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25 September 2013

Mr. Joe Andrus
Head of Transfer Pricing Unit
OECD Centre for Tax Policy and Administration
2, rue Andre Pascal
75775 Paris Cedex 16
France

Sent via e-mail: joe.andrus@oecd.org

Re: Revised Discussion Draft - Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Mr. Andrus,

The International Bar Association would like to take this opportunity to comment on the Revised Discussion Draft on Intangibles Transfer Pricing, released on July 30, 2013.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world's top lawyers and 197 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

We are submitting our comments on behalf of the IBA Taxes Committee which has 1037 members from around the world. This committee formed a Working Group to respond to the Consultation on the original draft, release in June 2012, and certain members reconvened to address the current consultation.

The comments made in this report are the personal opinions of the Working Group participants and should not be taken as representing the views of their firms, employers or any other person or body of persons apart from the IBA Taxes Committee of which they are a member.

The comments are enclosed with this letter.

Sincerely,

Claire Kennedy, Co-Chair of the Working Group, IBA Taxes Committee, Canada

A handwritten signature in cursive script that reads "Stuart Chessman".

Stuart Chessman, Director, Taxes Vivendi, USA

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INTRODUCTION

The IBA Taxes Committee has read with interest the Revised Discussion Draft on Transfer Pricing (the "Revised Draft") and thanks the OECD for the opportunity to provide written comments. The comment deadline of October 1, 2013 affords too short a time frame for detailed comments of the substantially revised draft, particularly when the Revised Draft was released on July 30, coincidentally with the OECD White Paper on Transfer Pricing Documentation and just days after the Action Plan related to Base Erosion and Profit Shifting.

In view of the short deadline, this submission concentrates only on the conceptual allocation framework espoused in Section B of the Revised Draft, which is entitled "Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles".

In summary, the IBA Taxes Committee finds that the approach taken by the Revised Draft, like the prior version, does not give a sufficiently clear priority to legally binding agreements and, in particular, to legal ownership¹ in determining the party entitled to returns from intangibles. The IBA Taxes Committee believes that where legally binding and properly documented intercompany service arrangements have not been compensated on arm's-length terms, transfer pricing adjustments *for these particular service arrangements, which we acknowledge may be material*, should be made as opposed to treating the service provider as a party entitled to the residual returns from intangibles. The conceptual allocation approach espoused by the OECD in this Revised Draft promotes instead a *de facto* recharacterization method that is at best confusing and at worst will give rise to uncertainty and more involved and costly disputes for both taxpayers and tax authorities. This is especially true given that this methodology continues to be inconsistent with the decision of courts in many jurisdictions, which under current law look to legally binding agreements, absent sham. The IBA Taxes Committee is also concerned that promoting an approach that is inconsistent with prevailing law risks undermining the utility of the Transfer Pricing Guidelines ("TPG") overall.

The combined impact of the Revised Draft provisions, including the willingness to set aside legally binding agreements that are currently respected in practice, the "remedy" of attributing intangible returns to service providers rather than adjusting the transfer price for intangible related service, and the lack of weight accorded to capital providers, appears to us to be inconsistent with the market place. While the Revised Draft makes passing acknowledgement of some third party R&D outsourcing arrangements, it does not in our view give sufficient weight to these comparables nor to the relative overall compensation of skilled researchers with post-doctoral qualifications in engineering or the sciences, on the one hand, and investors on the other.

¹ We use the term "owner" to mean legal and beneficial owner and not a mere legal title holder to property and we use "ownership" accordingly.

In light of the fact that the Revised Draft itself acknowledges that a hard-to-value intangibles are not adequately addressed in the document and will be considered in the context of BEPS, the IBA Taxes Committee urges the OECD not to confirm the Revised Draft as written and rather to reconsider the conceptual allocation framework in the course of the BEPS work and substitute a more robust application of the arm's length principle in the pricing of service arrangements and other transactions involving intangibles.

COMMENTARY ON THE REVISED DRAFT

Our comments on the Revised Draft concentrate on Section B entitled "Ownership of Intangibles and Transactions Involving Development, Enhancement, Maintenance and Protection of Intangibles". This Section proposes a conceptual allocation framework of the intangible return to members of an MNE group that are not the legal owners of the intangible yet who have contributed to its value through functions, assets and risks. The IBA Taxes Committee evaluates this proposed framework along with other statements in Section B, pointing out areas of agreement and difference, outlines specific concerns we have with the conceptual allocation framework and finally suggests a re-evaluation of the proposed approach in light of the ongoing work in connection with BEPS to which the Revised Draft already adverts.

Conceptual Allocation Framework

The opening paragraph of Section B of the Revised Draft states²:

"Although the legal owner of an intangible may initially be entitled to receive the proceeds from exploitation or transfer of the intangible, other members of the owner's MNE group may have performed functions, used or contributed assets, or assumed risks that are anticipated to contribute to the value of the intangible and for which they must be compensated under the arm's length principle."

The Revised Draft elaborates on this key principle elsewhere, including at paragraphs 74 and 97, respectively:

"The arm's length principle.....require[s] that all members of the group related to the creation of intangible value should be considered and appropriately rewarded."

"Appropriate compensation for research services will depend on all the facts and circumstances, including whether the research team possesses unique skills and experience relevant to the research, bears risks (e.g. where "blue sky" research is undertaken), uses its own intangibles, or is controlled and managed by another party. Compensation based on a reimbursement of costs plus a modest mark-up will not reflect the anticipated value of or the arm's length price for the contributions of the research team in all cases."

² Paragraph 65

The IBA Taxes Committee agrees with these statements and more broadly with the core principle that transactions between members of an MNE concerning intangibles should respect the arm's length principle. We repeat the statements made in our submission on the prior draft that we agree with the notion that bearing costs alone may not be sufficient to justify intangible-related returns and we believe that indicia of legal ownership, supported by exercise through personnel of at least some level of control over the intangible, that is normal to such ownership, are also critical.

The Revised Draft goes further, however, and restates the above-quoted clear and unambiguous assertion of the arm's length principle in the following very different terms:

*"The right of other members of the MNE group to receive compensation for their functions performed, assets used or contributed, and risks assumed may be conceptually framed as an allocation to those other members of all or part of the return attributable to the intangible."*³

In our respectful view, this restatement is erroneous. We are sensitive to the fact that the Revised Draft is a consensus document and consequently, this language may represent a political compromise. While we appreciate the delicacy of the OECD's task, we cannot accept that this conceptual framework is a valid proxy for the arm's length principle in intangibles transfer pricing.

The IBA Taxes Committee readily acknowledges that on a particular fact pattern, given the degree and nature of outsourcing and the application of the arm's principle to the determination of the compensation for outsourced services (in which a cost plus model may not be appropriate), the *quantum* of the residual return retained by the legal owner, after all applicable payments may be very modest. We must emphasize, however, that it is not necessary or desirable to attempt to achieve this result by substituting other parties for those legally entitled to retain the return attributable to the intangible. We therefore urge the OECD to revisit the following statements in the Revised Draft:

*"If...the legal owner...neither controls nor performs the [outsourced] function, the legal owner likely would not be entitled to any ongoing benefit attributable to the outsourced functions."*⁴

"The legal owner of an intangible is entitled to all returns attributable to the intangible only if, in substance, it:

- *Performs and controls all of the important functions described in paragraph [79] related to the development, enhancement, maintenance and protection of the intangibles;*

³ Paragraph 65

⁴ Paragraph 77

- *Controls other functions outsources to independent enterprises or associated enterprises and compensates those functions on an arm's length basis;*
- *Provides all assets necessary to the development, enhancement, maintenance, and protection of the intangibles; and*
- *Bears and controls all of the risks and costs related to the development, enhancement, maintenance and protection of the intangible."*⁵

Indeed, this conceptual reallocation of the return attributable to the intangible amounts to establishing as the norm, rather than the exception, a *de facto* recharacterization rule. This approach, therefore, contradicts the step-wise analytical approach outlined in the Revised Draft (with which the IBA Taxes Committee agrees), that places recharacterization as the last step and one that is limited to "exceptional circumstances".⁶

Problems Arising from Conceptual Allocation Framework

In our view, the conceptual reallocation framework is wrong in principle; however, the issue is not merely theoretical. The IBA Taxes Committee is concerned that the proposed approach is wrong in practice and will compound, rather than alleviate, difficulties in intangibles transfer pricing.

Conceptual Allocation Framework is at Odds with Domestic Laws

Framing the approach as one in which members other than the legal owner of the intangible are entitled to "an allocation.... of all or part of the return attributable to the intangible" will almost certainly invite continued struggle between taxpayer and tax authorities that the TPG should instead be trying to resolve.

The proposed conceptual allocation framework is flawed because it does not give a sufficiently clear priority to legally binding agreements in determining the party entitled to returns from intangibles of the intangible owner. As we stated in our original submission, such an approach is inconsistent with the approach adopted by courts in many OECD member jurisdictions, which under current law look to legally binding agreements, absent sham.

Conceptual Allocation Framework will Undermine Utility of the TPG

Establishing a framework that openly conflicts with the prevailing law in many jurisdictions will invite courts to disregard the TPG and will ultimately undermine their utility to the detriment of all interested parties, including the OECD.

⁵ Paragraph 89

⁶ Paragraph 66

Conceptual Allocation Framework Promotes Uncertainty & Undermines the Arm's Length Principle

The net effect of the conceptual reallocation approach is to make the *entitlement* of the owner to retain intangible returns (versus the *quantum* of retained return) dependent on the compensation to service providers, creating circular analysis and attendant uncertainty. This deleterious effect is compounded by the fact that these arrangements will be in place over many years and tax authorities are free to pick and choose which years to challenge, meaning that for this reason, as well as more fundamental ones, double taxation is even more likely to arise under the Revised Draft's framework than is currently the case.

We draw your attention to Example 13 in the Revised Draft concerning the transfer of patents and other IP to a new subsidiary, Company T, which in turn, outsources R&D to the parent (Shuyona) and a sister company (S) with Shuyona continuing to supervise the R&D. The Example is not able to draw a firm conclusion about the appropriate level of compensation to Shuyona for its functions assets and risks. Interestingly, however, the Example states in respect of the initial transfer of the intangibles to Company T⁷:

"For the purposes of this example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles reflects the arm's length value of the transferred intangibles at the time of the transfer."

It is a basic valuation principle that the arm's length value of the transferred intangible will reflect the value that the purchaser/new owner (and the vendor/original owner) of the intangible expects will accrue to the intangible following the transfer. Under the conceptual allocation framework in the Revised Draft, that amount becomes unknowable because the entitlement of Company T to retain the intangible related return depends on a potential reallocation years in the future of the benefits of ownership at the instance of tax authorities in Shuyona or Company S jurisdictions.

The conceptual allocation framework also fails to address how it should be applied in the context of negative returns to a purchased intangible in a fact pattern similar to that used in Example 13.

The IBA Taxes Committee notes that there have been numerous examples of competing technologies or platforms in which one ultimately prevails at the expense of the others, generating material losses for the owner of the superseded IP. The divergent fates of Facebook, Inc and Myspace are one such example. At its December 2008 peak, Myspace, which was acquired by News Corporation in 2005 for \$580 million, attracted 75.9 million monthly visitors in the United States. In 2009, the social networking service brought in a total of \$470 million in advertising.⁸ However, with the rise of Facebook Inc's online social networking service, Myspace quickly lost its place atop the social networking world, losing more than a million U.S.

⁷ Paragraph 271

⁸ Felix Gillette, "The Rise and Inglorious Fall of Myspace", *Bloomberg Businessweek* (22 June 2011), online: Bloomberg Business week <http://www.businessweek.com/magazine/content/11_27/b4235053917570.htm>

users a month between 2009 and 2011. By May 2011, the number of monthly visitors had dropped to 34.8 million and advertising fell to \$184 million.⁹ These events culminated in the sale of Myspace by News Corp. in 2011 to Specific Media Inc. for \$35 million, a fraction of what it paid for the social networking business in 2005.¹⁰

Similarly, the growth of Apple Inc.'s iPhone, Blackberry Ltd.'s handheld devices and Google Inc.'s Android software have come at the expense of Palm Inc. In December 2000, Palm accounted for three out of every four handheld devices sold in the United States. By that date, Palm had sold thirteen million devices in five years. However, within one year Palm's share price experienced a dramatic and rapid decline in value, dropping from a high of \$95.06 on March 1, 2000 to \$6.50 in June 2001, a decline of more than 90%.¹¹ This decline continued over the next decade, as Palm saw its U.S. market share drop to 3.5% in 2005 and then further, to 1.5% in 2009. The company was purchased by Hewlett-Packard Co. on April 29, 2010.¹² Moreover, Blackberry's board is now considering strategic alternatives in light of the precipitous decline of that company's fortunes.

BEPS Co-ordination

As we have described, the IBA Taxes Committee accepts and indeed endorses many of the statements in the Revised Draft. However, we have very serious reservations about the utility of the proposed conceptual allocation framework for both taxpayers and tax authorities and, more broadly, for its impact on the utility of the TPG.

We note with interest that the Revised Draft acknowledges that there is ongoing work on hard-to-value intangibles in the context of the BEPS Action Plan. We therefore urge the OECD to revisit the Revised Draft again in light of this work and to substitute for the problematic conceptual reallocation framework a more robust application of the arm's length principle in related party transactions concerning intangibles, one which better respects the weight accorded to ownership in OECD member jurisdictions.

CONCLUSION

While the IBA Taxes Committee agrees with the core principle espoused in the Revised Draft that all members of an MNE group that contribute to the value of an intangible must be appropriately compensated (and that a cost plus model may not be appropriate compensation), we do not agree that it is appropriate or advisable to express this core principle as a conceptual

⁹ *Ibid*

¹⁰ Andy Fixmer, "News Corp. Calls Quits on Myspace With Specific Media Sale", *Bloomberg Businessweek* (29 June 2011), online: <http://www.businessweek.com/news/2011-06-29/news-corp-calls-quits-on-myspace-with-specific-media-sale.html>

¹¹ Cliff Edwards, "Palm's Market Starts to Melt in Its Hands", *Bloomberg Businessweek* (3 June 2001), online: <http://www.businessweek.com/stories/2001-06-03/palms-market-starts-to-melt-in-its-hands>

¹² Justin Scheck and Yukari Iwatani Kane, "H-P Gambles on Ailing Palm", *The Wall Street Journal* (29 April 2010), online: <http://online.wsj.com/article/SB10001424052748704423504575212503407087936.html>

allocation of intangible value. We are concerned that such a conceptual allocation framework, which is at odds with the prevailing law in OECD member jurisdictions, will promote uncertainty, undermine the arm's length principle and ultimately, the utility of the TPG. Instead, we continue to advocate a robust application of the arm's length principle and urge the OECD to make suitable revisions to the Revised Draft in the course of the ongoing BEPS work on hard-to-value intangibles.