competition*** in the markets and the relative competitive positions of the buyers and sellers; the ***availability*** (risk thereof) ***of substitute*** goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; ***consumer purchasing power***; the ***nature and extent of government regulation*** of the market; ***costs of production***, including the costs of land, labour, and capital; transport costs; the level of the market (*e.g.* retail or wholesale); the date and time of transactions; and so forth." [***emphasis added***].

products manufactured in the new location are not the same as the ones which used to be manufactured in the previous location? Etc. At a minimum we suggest that para. 3 be relocated after para. 5 and that it be clarified that where reasonably reliable local market comparables exist, there is no requirement to go through all the steps outlined in para. 3.

D.7 Assembled Workforce

Paras. 16-17: We urge the OECD to encourage countries to take a reasonable approach regarding whether transfers or secondments of personnel result in the transfer of valuable know-how. Personnel seconded in mobility programs are often skilled personnel, and we fear that endless disputes may arise if the threshold is lowered to treat secondments as entailing transfers of know-how. This could potentially be massively burdensome and costly for MNE groups which have large employee mobility programs with sometimes thousands of employees being seconded at any moment. It would also be counterproductive in terms of the possibility to appropriately staff subsidiaries with skilled group personnel and would create significant issues in emerging and developing markets. Finally, it would be contrary to labor law requirements in some countries.

D.8 MNE Group Synergies

Paras. 18-23: We strongly support the view expressed in this section and at para. 63 that synergies are not intangibles.

Para. 18: While we understand the suggestion at para. 18 that comparability issues may arise because of the existence of synergies, we wonder what type of comparability adjustments for synergies the OECD is suggesting should be made and how they should be determined in practice. We believe that it might be possible depending on the circumstances of the case to adjust internal comparables (e.g. adjust the price that an affiliate would obtain from a third party to reflect the economies of scale made possible by its belonging to the group), but we fail to see what comparability adjustments the OECD suggests should be made to external comparables (derived from a database for instance). Given the broad definition of synergies, there is a risk that some tax administrations may claim that all members of MNEs always enjoy some positive synergy effects which are not found in independent comparables. We urge the OECD to clarify that it is not suggesting that comparability adjustments for synergies should be performed with respect to all external independent comparables as this would make it extraordinarily difficult, if not impossible, to use external comparables.

Paras. 21 and 28-29: We note that the proposed guidance in these paragraphs is not in line with the existing guidance at TPG 9.154 - 9.160. The latter is more fact-and-circumstances oriented and suggests that a range of possibilities exists, from performing a comparability adjustment to paying a mark-up or commission fee to the central purchasing function or in some cases sharing the savings. The proposed new guidance seems to be solely focusing on the question whether affirmative steps are taken to derive economies of scale. It does not reflect the full spectrum of the possible functional analyses and in particular what entity(ies) should be allocated the risks and profits or losses associated with the function. We therefore submit that these paragraphs should be toned down and that a reference to the corresponding section in Chapter IX should be added.

Paras. 24- 27: Examples 1 and 2 touch on complex issues. For instance, Example 2 suggests that the affiliate borrower benefits from incidental benefits or implicit support attributable to its belonging to the group, which should be taken into consideration to adjust its standalone credit rating and arrive at a “status-quo” credit rating. There should be a clear confirmation whether implicit support effectively should be taken into account in such situations. If this is the case, clearer guidance would be needed on how to determine whether implicit support exists for any given borrower and how the “status-quo” credit rating will be arrived at.

A typical situation is one where the parent company has a better credit standing than the individual affiliates on a standalone basis. However, we note that in practice there are also situations where an affiliate has a better credit standing than the group as a whole, and situations where the funding costs incurred by the parent company are actually more expensive than the funding costs that could be obtained by a given affiliate in its local market. There should be no automatic assumption that being part of a group always provides a positive advantage to the affiliates. All relevant facts and circumstances should be considered.

In addition, if implicit parental support is relevant to the pricing of financial transactions, then it should be taken into account not only in the interest rate but also in the quantum of debt a borrower can support.

Transfer pricing of financial transactions is a complex area. As part of the BEPS action plan, the OECD has announced that it will carry out a project to develop transfer pricing guidance regarding the pricing of related party financial transactions, including guarantees. We recommend deleting for the time being Examples 1 and 2 and re-examining them in the context of the broader financial transaction project, the outcomes of which should not be prejudged in the context of the work on intangibles.

Proposed amendments to Chapter II

Para. 34: The IAPT believes that the practical value of the guidance in Chapter II of the TPG would be extraordinarily diminished and that major uncertainties would be created if tax administrations had the freedom to use "other methods" without first giving due respect to the method selected by the taxpayer when the latter has been selected in accordance with the guidance in Chapter II. Taxpayers set prices while tax administrations audit prices. Tax administrations should therefore generally follow the method selected by the taxpayer, unless there is a good reason to reject it. We suggest that TPG 2.9 either be left unchanged, or that the guidance expressly state that, as noted at TPG 1.64, a tax administration's examination of a controlled transaction ordinarily should be based on the method applied by the taxpayer insofar as the selection of such method is consistent with the guidance in Chapter II. If and only if the method selected by the taxpayer is not the most appropriate to the circumstances of the case may the tax administration substitute for it another method. In doing so, the tax administration should follow the guidance in Chapter II on the selection and application of the most appropriate method to the circumstances of the case. In the event that neither the method selected by the taxpayer, nor any of the OECD-recognized methods is appropriate to the facts and circumstances of the case, the tax administration may use an "other method".

Proposed new Chapter VI

General comments

As indicated above we find that the revised discussion draft is a much improved document and that it contains a series of very helpful clarifications. We acknowledge that the OECD and a number of tax administrations are concerned about situations involving the attribution of "excessive" intangible return or residual profits to IP companies in low tax jurisdictions where such IP companies lack economic substance. We recognize that abuse should be tackled and support the development of further guidance on the determination of arm's length compensation for the various elements of the value chain, including the important functions, funding of the development or acquisition of intangibles and risk bearing.

In doing so, we submit, however, that the TPG should provide principled guidance on how to apply the arm's length principle and not disrupt well understood concepts which work well in the vast majority of cases. The new Chapter VI should in our view more clearly describe the scenarios which the OECD and its member countries regard as abusive or unacceptable. This would (i) have a better deterrent effect and (ii) provide more certainty to compliant taxpayers. We find that there is a regrettable tendency in the Revised Discussion Draft to regard abuse, lack of substance, and contractual terms which do not reflect the actual behavior of the parties as being the norm among multinational enterprises. The risk is an outcome that would lack clarity on "what exactly is wrong" and be open to potentially widely diverging interpretations of how to determine an arm's length return for all parties to the transaction, including those performing important people functions but also those providing funding and bearing risks.

A very broad scope

We would have found it more efficient for the scope of Chapter VI to be limited to transactions involving the transfer of valuable intangibles or rights in intangibles (including licenses). Any manufacturing, selling or service transaction inevitably involves the use of some intangibles (at a minimum some routine know-how). By not carving out those transactions from the scope of Chapter VI, the OECD risks weakening the guidance in Chapters I-III of the TPG and creating unnecessary disputes and compliance burdens for transactions that are unlikely to be the ones with which the OECD is primarily concerned.

A stringent analytical standard resulting in unnecessarily burdensome compliance burden

We found over 40 instances throughout the document where words such as "it is important to consider", "it is essential to consider", and similar phrases are used. Not every single issue can be considered to be important or essential in each case: there should be an element of proportionality and reasonableness, with a judgment call on a case-by-case basis as to what really matters to the facts and circumstances of the case. We fear that the proposed guidance as currently drafted may result in an unnecessary and unrealistic compliance burden. We believe that this is not in line with the OECD objective to make transfer pricing compliance and enforcement more workable and to better target the use of taxpayers' and tax administrations' resources.

Heavy reliance on recharacterization concepts

Recharacterization is an anti-abuse concept: it cannot be presented as the normal way of dealing with transfer pricing questions.

There are frequent references in the Revised Discussion Draft where the acceptability of the legal arrangements is subject to the "conduct of the parties", as in TPG 1.53 (i.e. the need to confirm the consistency between the conduct of the parties and the legal arrangements).

Legal contracts between related entities do have significance outside tax and transfer pricing, e.g. to steer operations, set goals for businesses, make clear which entities are responsible for what, and allocate risks. These contracts should not be easily dismissed as not "true". Contractual arrangements are a clear reference point and do not give rise to significantly different interpretations, whereas the conduct of the parties is a much more vague notion which may give rise to different interpretations. This will make dispute resolution more difficult and uncertain.

Although the individual elements in Chapter VI can be found in the current TPG, as a result of the way the chapter is written and the frequency of the elements, the balance seems much different. Below is a list of the multiple references to "conduct of parties" and recharacterization :

- Para. 66 provides the analytical framework of 6 steps, where the starting point (step 1) is the legal contract, step 3 is confirming the consistency between the legal contracts and the conduct of the parties, and step 6 provides for recharacterization in exceptional cases.
- Para. 67 notes that legal rights and contractual arrangements form "the starting point".

- Para. 71 includes a reference to "where the legal rights are consistent with the conduct of the parties (as discussed in TPG 1.53)".
- Para. 73: the second sentence starts negatively, emphasizing that legal ownership as such does not give rights to any receipts. Same for para. 74, first sentence.
- Para. 80 contains a reference to disregarding of actual structures under TPG 1.65.
- Para. 89: the returns to the legal owner are described in a negative way, saying: the returns can be attributed "only if, in substance, ...": it is written from a skeptical point of view.
- Para. 91: reference to reviewing consistency between the legal arrangement and the actual conduct of the parties, referring to "the true terms" of the transaction.
- Para. 107 states that "labels" do not control the transfer pricing analysis.
- Para. 108 contains another reference to legal arrangements and the actual conduct of parties.
- Para. 109: reference to TPG 1.52-1.54 and 1.64-1.69, and explicit example where legal arrangements need not be respected.
- Para. 113: reference to TPG 1.52-1.54.
- Para. 115: reference to legal arrangements and the actual conduct of parties, and to TPG 1.52-1.54.
- Para. 120: the characterization of the transaction does not necessarily dictate the use of a particular transfer pricing method.
- Para. 120: "the facts of each specific situation, and the results of the required functional analysis, will guide the manner in which transactions are combined, characterised and analysed for transfer pricing purposes": this paragraph ignores that the transaction already is characterized, mostly in legal contracts (and should be recharacterized in exceptional circumstances only).
- Para. 121: reference to legal arrangements and the actual conduct of the parties.
- Para. 132: reference to disregarding transactions, TPG 1.65. Further reference to considering whether the assertions are consistent with "the true facts and circumstances" of the case.
- Para. 150: reference to "arbitrary label".
- Para. 156: reference to TPG 1.65 again.

These many references seem to reflect a skepticism towards legal contracts, as if the norm was that the conduct of parties deviates from the legal arrangements.

In our view, more principled guidance could follow the following pattern:

- Establish that the comparability analysis is based on <u>5</u> comparability factors (including contractual arrangements and the functional analysis). Confirm that, as a general rule, intercompany contractual arrangements are to be recognized.
- On this basis, provide the detailed guidance of proposed Chapter VI, based on an expectation that most MNEs do their best to apply the ALP in a fair and reasonable way.
- This guidance could aim at giving more concrete guidance on very difficult transfer pricing topics relating to intangibles which in the current draft often are very briefly addressed (e.g. how to determine an arm's length compensation for funding and risk-bearing, etc.).
- Then there should be a final paragraph referring to abuse / exceptional cases - providing a clearer and well focused definition of what the cases are where recharacterization could apply:
    - Exceptional cases: where conduct of parties is not in line with legal arrangements (TPG 1.53).
    - Exceptional cases: recharacterization under TPG 1.64-1.68.

A.1 Identifying intangibles - In general

Para. 40: We welcome the addition to the definition of transfer pricing intangibles of the phrase "whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances". We believe that this is a significant improvement compared to the June 2012 draft.

Para. 41: We suggest that the sentence reading "Furthermore, the enhancement to value that may arise from the complimentary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet" should be deleted. In effect, it is referring either to synergies, which are within the scope of Chapter I rather than Chapter VI, or to a valuation question regarding a combination of intangibles, which is within the scope of Section C.1 (ii) or D.2. Leaving this sentence in para. 41 inappropriately suggests that synergies among intangibles are an intangible by themselves.

A.3 Categories of intangibles

Para. 51: The proposed definition of "valuable intangibles" relates to "intangibles whose use in business operations is expected to yield greater future economic benefits than would be expected in the absence of the intangible". However, the use of *any* intangible, even routine know-how or the most basic software, is expected to yield greater future economic benefits than would be expected in the absence of the intangible. Hence, this proposed definition of "valuable intangibles" defeats the very purpose of distinguishing between valuable intangibles and routine intangibles and may lead to an extraordinary broadening of the cases of application of profit split method. We believe that what is missing here is the notion than only intangibles whose use in business operations is expected to yield significantly greater future economic benefits should be regarded as valuable intangibles.

Paras. 60 - 62: We believe that the discussion of goodwill, although improved compared to the one in the June 2012 discussion draft, is still confusing. In our view a fundamental flaw in it is that it tends to confuse intangibles on the one hand and the value of combined intangibles / assets / business transfers on the other hand. For instance, we believe that it should be clarified in this section that reputational value is not an intangible, but value attached to an otherwise existing intangible or business. This is in line with the recognition that synergies are to be addressed as comparability factors, not as intangibles. The same misconception is found at para. 113 which unrealistically refers to the "licensing of reputational value".

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

Para. 65: We agree that this paragraph sets out the correct analytical framework, i.e. that the ultimate allocation of the return attributable to the intangible is accomplished by compensating members of the MNE group for functions performed, assets used or contributed, and risks assumed according to the principles described in Chapters I-III. We welcome the deletion of the notion of "intangible related return" which was found in the June 2012 discussion draft and which we found unclear.

Anticipated value

In multiple instances, Section B contains references to the *anticipated* value creation / *anticipated* value of the contributions / *anticipated* value of the intangibles / *anticipated* value of the functions, assets and risks. See for instance paras. 65, 73, 74, 77, 78, 84, 86, 90, 92, 93, 95, 96, 97, 102. It is unclear to us what the intended significance of this new language is.

The Revised Discussion Draft seems to use the words "anticipated value" or "value" interchangeably to refer to the same concept of the uncertain value of an intangible asset at a given date resulting from the discounting of forecasted cash flows that are at risk. If our understanding is correct, the word "value" could be substituted for ""anticipated value". In effect, finance theory argues that the *value* of an asset (or contribution) at any point in time depends on the *present* value of the *anticipated*, future cash flows that such asset (or contribution) can generate (i.e., discounted cash flow). Third party valuations follow the facts, circumstances, and what was known at the time of the transaction. Related-party transactions need to do the same. On the other hand, if the use of the words "anticipated value" is intended to have a meaning different from "value", it should be clarified.

Furthermore, on several occasions, the Revised Discussion Draft states that in identifying arm's length prices for transactions among associated enterprises, the *anticipated contribution* of the functions performed by members of the group related to the creation of intangible value should be considered and appropriately rewarded. Our view is that the relevance of the anticipated contribution depends on the facts and circumstances of each case. There are functions which at arm's length are most appropriately compensated on the basis of cost-based methods reflecting the employment of the supplier's resources. This would typically be the case for a low risk service provider. There are other functions which require a more complex economic analysis. We find that the use of the phrase "anticipated contribution of the functions to value creation" may be interpreted as encouraging a systematic use of the profit split method among all the parties that contribute to the value chain.

In the same vein, the use of the words "anticipated contributions" in a few instances seems to suggest that arm's length compensation should be determined on the basis of anticipated results, which in our view depends on the facts and circumstances of each case, and specifically on which party to the transaction bears the risk of discrepancy between anticipated and actual value creation. In particular, while the notion of expected / anticipated benefits is often relevant to the application of a profit split, it is generally less relevant to the application of a cost plus, resale price or TNMM method. If the OECD's intent was to introduce a new standard to systematically take into consideration anticipated contributions in the determination of the current value, it would create huge compliance and enforcement difficulties and depending on the case may not be consistent with third party transactions. It might also be contrary to the arm's length outcome-testing approach which is described at TPG 3.70.

Furthermore, the drafting at times mixes up actual and anticipated return. For instance at para. 73 it reads: "The return *ultimately* retained by the legal owner depends upon the contributions it makes to the *anticipated* value of the intangibles through its functions performed, assets used, and risks assumed, and upon the contributions to the *anticipated* value of intangibles made by other MNE group members through their functions performed, assets used, and risks assumed." This is an inaccurate statement. Assuming the legal owner bears the entrepreneurial risk, the return it will *ultimately* retain will depend on the actual value creation, not on the anticipated value creation.

We therefore recommend that the OECD re-examine the proposed use of the word "anticipated" throughout the document.

B.1 Intangible ownership and contractual terms relating to intangibles

Para. 72: It could be worth clarifying that where an intangible and a license relating to the same intangible are considered as two distinct intangibles, the transferability and value of each of them may be affected by the other.

We further note that the Revised Discussion Draft fails to draw the consequences of this distinction. For instance, in Section B there is little indication of the functions, assets, and risks relevant to the licensee (owner of a license right). There is also little indication of how to determine the intangible return attributable to the licensee (owner of a license right) and the one attributable to the licensor (owner of the licensed intangible).

Arm's length compensation for the legal owner

Paras. 73 and 74: We understand the concerns expressed by the OECD and some member countries about scenarios that lack economic substance and allocate excessive returns to entities which perform no functions or do not allocate sufficient returns to the entities performing the key functions leading to the creation of value. Our proposal is not to defend the "two men and a dog scenario" as we recognize that people functions (and not only the provision of funding and assets) should be compensated at arm's length. On the other hand, we believe that the Revised Discussion Draft in a number of instances goes too far as it is seemingly denying an arm's length compensation to the legal owner for the assets contributed and risks borne. We urge the OECD to clarify that the intention is not to deny arm's length compensation to the owner of intangibles not only for its functions, but also for its assets contributed and risks borne.

Thus, the second sentence of para. 73 ("It is important to note that, for transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain any return from exploiting the intangible that may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible") and first sentence of para. 74 ("As stated above, a determination that a particular group member is the legal owner of intangibles does not, in and of itself, imply that the member has the right ultimately to retain any receipts that accrue in the first instance to that member as a result of its commercial right to exploit the intangible, nor does it imply that the legal owner is entitled to any income of the business after compensating other members of the MNE group for their functions performed, assets used, and risks assumed") should be nuanced. As drafted, these sentences introduce a bias which we believe should be removed from the final text. Consistently with the last sentence of paragraph 65, the legal owner of the intangible should be compensated for its functions performed, assets used or contributed (including the intangible in question), and risks assumed (i.e. financial risk / risk of depreciation linked with the ownership of the intangible).

Similarly, we believe that the 4th sentence of para. 73 ("For example, where the legal owner makes no contributions that are anticipated to enhance the value of the intangible, the legal owner will not ultimately be entitled to retain any portion of the return attributable to the intangible") is erroneous. In this example, the legal owner should be entitled to an arm's length return for its assets contributed and risks assumed. It may not be entitled to the full intangible return, as an arm's length compensation will need to be allocated to the parties performing the enhancement function; but it would be seriously damaging to prejudge that it is not entitled to "any portion" of the intangible return.

In the same vein, we believe that the 5th sentence of para. 73 ("Legal ownership is simply a reference point for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions.") is biased and undermines the analytical framework set forth at para. 66. In our view the sentence should be deleted or redrafted to read in a neutral way: "Legal ownership is *the starting point* for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions. *It is not however the only element to be considered in the analysis. See para. 66.*" Such a redrafting would be in line with the 8th and 9th sentences of para. 73 ("Thus, identification of legal ownership, combined with the identification of relevant functions performed, assets used or contributed, and risks assumed by all contributing members, provides the analytical framework for identifying arm's length prices and other conditions for transactions involving intangibles. As with any other type of transaction, the analysis must take into account all of the relevant facts and circumstances present in a particular case.").

Para. 76: We recommend that the first sentence be slightly amended to more accurately read: "In those cases where the legal owner of intangibles is to be entitled ultimately to retain the returns attributable to the development, enhancement, maintenance and protection of the intangibles, it will either perform the corresponding functions related to development, enhancement, maintenance and protection of the intangibles, or arrange to have such functions performed under its control by independent enterprises or by associated enterprises." Otherwise, the sentence seems to suggest that only those functions ought to be compensated, and that assets contributed and risks assumed by the legal owner can be ignored.

Para. 77: We believe that the first sentence should be slightly amended to read: "If other members of the group perform functions contributing to the development, enhancement, maintenance or protection of intangibles under the control of the legal owner, the legal owner of the intangibles must compensate those members performing such outsourced functions on an arm's length basis for the ~~intangible value anticipated to be created through such~~ functions performed." Otherwise, the sentence seems to suggest that all the listed functions give rise to a profit split type of remuneration. We believe that at arm's length there are cases where another method would be more appropriate than a profit split to compensate the above-listed functions.

Para. 78: Again we wonder whether the intention of this paragraph is to suggest that the functions related to the development, enhancement, maintenance, or protection of intangibles should always be compensated based on a profit split method. We would not support this proposal if it is the intended meaning; we would urge the OECD to rephrase the draft if it is not.

Para. 90: We suggest rephrasing this paragraph as follows: "To the extent that one or more members of the MNE group other than the legal owner performs functions, uses or contributes assets, or assumes risks or costs related to the development, enhancement, maintenance, and protection of the intangible, returns ~~attributable to the intangible~~ must accrue to such other members through arm's length compensation reflecting their ~~anticipated contribution to intangible value~~ functions. This may, depending on the facts and circumstances, constitute all, ~~or~~ a substantial part or a small part of the return attributable to the intangible."

C - Transactions involving the use or transfer of intangibles

Para. 109: The next to last sentence ("a written specification that a licence is non-exclusive or of limited duration need not be respected by the tax authority if such specification is not consistent with the conduct of the parties") seems to suggest that a non-exclusive license will only be regarded as such if there are other actual licensees, and that a limited duration license will only be respected as such if it is terminated from time to time. We believe the conduct of the parties should comport with the legal terms of the agreement. However, there are cases of non-exclusive licenses between unrelated parties where the licensor has not provided a competing license to another firm. In order for a license with a related party to be recognized as non-exclusive, the licensor should not be required to provide those rights to other parties as well.

D - Supplemental guidance for determining arm's length conditions in cases involving intangibles

CUP method

Para. 164: We think that the statement in the last sentence should be nuanced ("It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible"). We believe that the thrust of the transfer pricing analysis should be to select and apply the most appropriate transfer pricing method based on the criteria set forth at TPG 2.2. There are cases where a CUP method applied with imperfect comparables is the more appropriate method (in view of the criteria of TPG 2.2, including reliability of comparables and consistency with the functional analysis of the parties), and the OECD should not prejudge the outcome of analyses which need to be fact specific.

Profit split methods

We find that in general the Revised Discussion Draft contains a bias towards the use of the profit split method irrespective of whether this method is or is not appropriate to the functional analysis of the transaction. The IAPT urges the OECD to reaffirm that the profit split method should be selected when and only when it is the most appropriate method based mainly on the functional analysis of the parties, e.g. where each of the parties makes valuable and unique contributions in relation to the controlled transaction; rather than solely based on the lack of perfect comparables. We believe that this is consistent with the guidance in TPG 2.2 and 2.4, 3.39 and 2.109.

Despite the balancing language at para. 213, we note that the Revised Discussion Draft generally sets forth an extraordinarily stringent comparability standard, see for instance paras. 18-23 dealing with synergies, para. 149 ("the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases"), para. 156 ("it will often be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions"), etc. We fear that this, combined with language in the Revised Discussion Draft about the use of profit split method in cases where reliable comparables are not available, will encourage the use of a profit split method in situations where such method is not consistent with the functional analysis of the parties, based on the mere rejection of imperfect comparables. For instance, if the factual situation is that one party to a transaction provides routine R&D services for which it does not contribute any valuable, unique intangible and does not bear any significant risk, it would not be appropriate for the tax administration to reject the use of a cost plus or TNMM method on the sole ground that no perfect comparable was found for the R&D services in question. This is not a theoretical issue, but one which gives rise to numerous and significant disputes.

Para. 147: We suggest the last sentence should be edited to read: "If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions<u>, taking into consideration the various criteria set forth at TPG 2.2 and in particular consistency with the functional analysis of the transaction</u>."

Para. 148: In line with our comment on para. 147, we suggest adding a reference to TPG 3.39 after the one to TPG 3.38. Importantly, TPG 3.39 indicates that "even in cases where comparable data are scarce and imperfect, the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties."

Para. 170: We suggest that the 3rd and 4th sentences be slightly edited as follows: "In particular, functions performed and risks assumed by the licensee/transferee <u>in relation to the intangible </u>should specifically be taken into account in such an analysis. Other intangibles used by the licensor/transferor and by the licensee/transferee in their respective businesses <u>in relation to the intangible transferred</u> should similarly be considered, as well as other ~~relevant~~ factors <u>to the extent they are relevant to the intangible transfer</u>."

Valuation techniques

Paras. 171- 198: We read the language in paras. 171-175 as overly cautionary concerning the possibility of using valuation techniques (see para. 174 in particular). Given the stringent comparability standard set forth in the Revised Discussion Draft and the presumption in the document that reliable comparables are scarce, we believe that the OECD should better acknowledge that in real life cases, valuation techniques are often the most appropriate method available.

More generally, we believe that this section is either saying too much or too little on valuation techniques. There is a vast amount of literature on valuation techniques which provides more precise and helpful guidance on when and how to apply them. The OECD should restrict its comments on valuation techniques to those which are specific to transfer pricing considerations or novel.

Situations where no comparables exist

Para. 220: It is important to differentiate cases where comparables do not exist (as stated in the heading) from cases where comparables cannot be identified (as stated in para. 220). A significant number of countries do not have access to public databases or have limited information about public companies (see Chinese contribution to Chapter 10 of the United Nations' Transfer Pricing Manual). The lack of publicly available information is an issue *per se*, but it should not lead to the selection of a profit split method where such method is not appropriate to the circumstances of the case and in particular to the functional analysis of the transaction. Tax administrations should not attempt to apply a profit split method to routine manufacturing, services, or distribution functions just because of the lack of publicly available information on comparables in their country.

Examples 1, 2, 3 and 12: We believe that in these examples, the reason that the legal owner is not entitled to retain income from the intangibles is that it only paid a nominal price, which is assumed to be significantly below arm's length, to acquire them. If the facts were the same but the legal owner had paid a significant price to acquire the intangibles, we believe that the determination of an arm's length compensation to S should reflect not only the functions it performs but also the funding provided and associated risks borne.

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Once again, the Alliance appreciates the opportunity to comment on the Revised Discussion Draft and stands ready to respond to any questions or to provide further input as the OECD's work in this area continues.

Sincerely yours on behalf of the Alliance,

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Cc: Ms. Michelle Levac, Chair, Working Party 6