Innovation & Information Consultants, Inc.
ECONOMIC RESEARCH, ANALYSIS & CONSULTING

72 Junction Square Drive, Concord, MA 01742 • (978) 369-0550 (voice) • (978) 369-8815 (fax) • www.iic-inc.com

September 30, 2013

Organization for Economic Cooperation and Development (OECD)
Sent via e-mail to TransferPricing@oecd.org

Comments on "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles"

Innovation & Information Consultants, Inc. (hereafter "IIC, Inc.") is pleased to submit these comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. As an applied economics and finance consulting firm, we maintain expertise in the areas of transfer pricing, valuation and industry analyses; and welcome the opportunity to provide these comments on the important transfer pricing issues the OECD is addressing through Working Party No. 6. We recognize that the OECD has previously issued a Draft Discussion and received considerable feedback. As a result, we limit our comments to specific topics included in the Revised Discussion Draft and attempt to avoid specific editorial edits, unless necessary.

We commend the OECD for undertaking an update to the Transfer Pricing Guidelines, particularly given the myriad complex and contentious issues surrounding the treatment of intangibles in transfer pricing. The mere fact the OECD received in excess of 1,000 pages of comments with respect to the Draft Discussion issued in June 2012 underscores the importance of clarifying and delineating the procedures and processes through which taxing authorities and multinational enterprises ("MNEs") view the role of intangibles in transfer pricing practice. With respect to the Revised Discussion Draft, our comments are as follows.

Chapters I-III of the Transfer Pricing Guidelines

<u>D.6.1. Location Savings</u>

With respect to paragraph [5], we support the recognition of location savings in a transfer pricing context, but one must be careful in assessing how to allocate such savings in the context of an MNE. For example, location savings may arise due to "first mover advantages" and the entity responsible for deciding to enter the market should be allocated these benefits, if it assumes the risks and controls the entry decision. This may hold true regardless of whether local comparables exist, although if first mover advantages exist then local comparables are unlikely to exist.

<u>D.7. Assembled Workforce</u>

We commend the OECD for explicitly recognizing issues associated with an assembled workforce. However, we recommend that the OECD return to the prior view of an assembled workforce as an identifiable intangible. This is particularly the case when such a workforce may be transferred from one entity within an MNE to another in a different jurisdiction. Although paragraph [15] seems to recognize this situation, treatment as an intangible should be more explicit. The Revised Discussion Draft explicitly removes assembled workforce from Chapter VI, A.4., and we recommend instating workforce in place as an intangible in Chapter VI. We note that even if classified as an intangible, the specific facts and circumstances of each transfer pricing scenario will dictate whether there is any value associated with an assembled workforce. In addition, the economic literature clearly recognizes an assembled workforce as an intangible asset.[1]

Should the OECD elect to treat an assembled workforce in the context of the Revised Draft Discussion (i.e., not reinstate in Chapter VI), then at the minimum we recommend the OECD clarify the provisions of paragraph [15] to recognize the existence of the assembled workforce as an identifiable asset, with a value that is not limited to the "comparability adjustments" referenced within paragraph [15].

D.8. MNE Group Synergies

We believe that paragraph [20] is vague with respect to what constitutes "specific concerted group actions" that might give an MNE group "a material, clearly identifiable structural advantage or disadvantage." While the examples that follow are helpful, we recommend the OECD elaborate on the process through which MNEs and taxing authorities can readily identify the structural advantages created by the specific concerted group actions.

Chapter VI Special Considerations for Intangibles

With respect to paragraph [38], we agree with the OECD's vision for a clear roadmap involving evaluation of intangibles.

A.1. General

We recognize that the OECD has added paragraph [39], but remain unsure the significance of whether this paragraph adequately addresses discrepancies in the definition of "intangible." While we understand the differences in opinion that arise when attempting to define what constitutes an "intangible" within the transfer pricing arena, we recommend the OECD continue to pursue a more definitive definition. Along these lines, paragraph [40] remains vague, despite a number of comments requesting revisions to the same text in the June 2012 Draft Discussion. At a minimum, we believe the OECD should clarify whether the appropriate discussion is intangible asset or intangible property. We prefer emphasis on property, and the economic literature provides useful definitions of intangibles as well as useful lists.

[1] For example, see Gordon V. Smith and Russell L. Parr *Valuation of Intellectual Property and Intangible Assets*. Third edition. p. 19; Michael J. Mard, James R. Hitchner, and Steven D. Hyden. *Valuation for Financial Reporting*. Third Edition. p 76.; Shannon P. Pratt. *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*. Fifth edition. p 366.; Reilly, R.F., Dandekar, M.P, "Valuation of intangible contract rights", *The CPA Journal*, Vol. 67 No.6. 1997. p 75.; Willamette Management Associates, "Valuation of Intangible Assets for Fair Value Accounting Purposes," February 12, 2009.; Reilly, Robert, "Valuation of the Trained and Assembled Workforce Intangible Asset," *Valuation Strategies*, Nov/Dec 2006.; and Marc M. Levey, Victor H. Miesel, William S. Garofalo, "Cost-sharing agreements: 'Pandora's Box' or the buy-in, buy-out challenge?", *The International Tax Journal*, vol. 27, No. 3, 2001.

A.3. Categories of Intangibles

We recommend that the OECD clarify the positions taken in paragraphs [49] and [50]. One on hand, paragraph [49] implies no delineation of categories with precision, yet paragraph [50] proceeds to discuss certain categories that appear to have obtained common acceptance. We believe that if the OECD's intent in listing categories is to facilitate resolution in transfer pricing it should amend paragraph [49] to remove the language regarding an inability to delineate with precision these various classes or categories.

With respect to paragraph [51], we recommend adding the word "significantly" before "greater future economic benefits" in sub-point (ii). We believe that unique and valuable intangibles should not be confused with routine or pervasive intangibles and one reason is often the significant future economic benefits.

A.4. Illustrations

Per our previous comments, we would recommend recognition of an assembled workforce as an intangible.

B.1. Intangible ownership and contractual terms relating to intangibles

We generally agree with the modifications and additions to this section, including the framework for analyzing transactions involving intangibles. We commend the OECD for emphasizing the functional analysis as being important to analyzing the rights of various members of an MNE to receive compensation for exploiting an intangible. Finally, we agree with OECD's view that the legal protection of an intangible is not a pre-requisite for identifying an intangible that may have significant value.

B.2. Functions, assets, and risks related to intangibles

Paragraph [79] provides a good context for taxing authorities and MNEs when evaluating functions that are particularly important in allocating returns to intangibles. In addition, we agree with the focus of paragraph [83] regarding differentiation of between funding and risk-taking. Too often, we encounter the extremes in transfer pricing situations, where taxpayers equate funding with risk taking (when in fact funding may be driven by decisions made by a different entity within in an MNE who in effect assumes the risks associated with such funding) or taxing authorities summarily dismiss any potential relationship between funding and risk-taking (in essence ignoring any relationship between the financial risk an entity within an MNE takes by assuming the risk of market failures or lost funds). As a result, the focus should reflect a balance by focusing on how the intangible property benefits different entities within the MNE, who controls and makes decisions regarding the intangible property, its use, and the financial risks assumed in funding the intangible property. We believe that paragraph [84] is instrumental in facilitating this balance.

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

Paragraphs [94] through [96] identify a very key issue in today's transfer pricing landscape. We commend the OECD for addressing the role of marketing intangibles. However, we would recommend that the OECD expand upon the difficulty in trying to determine or measure the remuneration due a marketing subsidiary that "enhances" the value of the marketing intellectual property, particularly where there are issues of control. While the text and examples are informative regarding marketing and distribution agreements, we believe there is still the inherent difficulty and lack of consensus regarding how to measure incremental contributions to marketing intangibles.

Paragraphs [99]-[103] imply that the company name is somehow distinct from the development and enhancement of marketing intangibles. Furthermore, we are concerned that the language in paragraph [101] is also implying a residual profit split method with costs used as proxy for value. This position is contradicted by paragraph [160], in which we strongly agree that cost should not equate to value when considering intangibles. We believe the OECD should focus on the "costs and benefits associated with alternatives" as the appropriate measure for appropriate compensation with respect to a company or group name. Specifically, the focal point of this paragraph should be what a third-party would do or earn if it did not have access to the particular company name in selling its product.

C.2. Transactions involving the use of intangibles in connection with sales of goods or provision of services

We strongly agree with this section, including the addition of paragraph [122].

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

We agree with the language of paragraph [147] especially regarding the fact that the larger the adjustment the less reliable the result. This is true regardless of the type of method used, i.e., a CUT is not inherently more reliable than another method and therefore is not okay to use even if there are large adjustments.

With respect to paragraph [148], we appreciate the OECD addressing the limitations and drawbacks of using comparables drawn from data bases. The provisions of paragraphs 3.31 are particularly relevant when covering a number of limitations to commercial data bases. While we are not advocating the abandonment of the comparable uncontrolled transactions method, our experience has shown a number of deficiencies with the selection of comparables drawn from both public and proprietary databases. At the root of the issue is that the comparable transactions drawn from such data bases are in many cases, not comparable to the controlled transaction or provide insufficient information to make a determination regarding comparability.

Yet, MNEs and taxing authorities alike often attempt to "make the method work" under the presumption that a flawed CUT method is somehow preferable than a more rigorous alternative method under the OECD regulations. In these cases, parties often ignore fundamental and critical differences in transaction details or alternatively, attempt to make myriad adjustments to somehow make the uncontrolled transactions reliably comparable with the controlled transaction. In many cases, these adjustments simply reduce the reliability and fail to enhance the comparability, such that the sheer number of adjustments needed raises questions about the viability of the transactions drawn from proprietary data bases, or alternatively, the size of the adjustments can begin to dwarf the original economics of the uncontrolled transaction.

Compounding and confusing the issue is that many transactions drawn from these data bases include agreements with redacted information. The redacted information might be paramount to determining important comparability elements under a functional comparison to the controlled transaction. For example, redacted information often precludes the ability to effectively measure the profit potential of a license agreement, where assessment of profit potential is a critical element in comparing controlled and uncontrolled transactions. As a result, even though the redacted information might represent a small fraction of the entire license agreement, it could be the most important and relevant information in the entire agreement.

While we do not discount the potential value in searching for comparables drawn from data bases, we urge caution on the OECD in potentially advocating or proffering regulations that suggest that the comparables drawn from data bases are somehow the preferred or recommended method to assess the arm's length nature of controlled transactions.

We agree with the language included in paragraph [154] and recommend the OECD focus on determining the right method, as opposed to focusing on a hierarchy of methods.

Paragraph [158] is a new addition and appears to be a very important paragraph. However, the last sentence is vague and confusing. If controlled entities engage in a transaction that is structured in a manner unlike how third parties would structure such a transaction, we are unsure how one can measure "the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances…" By definition, there do not appear to be any comparable circumstances. Absent the comparable circumstances, it appears the paragraph may be hinting towards recharacterizing the transactions, which creates potential issues for both MNEs and taxpayers. MNEs should not be subject to taxing authorities recharacterizing transactions without due consideration of the facts and circumstances applicable to the specific transaction.

We strongly agree with paragraph [160] and the economic literature supports the notion that cost does not equate with value.[2] In addition, we believe the equivocation in paragraph [161] should be limited to instances of low-value intangibles. The paragraph seems to imply this, but we recommend the OECD state this more explicitly.

---

[2] For example, see Russell L. Parr and Gordon V. Smith, *Intellectual Property: Valuation, Exploitation and Infringement Damages*, John Wiley & Sons, Hoboken, New Jersey, 2005, at p. 165; Gregory K. Leonard and Lauren J. Stiroh, "A Practical Guide to Damages," *Economic Approaches to Intellectual Property: Policy, Litigation and Management*, 2005, p. 51; and Christine Meyer and Bryan Ray, "A Critique of Noneconomic Methods of Reasonable Royalty Calculation," *Economic Approaches to Intellectual Property: Policy, Litigation and Management*, 2005, p. 85.

Paragraph [162] is on point with the assessment of rules of thumb. Economic literature supports the notion that rules of thumb are not a reliable source when allocating profits, particularly from high-value (non-routine) intangibles.[3]

We disagree with paragraph [163], which is contrary to language in paragraph [154]. Selection of a transfer pricing method requires a case by case analysis and no one method (e.g., CUP or profit split method) will always be the preferred or best method. The key to determining the best method rests with the functional analysis. In certain cases, we have found that income methods may provide the most appropriate measure as well as non-CUT transactional methods. We believe that paragraphs [171] and [180] support this position and that the OECD should remove the language related to a preferred hierarchy of methods.

Paragraphs [167]-[169] are particularly informative regarding the potential pitfalls of a profit split method. One area that the OECD has not addressed explicitly is the longevity of certain intangibles that have been around a long time. Examples include trademarks and brand equity. Too often profit split methods fail to account for the substantial value inherent in the longstanding nature of the trademark/brand value that was developed the parent company over many years prior to its introduction in other areas.

Paragraph [179] is informative concerning the examination of other valuations used by an MNE. However, we caution reliance by taxing authorities on discount rates determined from other valuations without due consideration of the facts and circumstances related specifically to the controlled transaction. In our experience, we have found that the use of assumptions from an unrelated valuation often may have little, if any, correlation with the facts present in assessment of the controlled transaction.

<u>D.3. Arm's length pricing when valuation is highly uncertain at the time of the transaction</u>

With respect to paragraph [199], we encourage the OECD to continue development of the issues pertaining to high-value intangibles that are very difficult to value. These continue to be an increasingly important area in transfer pricing.

We appreciate the opportunity to submit these comments and would be pleased to answer any questions you might have regarding our input. We commend the OECD for initiating the revision of the Transfer Pricing Guidelines with the focus on treatment of intangibles. We recognize the hard work put in by Working Group No. 6 and remain interested to see continued progress towards reaching consensus on these complex transfer pricing issues.

Peter K. Ashton

Lee O. Upton, III

[3] For example, see Marco Fiaccadori, Arindam Mitra, and Robert Plunkett, International Tax Review, *Licensor-licensee profit split and income approach*, December 17, 2012.