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MEDEF's comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (July 2013)

Dear Pascal,

MEDEF is pleased to respond to the OECD request to send comments on the revised discussion draft on Transfer Pricing Aspects on intangibles.

As we have already sent a number of comments, we will now mainly focus on key issues or changes that have been added to the previous version of the draft.

MEDEF acknowledges that some business comments have been taken into consideration such as intangible's ownership and prevalence of arm's length and functional analysis.

However, there are remaining issues that we thought important to draw to your attention.

Section A

Definition of intangibles

As a general comment, we would like to express our concern on the key issue of defining intangibles. It is clear to us that the starting point for the revision of Chapter VI of the Guidelines has to be a clear definition of the addressed item. We also understand from the BEPS Action Plan that OECD is looking for a "*clearly delineated definition of intangibles*" (cf Action 8). We agree on this expressed necessity.

What worries MEDEF is how this can be achieved if the definition in the draft is still referring to "*something*". The question is not whether it should be broader or narrower. The question simply is how this can be dealt with by taxpayers without creating significant uncertainties. For example, § 46 states that "*it is important to identify the relevant intangibles with specificity*": we find it challenging knowing that the definition is mainly a reverse definition. Indeed, the draft is more explicit on what an intangible is not rather than on what it is.

Paragraph 60 is a typical example of an ambiguous situation and the risk it entails. It mentions that "*It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or on-going concern value for transfer pricing purposes*." However, the "*value* [of the goodwill] *should be taken into account in determining an arm's length price for the transaction*". We know, as was brought up in the last meeting, there are wide differences between tax administrations' approaches. These differences have led to the statement in the same paragraph that goodwill is an intangible without defining it.

We are concerned by the fact that intangibles are to be included in the functional analysis without having a clear definition of what they are.

We therefore reiterate our proposal to replace "*something*" by "*an asset*". This would be consistent with the wording of the comments of the OCDE Guidelines (TPG) which mainly refer to an "*intangible asset*".

Protection of intangibles

Chapter VI is meant to provide guidance "*specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles*".

However, § 42 states: "*The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible*".

MEDEF is puzzled by this clause. If an element is not protectable -in some way- it does not give an exclusive right to use and transfer it. We do not see then who would pay for such an element in a transaction? And how can the company find a comparable (equivalent situation between third parties) to determine the arm's length price?

From our perspective, the notion of protection is paramount for it includes all the valuable creations of the company, as well as excludes the elements that are not generated by the company (i.e. they cannot be considered as the company's assets and therefore are not imputable to the company). This idea is supported by the §43 where it is underlined that intangibles are to be differentiated from elements that "*are not capable of being owned or controlled by a single enterprise*".

Moreover, whereas we support that some intangibles can be transferred as a whole, including several elements among which intangibles can be found, we do not agree with the idea in § 42 that "*separate transferability is not a necessary condition for an item to be characterised as an intangible*".

Section B

Owned intangible as opposed to expense / value-driver

Some expenses can be defined as "value-drivers". It means in practice that the company does not own an intangible by itself but through its involvement (costs and employees): the company has influenced the value and/ or the creation of the intangible asset.

A typical case is Research and Development expenses where an entity has incurred expenses in R&D including payments of key employees directly linked to the research (recorded in P&L account). This non-risky contribution gives rise to a total refund of the expenses, but does not give the right to use such industrial property as an owner would be entitled to.

In that case, the main issue is to determine what the fair remuneration of this entity would be based on the added value provided globally to the group.

This example can be compared to the following one: a company owns an intangible and licenses it to its subsidiary, which sells and commercialises the goods or services developed by its parent company. The subsidiary indeed contributes to local market development and needs to earn a sufficient margin to reflect this, but does not "co-own" its parent's intangible because it simply plays a normal role in the value chain. Ownership cannot derive directly from the existence of a right to a part of a profit as can be seen in relations between a principal and a distributor.

We therefore reiterate our suggestion to differentiate between ownership/ creation of the intangible and value drivers that give rise to a fair remuneration/compensation.

Moreover, MEDEF is of the opinion that the notion of economic ownership should not generally be taken into consideration in the field of intangibles. Such a notion will inevitably lead to double taxation as it would be in competition with the legal ownership. Two distinct States would most probably have opposite positions taking into account their own concepts or interests. Moreover it would induce some States to consider any development effort realised on their territory to be an asset. Some tax authorities could, for instance, argue that certain distributing entities economically own (part of) a trade name by virtue of locally incurred (and deducted for tax purposes) marketing expenditure.

Such a position could be linked to § 9.114 of the OECD Guidelines which states that tax authorities have to examine, as a priority, the terms of the agreements concluded between related parties before they check whether the agreement is at arm's length and whether a third party would have concluded the agreement under the same conditions.

We support paragraph 66, which gives a clear idea of the different steps to be followed when analysing transactions. However, the underlined idea of iv) and its practical meaning is not clear to us.

We also support §79 underlining the importance of control (whether on costs, strategic decisions, planning…). However, we would plead for flexibility in this area: if our understanding is correct, the enumeration is not exclusive ("*among others*") and only indicative. For example, we consider that "*management and control of budgets*" is definitely not an important function from a business perspective.

<u>Section D</u>

Location savings

This section deals with the appropriate treatment of location savings in the transfer pricing context and more specifically, business restructuring (BR).

1. Business restructuring does not systematically fall into the aggressive tax planning area. Automatically considering business restructuring as tax planning, deprives the company of its right to manage its business according to its economic interest.
2. An important issue should be underlined: If the objective is to share the cost savings between the parties to the transaction, how is the company supposed to possibly do it? In practice, it means:
    a. Being able to assess the economies or savings that have been made. Knowing that savings may not be entirely due to location but also to external factors -i.e change of financial context, new legislation…-, on which the company has no influence, how can these external factors be taken into account?
    b. What if the BR creates losses? Should they be taken into account also and be subject to reallocation?
    c. According to what elements is the allocation supposed to be made? Paragraph 5 suggests: according to "functions, risks and assets" as in the usual functional analysis. Are economies of scales part of this?

Paragraph 6 states that "*Features of the local market […] may affect the arm's length price*". These features could be as varied as the size of the market, the purchasing power of households, and the degree of competition… It is a gateway for countries to further challenge the prices on facts and circumstances, which are, per se, challengeable. This will:

- maintain high legal uncertainty (as no admitted database available)
- promote the number of audits/conflicts (also between countries)
- give rise to difficult assessment for companies
- create greater complexity in the TP documentation

We understand that the elements which were rightly considered too remote to be considered as intangibles (such as sates of facts) are now to be reintroduced somehow into the functional analysis as well as for adjustments (cf §219). This is extremely problematic.

Concerning the assembled workforce, we still disagree with the idea that the "*transfer of a person may result in the transfer of valuable know-how or trade secrets*" (§ 17). Even if the employee has contributed to the development of an intangible, his transfer cannot be regarded as the transfer of the said intangible (he is neither an asset, nor a "something"). Otherwise, it would mean that a person could be owned, controlled or transferred. Moreover, this is contradictory to the statement that -as already mentioned above- elements that "*are not capable of being owned or controlled by a single enterprise*" are not intangibles.

In such a case, how should the movement of expatriates be treated? From a practical point of view this situation would be totally unmanageable for companies.

This can be illustrated by the following example:
A very small number of people have a specific gift which allows them to analyse any perfume (i.e. identify the fragrances) and to propose formulas to create new perfumes. Such people are currently called "noses". Because of their scarcity they can command high remuneration, sometimes higher than that of the CEO, as they provide a large part of the creative value. However, when a "nose" leaves his/her employer, the company, keeps the results of the work carried out by the "nose" to create the perfumes. What the "nose" brings with him/her is only talent to analyse and to participate in the creative process, this gift belongs to him/her independently of the company.
It is important to note that between third parties there will not be any compensation for the transfer of such a person because the know-how belongs to the person and not the employer.

This above example which refers to a particular case can be extended and the principle applied to many other professions.

<u>Examples</u>

Example 5 (§241): this example provides reimbursement of marketing expenses with a mark-up. Companies sometimes (mainly/ always?) treat this reimbursement as a cost reimbursement and not as the payment of a service. Therefore, application of a mark-up is not appropriate, not to mention the fact that a service is also subject to additional indirect taxes, such as VAT.

Example 16: the transfer of a goodwill following the closing of a subsidiary is in practice very difficult to manage.

We hope our contribution will give you a clearer insight into our expectations and will be pleased to answer any questions you may have regarding these comments.

Yours sincerely,

Vanessa de Saint-Blanquat