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

I am a PhD student from King's College London, working on transfer pricing of intangibles, supervised by Professor John Phillips and Professor Jonathan Schwarz. I respectfully submit my comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles. The following comments are my personal opinions. I published an article commenting on the first Discussion Draft in the International Transfer Pricing Journal in the May/June 2013 issue.[1] The following comments, based on the previous article, focus on three points: the definition of intangibles, the use of "outsourcing" and valuation techniques.

In 2011, the OECD invited public comments on the scope of the potential revision of the chapter on intangibles. The definition, identification and valuation of intangibles emerged as the aspects most in need of addressing in the revised chapter.[2] The Discussion Draft[3] is structured accordingly. The Discussion Draft presents a systematic and logical analysis of the transfer pricing of intangibles.

Both drafts are structured in four sections. The first three sections consider three threshold questions, namely identifying intangibles; identification of parties entitled to intangible-related returns; and transactions involving the use or transfer of intangibles. Accordingly, these three sections attempt to answer questions as to (1) what are intangibles for transfer pricing purposes; (2) the determination of ownership of intangibles (legal or economic ownership) and; (3) identification of intangibles in related transactions. The last section, "Determining arm's length conditions in cases involving intangibles", demonstrates the application of the arm's length principle to associated transactions involving intangibles, where the valuation of intangibles has been explained.

In general, the draft is well-structured in explaining the issues. After looking into the details

[1] Jingyi Wang, "A Tentative Improvement: Comments on OECD Discussion Draft on the Transfer Pricing of Intangibles", International Transfer Pricing Journal, May/June 2013, (Volume 20), No. 3, pp 136-143

[2] www.oecd.org/ctp/taxadministration/publiccommentsreceivedonthescopingofanewprojectonthetransferpricingaspectsofintangibles.htm , accessed on 30 Oct. 2012.

[3] When it is not specifically referred to "first draft" or "second draft", general use of "Discussion Draft" indicates relevant aspects are the same in both drafts

included in each section, one can see that various aspects have been addressed in line with comparability analysis. If they follow the draft, enterprises engaged in associated transactions involving intangibles can obtain instructive guidance for preparing contemporaneous documentation and determining transfer pricing methods. In particular, the second draft mentions occasionally that written records should be prepared to demonstrate important decisions and arrangements made in relation to intangibles. It would be helpful if cross-reference could be made to the White Paper on Transfer Pricing Documentation.

The table of contents of the second draft looks like a condensed version of that of the first draft. Nevertheless, in terms of accessibility and clarity, the first draft provides a better presentation.

Definition of intangibles for transfer pricing purposes

In the second draft, an "intangible" is described as "something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances". The part regarding compensation is added to the definition used in the first draft. Nevertheless, emphasis on receiving compensation may not be necessary in the definition of intangibles, as some unique intangibles are valuable to certain parties while worthless to outsiders. This definition is generally consistent with accounting recognition of intangible assets, which is a pragmatic way to define intangibles for transfer pricing purposes.

Both drafts mention the following regarding the definition of intangibles for transfer pricing purposes:

- Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes
- The determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterisation for general tax purposes
- The existence of [legal, contractual, or other forms of protection of an intangible] is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes

- Separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes
- It is important to distinguish intangibles from market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise
- The identification of an item as intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case

These exceptions render the definition of intangibles broad, vague and not restrained by any other relevant rules. The drafts claim that “the guidance contained in this chapter is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes” (paragraph [47] of the second draft). If so, is it possible to conclude that the opposite is also right, i.e. intangibles for other tax purposes are not relevant to transfer pricing purposes either?

The example given for “other tax purposes” is article 12 (“royalties”) of the OECD Model Tax Convention on Income and on Capital (OECD Model). The Discussion Draft asserts that the definition of “royalties” in the Commentary on Article 12 of the OECD Model is “not intended to provide any guidance on whether, and if so at what price, the use or transfer of intangibles would be remunerated between independent parties” (paragraph [47] of the second draft). However, the fact that other tax rules do not refer to transfer pricing issues explicitly does not mean they are not applicable or relevant to transfer pricing at all.

The examples given for the non-relevance of article 12 (royalties) are payments related to goodwill or going concern value which may be characterised as payment for intangibles for transfer pricing purposes but which will not be recognized for article 12 purposes (paragraph [47] of the second draft). Nevertheless, the status of goodwill and ongoing concern is a major controversy, and the determination of their compensation is contentious. The treatment of goodwill and ongoing concern varies from one taxpayer to the next. Depending on the assumption as to what constitutes goodwill or ongoing concern, different valuations can be obtained. The issue of goodwill is even more complicated than marketing intangibles. If no consensus can be reached on the definition of goodwill, the OECD should be cautious before including both goodwill and ongoing concern as intangibles for transfer pricing purposes.

Another example that "proves" the non-relevance of article 12 is payments for technical services which are treated as royalties for purposes of article 12, but are not recognized as compensation for transfer pricing purposes. Payments for technical services are deemed to be royalties in article 12, which is a matter of law rather than a matter of fact. Developing countries tend to treat technical services fees as royalties, but this is not universally accepted. These two less persuasive exceptional examples do not prove the OECD's argument.

For both taxpayers and tax authorities, the purpose of transfer pricing is to determine an appropriate price for associated transactions. Considering that royalties are one of the major means of compensation to remunerate for the use or transfer of intangible property, how can the guidance totally ignore the existence of article 12? It would be rare if a payment characterised as royalties for use or transfer of intangible property for transfer pricing purposes were not recognized as royalties for withholding tax purposes, or vice versa.

Unlike the current guidance, under which intangibles are divided into trade intangibles and marketing intangibles, the Discussion Draft:

> does not turn on these categorisations (such as trade intangibles and marketing intangibles, soft intangibles and hard intangibles, routine and non-routine intangibles and other classes and categories). No attempt is made in these Guidelines to delineate various classes or categories of intangibles. (paragraph [50] of the second draft)

The existing distinction drawn between trade intangibles and marketing intangibles does not provide much useful guidance in taxing different intangibles, but rather complicates the treatment of intangibles and triggers many disputes between tax authorities and taxpayers. No artificial categorisation of intangible assets should be regarded as a positive step towards sorting out the existing chaos in taxing transactions involving intangibles between related parties. This can be seen as a major improvement.

However, the second draft adds back two paragraphs explaining the meaning of marketing intangibles. Although the new definition of marketing intangibles in paragraph [50] clarifies the functions of these intangibles as "used in marketing and selling goods or services to customers", this by no means alleviates the current controversy over marketing intangibles. Rather than use "marketing intangibles" to categorise a group of intangible assets, which are identified and valued individually in economic activities, this abstract concept should be removed. Instead, the specific name of those intangible assets carrying a marketing feature should be used.

Both drafts examine several major types of intangibles using relatively detailed illustrations, including:

- patents;
- know-how and trade secrets;
- trademarks, trade names and brands;
- licences and similar limited rights in intangibles;
- goodwill and ongoing concern value;
- group synergies;
- market-specific characteristics; and
- assembled workforce (removed from section A.4. of the second draft)

The drafts assert that the above examples are only for clarifying the provisions of section A.1. of the Draft, which offers general guidance on identifying intangibles, without intending to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles (paragraph [52] in the second draft). Although the draft contends that there may be numerous items not included in this listing which may be intangibles for transfer pricing purposes (paragraph [52]), no single example is mentioned.

In the following discussion, the illustrations provided by the Discussion Draft will be reviewed to determine whether any new intangible asset has been included under the new definition.

- *Patents, know-how and trade secrets, trademarks, trade names and brands*

The first three categories are traditionally recognized intangible assets. The definition of patents, know-how and trade secrets, trademarks, and trade names complies with current guidance. A "brand" is clarified as "a combination of intangibles including, among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill".

- *Licences and similar limited rights in intangibles*

In the fourth group, rights granted by licensing contracts and similar contractual arrangements are recognized as intangible assets for transfer pricing purposes, which is new vis-à-vis the existing OECD Guidelines. The recognition of licensing rights or other contractual rights as separate intangible property has already been seen in the US domestic transfer pricing regulations.

The rest of the intangible items included in the Discussion Draft are controversial topics indeed. Although, at this stage, the inclusion of these less clear items can provide an opportunity for public discussion, it is not easy to reach a consensus as regards these topics.

- *Goodwill and ongoing concern*

As acknowledged by both drafts, the term goodwill can be used to refer to a number of different concepts in different contexts (paragraph [60,61,62] in the second draft).

For example in an accounting context, goodwill is subcategorised into internally generated goodwill and externally acquired goodwill. "Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost".[4]

The value of goodwill will be determined in the process of business combination or mergers and acquisitions, where goodwill is acquired externally. The value of goodwill is usually represented by the excess value after deducting the value of other identifiable assets from the value of the whole enterprise.[5] Normally, for an enterprise carrying on an ordinary business operation, there is no need to identify the excess value. Transfer pricing focuses on ordinary transactions between related parties. Externally acquired goodwill is of less relevance in a transfer pricing context.

The discussion of ongoing concern is split between the Discussion Draft and the Business Restructurings chapter,[6] where ongoing concern is defined as "a functioning, economically

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[4] International Accounting Standards Board, *International Financial Reporting Standards* (International Accounting Standards Board 2011), at A941.

[5] G.V. Smith & R.L. Parr, *Valuation of Intellectual Property and Intangible Assets* (3rd ed, J. Wiley & Sons 2000), at 26.

[6] *OECD Guidelines* (2010), ch. IX Transfer pricing aspects of business restructurings, paras. 9.93-

integrated business unit", the transfer of which entails "the transfer of assets, bundled with the ability to perform certain functions and bear certain risks".[7] The description of ongoing concern in the Discussion Draft, given as "the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets", does not seem consistent with the definition given in the Business Restructurings chapter. According to the description in the Discussion Draft, ongoing concern represents a residual value rather than the value of the operating business unit as a whole. These two divergent understandings of ongoing concern will lead to different valuations, which needs clarifying.

Regarding the valuation of goodwill and ongoing concern in the business restructuring context, the guidance proposes that the valuation methods that are used in acquisition deals between independent parties may prove useful for valuing the transfer of an ongoing concern between associated enterprises.[8] However, the Discussion Draft asserts "in most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis" (in paragraph [62] of the second draft). The Discussion Draft once more isolates itself from normal business practices by not specifying which accounting and business valuation measures are irrelevant, or alternatively providing explicit instructions on which special valuation methods should be used for valuing goodwill and ongoing concern for transfer pricing purposes.

A specified aspect of goodwill is mentioned in the Discussion Draft:

> when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark or other licence that reputational value should be taken into account in determining an appropriate royalty. To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as intangibles within the meaning of section A.1. (paragraph [61] of the second draft)

Can it be inferred that goodwill and ongoing concern are relevant for transfer pricing purposes only when they can be reflected in royalties paid for trademarks or other licences? If true, this may lead to a potential problem of double charging trademarks or other brand-related intangibles, as it is less possible to disaggregate the element of goodwill from a successful trademark. A similar statement is shown in paragraph 114 of the second draft:

9.95.

[7] *OECD Guidelines* (2010), ch. IX, para. 9.93.

[8] *OECD Guidelines* (2010), ch. IX, para. 9.94.

"attempts to artificially separate trademarks or trade names from the goodwill or reputational value that is factually associated with the trademark or trade name should be identified and critically analysed."

Compared with prices paid for generic products, transactions involving the use or transfer of well-known brands are usually compensated by premium prices. The reputation embedded within the trademarks or trade names contributes to or represents the goodwill of the brand owners. If goodwill and ongoing concern are to be included as intangible property for transfer pricing purposes, more specific guidance should be provided for determining arm's length prices for the use or transfer of goodwill and ongoing concern.

As the Discussion Draft admits that "goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets",[9] an alternative way would be to take account of goodwill and ongoing concern in comparability analysis.

- *Group synergies*

Without delineating a definition of group synergies, only a few forms of group synergy have been enumerated, including streamlined management, elimination of costly duplication of effort, integrated systems, purchasing power, etc.[10] It is acknowledged that although such features may have an effect on the determination of the arm's length conditions of controlled transactions, because they are not owned or controlled by a single enterprise, group synergies are not intangibles for transfer pricing purposes. They should be taken into account as comparability factors in the comparability analysis.[11]

- *Market specific characteristics*

Similarly, because market specific characteristics, such as the high purchasing power of households, low prevailing labour costs, proximity to markets, favourable weather conditions and the like, may not be owned, controlled or transferred by an individual enterprise, such items are not intangibles for purposes of transfer pricing and should be considered in the

[9] OECD Ctr. for Tax Policy and Admin., *supra* n. 2, para. 21.

[10] OECD Ctr. for Tax Policy and Admin., *supra* n. 2, para. 23.

[11] OECD Ctr. for Tax Policy and Admin., *supra* n. 2, para. 23.

comparability analysis,[12] probably as part of the economic circumstances.

- *Assembled workforce*

In the first draft, assembled workforce was included in the definition section. The second draft escalates the discussion of assembled workforce to Chapter I and removes it from examples of intangible assets.

The new explanation to be inserted in Chapter I in terms of assembled workforce echoes my discussion of this aspect in my previous article:

> The transfer of employees usually happens for the purpose of providing relevant services. Compensation to the skilled and experienced workforce will be reflected in premium prices for the services provided. Whether compensation should be paid separately for the transfer of the assembled workforce is questionable. This confusion can be sorted out by clarifying the boundary between the provision of services and the transfer or use of relevant intangibles.[13]

The use of outsource/outsourcing

A change in the revised draft is the frequent use of the term "outsource" in discussing the allocation of important functions between the legal owner and other parities. For example, "In transactions between independent enterprises, certain functions are sometimes outsourced to other entities" in paragraph [76] and "if those important functions are outsourced in transactions between associated enterprises, they should be compensated accordingly" in paragraph [80].

However, the term outsourcing usually means the practice of obtaining services from a third party instead of undertaking the task in-house. Transfer pricing focuses on related transactions, i.e., the exchange of services and payments is conducted within a group. MNEs can choose to buy relevant services from third parties (i.e. outsourcing) or to set up a subsidiary in the same country as the third party to conduct relevant activities (e.g. integration of the supply chain).

The sharing of risks in pursuing a similar result may be different in outsourcing arrangements and controlled transactions. Take contract R&D for example: in an outsourcing case, the risks

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[12] OECD Ctr. for Tax Policy and Admin., *supra* n. 2, para. 24.

[13] Jingyi Wang, *supra* n.1, p139

could be shared between the recipient and provider of the outsourced services, while the risks in an intra-group contracting R&D case may be mainly assumed by the party providing the funding, e.g., the parent company. Because the parent company not only bears the risk of the failure of the R&D project, it also incurs investment costs in establishing the subsidiary conducting the R&D or acquiring it from other parties, which is not necessary in an outsourcing situation. The control that could be exerted on a third party providing outsourcing services from the recipient of the service over the R&D process may be also different from that which can be implemented between related parties conducting similar R&D.

The confusion between outsourcing and intra-group allocation of different functions in different jurisdictions should be clarified. The term outsourcing or outsource should be properly used. Because outsourcing happens between independent parities, a further study on the development of outsourcing in relation to intangible assets would be useful in providing comparable information.

Valuation Techniques

Valuation techniques applicable for transfer pricing purposes when comparables cannot be identified should meet the requirements of:

> giving due regard to these Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle. (in paragraph [174])

In particular, the Discussion Draft discusses several key parameters in estimating the discounted value of projected future cash flows, including:

- accuracy of financial projections
- assumptions regarding growth rates
- discount rates
- useful life of intangibles and terminal values
- assumptions regarding tax

Nevertheless, according to the Discussion Draft, an obvious problem with the application of valuation techniques in a transfer pricing context is that the valuation could be achieved without referring to comparables at all, although the techniques are applicable under the prerequisite that there are no sufficiently reliable comparables. Although the Discussion Draft stresses that caution should be exercised when determining underlying assumptions and valuation parameters, it does not provide explicit guidance on what assumptions are appropriate in valuing associated transactions involving intangibles. These assumptions should be consistent with the arm's length principle.

The five OECD transfer pricing methods rely on comparables in varying degrees of importance. Some such methods rely on comparables more than others. Where sufficiently reliable comparables cannot be identified, taxpayers are required to rely on what would have been agreed between independent parties, in order to make sure that the application of any of the transfer pricing methods is consistent with the arm's length principle. A similar requirement should also be imposed on the application of valuation techniques in a transfer pricing context.

What is the role of valuation techniques in a transfer pricing context? To what extent can the application of valuation techniques replace a transfer pricing method, if this is allowable? How can one ensure that the application of valuation techniques is consistent with the arm's length principle? These essential questions should be answered by the OECD Guidelines; otherwise the OECD Guidelines may deviate from the arm's length principle.

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I appreciate the chance to comment on the revised draft. I would welcome an opportunity to participate in the subsequent discussion of the revision of the draft. If there are any comments or questions, please do not hesitate to contact me.

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