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Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Mr. Joseph L. Andrus
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Re: Comments on OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles and White Paper on Transfer Pricing Documentation

Dear Mr. Andrus,

The National Foreign Trade Council (the “NFTC”) is pleased to provide written comments on the Revised Discussion Draft and the White Paper, each published July 30, 2013 and referenced above. In light of the short time frame for submitting these comments, our comments may be further refined or supplemented after October 1, 2013.

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project.

The Revised Discussion Draft makes significant changes to the Discussion Draft on Transfer Pricing Aspects of Intangibles published on June 6, 2012. The Revised Discussion Draft includes new proposed revisions to certain sections of Chapters I – III of the OECD Transfer Pricing Guidelines (the “Guidelines”), as well as numerous changes to the Discussion Draft’s proposed re-write of Chapter VI of the Guidelines and the examples thereto. These aspects of the Guidelines address the transfer pricing aspects of intangible assets.

Our comments on the Revised Discussion Draft are based on the same overarching principles as our comments on the Discussion Draft. First, it is absolutely critical that any revisions to the Transfer Pricing Guidelines provide more clarity and certainty for businesses and governments with respect to the issues addressed. The goal of revisions to the Guidelines should be to further the consensus among governments and businesses as to the application of the arm's length principle, thereby minimizing the risks of double taxation, consistent with the language and the purpose of the tax treaties under which the Guidelines are relevant.

Second, this project should not be used as a platform to reopen issues that were resolved in the recent guidance on business restructurings included in the Guidelines in 2010 or to revisit more fundamentally the arm's length principle itself. Rather, any further revisions to the Guidelines should incorporate and build upon the consensus reached in the business restructurings project and the longstanding global consensus supporting the arm's length principle.

The White Paper on Transfer Pricing Documentation summarizes current documentation requirements and proposes modifications that may be considered to make transfer pricing compliance simpler and more straightforward for business, while at the same time providing tax authorities with more useful information for consideration in connection with transfer pricing audit.

We provide general comments on the White Paper and the Revised Discussion Draft. Our comments on the Revised Discussion Draft are based on the organization of the Draft, addressing the proposed amendments to Chapters I – III of the Guidelines and then the proposed amendments to Chapter VI. Before addressing these items, however, we first address the interaction between the Revised Discussion Draft and the OECD's work on base erosion and profit shifting ("BEPS").

A. Interaction between Revised Discussion Draft and BEPS Project

Since the publication of the Discussion Draft, the OECD has issued two reports related to BEPS, and OECD officials have made numerous public presentations regarding BEPS. The content of these reports and presentations calls into question for some the extent of the OECD's ongoing commitment to the arm's length principle. A substantial part of the OECD's Action Plan on BEPS, published shortly before the Revised Discussion Draft, focuses on transfer pricing matters central to the matters addressed in the Revised Discussion Draft. The BEPS Action Plan acknowledges that the existing transfer pricing rules, based on the arm's length principle, effectively and efficiently allocate the income of multinationals among taxing jurisdictions "in many instances." It rejects calls to upend the arm's length principle. The BEPS Action Plan expresses concern, however, that in cases involving the transfer of intangibles, the allocation of risk, or the over-capitalization of companies, the rules may be used or misapplied "to separate income from the economic activities that produce that income." It therefore concludes that "special measures, either within or beyond the arm's length principle,

may be required with respect to intangible assets, risk and over-capitalisation to address these flaws.” (Emphasis added.)

While our comments are otherwise limited to the Revised Discussion Draft, the interaction between the draft and the BEPS Action Plan is notable and merits additional explanation. In particular, the call in the BEPS Action Plan for consideration of special measures “beyond the arm’s length principle” raises the prospect that elements of the Revised Discussion Draft may be viewed by the OECD as justified regardless of whether they adhere to the arm’s length principle. This may be the case, for example, with the language regarding the entitlement of a legal owner of intangible assets to material returns if it does not perform certain functions through its own employees. Our comments assume that the global consensus supporting the arm’s length principle continues to motivate the work of the OECD reflected in the Revised Discussion Draft. Accordingly, our comments are grounded in the arm’s length principle. We urge the OECD to identify any elements of the Revised Discussion Draft intended as special measures “beyond the arm’s length principle,” to explain why the arm’s length principle is not adequate to address whatever issue is intended to be addressed by such elements, and to propose clear guidelines for the circumstances in which measures beyond the arm’s length principle are intended to apply. This will allow appropriate consideration of such elements at a non-technical level. If the OECD believes that the entirety of the Revised Discussion Draft adheres to the arm’s length principle, it should state this unequivocally.

B. White Paper on Transfer Pricing Documentation

The NFTC strongly supports the stated goal of the White Paper to consider how transfer pricing documentation requirements might be modified to make transfer pricing compliance simpler and more straightforward for business, while at the same time providing tax authorities with more useful information for consideration in connection with transfer pricing audit. There are many improvements that can be made in this regard.

We are concerned, however, with the imprimatur in paras. 71 and 72 given to country-by-country reporting or other “big picture” information that is not currently maintained for business purposes. Such reporting raises significant issues in terms of compliance burden and business confidentiality. More fundamentally, we question the probative nature of such information and are concerned regarding its likely misuse by tax authorities. The White Paper suggests that significant deviations between the relative allocations of income among jurisdictions and the relative allocation of employees or tangible assets might provide an indication of transfer pricing risk. This is the case only if one were to start with the premise that the profits of a multinational enterprise ought to be allocated across jurisdictions in proportion to employees or tangible assets, and that any deviation from such results must reflect transfer pricing practices inconsistent with prevailing international norms. The prevailing international norm, the arm’s length principle, provides a framework for testing transfer prices in transactions between legal entities within a multinational group based on a functional analysis that takes into account the functions performed, assets used, and risks assumed by these entities. The results of this analysis will differ from those of a formulary approach, and

the relative difference does not provide particularly helpful information as to the propriety of the transfer pricing analysis. We are concerned that such information may be used by some tax authorities not as a risk assessment tool but rather to justify arbitrary adjustments that are not consistent with the arm's length principle under a thorough analysis of the facts and circumstances. This would result in more disputes and less certainty for businesses and governments. We believe that these risks, combined with the additional compliance burden and business confidentiality concerns, far outweigh any marginal benefit that would be derived by tax authorities from such information. We urge the OECD to reconsider the relative benefits of requiring the reporting of such information as compared to the costs.

C. Proposed Amendments to Chapters I – III of the Transfer Pricing Guidelines

In general the NFTC welcomes the confirmation by the proposed amendments to Chapter I that location savings and other market features and group synergies are not intangible assets, but rather that based on the facts and circumstances such attributes may be taken into account in a comparability analysis. We limit our comments to two items: (1) the suggestion in para. 16-17 that transfers or secondments of employees may sometimes result in transfers of intangible assets, and (2) the conclusions regarding the manner in which "implicit support" is taken into account in the pricing of a financial guarantee in Example 2 at para. 27.

Individuals employed by one member of a multinational group routinely are seconded or transferred to other entities. The reasons for such movements of people are myriad and include, for example, appropriately staffing special projects with capable personnel regardless of the home country of such personnel or ensuring that executives gain experience working with business units outside of the home office. In normal business settings, such secondments or transfers do not result in a transfer of proprietary know how or any other intangible asset. The NFTC recommends that the language regarding transfers or secondments of employees either be struck or limited to the first sentence of para. 16. Alternatively, the circumstances in which transfers of intangible assets may accompany (rather result from) movements of people should be specified with more precision so as to preclude inquiries every time employees are transferred or seconded.

The pricing of financial guarantees raises challenging conceptual issues and has led to controversy between and among businesses and tax authorities. Rather than fully address such issues, the Revised Discussion Draft provides an example, Example 2, that adopts a position on the pricing of financial guarantees based on an application of the guidance regarding group synergies. The example posits a subsidiary company, S, that is able to borrow from third parties based on an implicit credit rating (A) that is higher than the credit rating supported by its balance sheet (Baa) but lower than the credit rating of the parent, P (AAA). S borrows from a third party bank, and P provides a guarantee. The example correctly concludes that S should be required to pay P for the express guarantee. The example then goes on to state that such a fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA, because the latter is attributable to the group synergy derived from passive association. Under the arm's length principle, however, if S were to seek a third-party guarantee of its debt, the guarantor likely would charge S based on the full benefit of raising S's credit standing from that supported by its balance sheet to that achieved with the guarantee. The third-party guarantor would not take into account the "implicit

support” provided by P because P is unlikely to provide such support once the guarantee is in place. It is not clear why the arm’s length principle would require that S pay a lower fee to P than it would be required to pay by a third party. An arm’s length fee should compensate P fully for putting its capital at risk by providing the guarantee, and the provision of “implicit support” is not without cost. Although the passive association rules are very reasonable where there is no transaction, once a formal guarantee is in place it is not clear what continuing effect they should have. While the NFTC welcomes the OECD’s efforts to bring clarity to this area, we recommend that the OECD more fully consider this issue and propose a reasoned analysis based on the arm’s length principle. For the time being, in the absence of a more comprehensive analysis we recommend that Example 2 at para. 27 be deleted.

D. Proposed Revisions to Chapter VI of the Transfer Pricing Guidelines

1. Part A – Identifying Intangibles

The NFTC appreciates the more appropriate definition of “intangible” in the Revised Discussion Draft than appeared in the Discussion Draft. The revised definition is responsive to comments and would provide some measure of certainty for governments and industry over what constitutes an intangible. In our view, however, the concept of “intangible” could be further refined to increase clarity and certainty in this area by emphasizing that intangible assets must be proprietary to some extent before parties at arm’s length could be compelled to pay for their use. Further, we reiterate our comments that goodwill and ongoing concern value should not be designated as intangible assets for transfer pricing purposes, although of course such items should be taken into account as appropriate in determining the arm’s length results of a transfer of a business to which goodwill or ongoing concern value attach.

The Revised Discussion Draft at para. 39 rightly points out that a definition of “intangible” that is too broad creates the risk that taxpayers or tax authorities would treat as compensable an arrangement that would not require compensation at arm’s length. Whereas the Discussion Draft defined “intangible” 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,” the Revised Discussion Draft refines that definition by adding the crucial clause “and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.” Para. 40.

Although this revised definition properly grounds the definition of intangible within the relevant context, it could be further improved by articulating the feature of intangible assets that gives rise to compensation at arm’s length: their proprietary nature. Chapter VI as amended should therefore make clear that an item must be protected by law or contract, i.e., proprietary, to require compensation when transferred to or used by a related person. If third parties could not be excluded from using an intangible asset, they would not pay to acquire its use. The guidelines should reflect the significance of proprietary rights and recognize that legal protections are relevant not only for valuation purposes (as noted in para. 73) but are a defining characteristic of intangible assets for transfer pricing purposes. This clarification is consistent with the arm’s length principle, would bring needed certainty to this area, and would allow governments and industry to focus on determining the arm’s length result of transfers of real business assets, including proprietary intangible assets, rather than wasting resources in

controversy over whether ephemeral or inchoate non-proprietary attributes constitute intangibles.

Regarding the Revised Discussion Draft's treatment of goodwill and ongoing concern value, we reiterate our concerns that these items should not be designated as intangible assets. As we stated in our previous comments, goodwill and ongoing concern value do not constitute interests in property in their own right given that they cannot be transferred separate from the entire business to which they relate. Treating these items as intangible assets creates the risk that goodwill and ongoing concern value will be mistakenly viewed as always attaching to collections of assets or capable of being separately transferred. Treating goodwill and ongoing concern value as intangibles is not a prerequisite for requiring that they be considered as part of a comparability analysis and source of value for which arm's length consideration must be paid in an intercompany transfer of a business to which such items attach. There is no purpose served by designating goodwill and ongoing concern value as intangible assets for transfer pricing purposes, and doing so would promote continuing confusion and controversy in this area. In our view, the draft should be revised to provide that these items are to be taken into account in determining the arm's length results of a transfer of a business to which they attach but do not constitute intangible assets in their own right.

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

The NFTC welcomes many of the changes to Part B, in particular the de-emphasis of the “intangible related returns” construct in favor of a more traditional functional analysis framework. In the view of the NFTC, however, the Revised Discussion Draft retains the most troubling components of Part B. At bottom, the current draft fails to acknowledge and accommodate demonstrable allocations of actual returns from intangible assets among parties in third party arrangements and therefore is inconsistent with the arm's length principle. Among parties dealing at arm's length, the person that funds intangible development or otherwise acquires ownership of intangible assets often retains for itself material returns from such intangible assets even in cases where the intangible development functions are performed by others. Guidelines under the arm's length principle should therefore accommodate such arrangements.

The Revised Discussion Draft adopts a six-part framework for identifying the party entitled to the returns attributable to an intangible asset. This framework appropriately begins with legal ownership of the intangible “based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership.” Para. 66. The rest of the framework identifies the components of a functional analysis. While the framework aptly characterizes the elements of a functional analysis, the language regarding the relative weight of these elements in determining an allocation of returns, as well as the prescriptive guidance virtually requiring the use of profit splits, causes concern.

The notion presented in para. 76, that a legal owner of an intangible must either develop itself or control the development of the intangible in order to be entitled to material returns, is contrary to demonstrable arm's length behavior. Transacting at arm's length, it is not

uncommon for legal owners to outsource the development of intangibles for fixed fees and retain the rights to residual returns generated by those intangibles. The Revised Discussion Draft's conclusion that a legal owner is entitled to receive those returns only if it conducts the activities described in para. 79 inappropriately subordinates the traditional application of the arm's length principle, which focuses on functions, assets, and risks under a facts and circumstances analysis, to a threshold inquiry focused exclusively on functions. The para. 79 functions -- "design and control of research and marketing programmes, management and control over budgets, control over strategic decisions regarding intangible development programmes, [and] important decisions regarding defence and protections of intangibles" - are significant and entitled to appropriate returns. Depending on the applicable contractual terms, such returns might be relatively risk-free functional returns, or they might depend on the success or failure of the intangible development and exploitation efforts. Contrary to the prescriptive language of the Revised Discussion Draft, persons performing such functions do not always seek or successfully negotiate for such residual returns. Ultimately only the legal owner can exclude others from the use of intangible assets, and legal owners routinely engage research and development, marketing, IP counsel, and other consultants on a work-for-hire or other fixed-consideration basis without sharing with them the returns from the intangible assets.

The Revised Discussion Draft adopts a similar view with respect to the returns properly allocable to group members that bear economic risk by funding intangible development activity, which are in a real sense the economic owners of the intangible assets developed. Under the current draft, bearers of funding risk are not necessarily entitled to anything more than a fixed risk-adjusted rate of return. The funder of intangible development activity may earn a higher return if it assumes additional risk and has "control over the use of the contributed funds or the conduct of the funded activity." Para. 84. This approach disregards demonstrable evidence of third party arrangements in which entities putting capital at risk reserve residual upside and downside for themselves, while providers of important services are content with relatively risk-free consideration. Indeed, if bare legal ownership of intangibles within a controlled group is to be disregarded, it should be disregarded in cases where the legal owner does not bear the risk of intangible development.

There are many examples of third party arrangements in which the legal owner of intangible assets and/or the person putting capital at risk reserves for itself the returns from the intangible assets or other products of the risky endeavor even where other parties undertake critical functions to help realize successful outcomes. For example, venture capitalists seek to finance start-up activities directed and managed by others in exchange for substantial upside in the resulting business should the activities be successful. Venture capitalists themselves typically do not undertake to control the conduct of the funded activity or assume risks far beyond a funding risk. Yet their actual returns can be very significant and typically are contingent on, and commensurate with, the success of the underlying business venture.

Another example is the growing inclination of companies to crowdsource research and development activity and retain rights to the results of the research. The crowdsourcing model gives developers an opportunity to create or improve upon specific technology desired by a corporate sponsor. A developer competing in this process relies on its own resources to complete the development activity and receives a fixed payment only if its product is chosen by the company. Acceptance of the fixed payment typically is accompanied by a relinquishment of

rights in the intangible assets developed to the corporate sponsor.¹

As real-world arm's length scenarios, these contests demonstrate the range of terms that independent parties may negotiate with respect to the use or transfer of valuable rights in intangible assets, and the primacy of ownership and funding over functions in attracting residual returns should projects prove successful. In this context, the sponsor is entitled to whatever returns are generated by its use of the developed intangible assets, while the party that controls and performs the development activity is entitled only to a fixed fee. It is not clear why the current draft does not accommodate such arrangements.

There are countless other examples. Indeed, Example 18 of the Revised Discussion Draft (which has come under criticism for other reasons) posits a common third party transaction – the acquisition by a multinational enterprise, Birincil, of the equity interests of an independent research and development company with minimal sales but several promising partially developed technologies. There is no doubt that the Birincil group will be entitled to returns from the exploitation of the acquired intangible assets because it has put capital at risk in acquiring those assets. This is the case notwithstanding the fact that Birincil's employees played no role in research and development or other para. 79 functions. The principles of the current draft might be extended to suggest that the proprietors of the target, or even its research personnel, would continue to be entitled to returns from the intangible assets they developed. This is clearly not the case. One might argue that the proprietors of the target have been rewarded in the form of purchase price. But that is the case as well for providers of para. 79 functions that are willing to take a risk-free functional return and forego the possibility of significant profits (or losses) depending on the results of the intangible development activities.

The problems raised by the elevation of para. 79 functions in the current draft are exacerbated by the guidance on pricing arrangements where legal ownership is held by a person that does not perform all or most of these functions, or where more than one person performs some of these functions. The guidance in the current draft, particularly paras. 80 and 81, would lead almost invariably to the application of a profit split. There is little guidance on precisely how profits might be split in such circumstances. While we do not believe the current draft is correct in its presumptions, at a minimum there should be much more consideration given to how taxpayers and tax authorities are to evaluate such arrangements once the businesses are stripped of the ability to specify by contract the extent to which para. 79 functions may be compensated for on a non-contingent basis.

We recommend that the draft reaffirm a commitment to the arm's length principle by recognizing the range of contractual arrangements that parties at arm's length demonstrably enter into. The prescriptive guidance in Section B of the Revised Discussion Draft requiring para. 79 functions to be performed by employees of the legal owner of intangible assets should be removed. Assuming the arrangement has economic substance and the conduct of the parties is consistent with their legal rights and obligations, legal owners and parties that bear

¹ GE Uses Crowdsourcing To Solve Air Travel Delays And Healthcare, available at <http://www.forbes.com/sites/tomiogeron/2012/11/29/ge-launches-crowdsourcing-quests-to-solve-air-travel-delays-and-healthcare/>; "GE Jet Engine Bracket Challenge," available at <http://grabcad.com/challenges/ge-jet-engine-bracket-challenge>. See <http://www.netflixprize.com/rules>.

significant risk with respect to developing intangible assets may retain for themselves material returns from successful exploitation consistent with their ownership and risk-taking. The guidance should not elevate para. 79 functions and require that they be compensated with a share of residual profits in all cases given that such functions often are performed for non-contingent compensation by independent parties.

A preferable standard would focus on the person that funds the intangible development costs and ensure that it adequately compensates all related persons that contribute to intangible development activities, either on a risk-free basis or on a contingent basis as specified in agreements. Such a standard would be consistent with the arm's length principle and would accommodate a range of arrangements consistent with those observed in the marketplace. It would be easier to comply with, easier to administer, and lead to more predictable outcomes.

3. Part D – Supplemental Guidance for Determining Arm's Length Conditions

The NFTC continues to be concerned with the bias of the current draft in favor of the profit split method to arrive at arm's length pricing in cases involving intangible assets. The draft states as a general matter that "any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method," and that alternative methods may also be appropriate. Para. 154. The draft asserts, however, that "it will often be the case in matters involving transfer or intangibles or rights in intangibles. . . that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions." In addition, due to the nature of intangibles, one-sided methods such as the resale price method and the transactional net margin method are generally unreliable, para. 159, as are methods that seek to estimate the value of intangibles based on development costs, para. 160.

The draft concludes that the comparable uncontrolled price ("CUP") method and the profit split method are the "methods most likely to prove useful in matters involving transfers of one or more intangibles." Para. 163. The draft cautions, though, that the CUP method is useful to determine arm's length prices for intangibles only in the rare case when reliable comparable uncontrolled transactions exist. Paras. 163-64. The clear implication of the draft is that a profit split method may often be the only reliable method for pricing intangibles.

The draft's emphasis on profit splits and factual assertions regarding the unavailability of comparable transactions and inappropriateness of one-sided methods runs contrary to the guidance in Chapter II of the Guidelines, which is centered on finding "the most appropriate method for a particular case." As noted above, given the nature of the profit split method and the lack of meaningful guidance as to how to weight contributions in dividing residual returns, the profit split method is the most subjective of the sanctioned methods and in our experience leads to the widest range and therefore most uncertain outcomes. Without more precise guidance on how to apply the profit split method, the current draft's thumb on the scale in favor of that method will lead to more uncertainty, more controversy, and more double taxation.

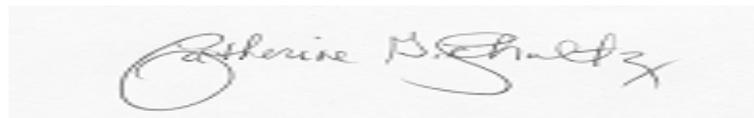
The NFTC recommends the review and elimination of prescriptive language or factual assertions in the draft that tend to favor the application of the profit split over other methods. Statements that it will "often be the case" that comparable transactions cannot be found (para.

156), or that one-sided methods “are generally not reliable methods” tend to become self-fulfilling as applied by taxing authorities. If the CUP method is the best method under the facts and circumstances of a particular case, a factual assertion that it will often be the case that comparable transactions cannot be found is irrelevant and even unhelpful as it may lead a taxpayer or a tax authority to dismiss a good method. The NFTC also recommends additional guidance on the use of profit splits in the case that the draft continues to favor their use.

The NFTC appreciates the open process adopted by the OECD and we believe that it will result in rules consistent with the arm’s length standard. We recommend that the OECD release another draft that takes into consideration the changes recommended by the NFTC and others as part of the public consultation, so that a final consultation can be conducted before these important rules are finalized.

Sincerely,





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