PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft

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

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Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Mr. Andrus,

We appreciate the opportunity to provide our comments on the revised discussion draft on Transfer Pricing Aspects of Intangibles (RDD), especially with respect to the potential implications on the German transfer pricing practice.

New Section addressing features of the local market, location savings, assembled work force and group synergies

The RDD starts with a new section addressing features of the local market, location savings, assembled work force and group synergies. This new section will supplement Chapter I of the current Transfer Pricing Guidelines (TPG). The new section clearly states, that the addressed features are not intangibles from a transfer pricing perspective, but need to be analysed as they can affect comparability and arm's length pricing. The criteria defined in that section are in line with aspects of Chapter VI of the TPG as well as the White Paper on Transfer Pricing Documentation.

"Where comparable entities and transactions in the local market can be identified, those local market comparables will provide the most reliable indication regarding how location savings not passed on to customers or suppliers should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required." (Paragraph 4) The White Paper on Transfer Pricing Documentation also expects that the taxpayer will provide local comparables, if available, and not just focus on regional studies. Although this will significantly increase the compliance burden for the tax paper, comparability is seen to be the key factor.

This section also provides support regarding appropriate comparability adjustments in situations where reasonably reliable local market comparables cannot be identified (see paragraph 8). Aspects mentioned in that paragraph should also be helpful, when applying other methods such as a profit split or a discounted-cash-flow method.

This section also gives guidance regarding sharing of group synergies: "… an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group …". Only in the case of a deliberate concerted action of group members … such synergistic benefit" (paragraph 19) has to be allocated.

Overall, we appreciate the clear and additional guidance of this new section and hope that it will be considered on a global basis to avoid double taxation.

Amendment of paragraph 2.9 of Chapter II of the existing TPG

"Moreover, MNE groups and tax administrations retain the freedom to apply methods not described in Chapter II of these Guidelines (hereafter "other methods") to establish prices or to demonstrate that the prices charged either do or do not satisfy the arm's length principle in accordance with these Guidelines." (Paragraph 34)

The amendment shows that the OECD considers the use of "other methods" not only helpful for the taxpayer to establish arm's length prices, but as well for the tax authorities to evaluate certain pricing. This does not come as a surprise as a number of tax authorities are building up capacity and know-how, e.g. regarding economic and valuation topics.

Special Considerations for Intangibles

The new Chapter VI of the TPG starts with special considerations for intangibles.

"Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities." (Paragraph 36)

We support the notion of the OECD that the labelling of an intangible cannot be decisive, but instead "… the analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis. That functional analysis should identify the functions performed, assets used, and risks assumed by each relevant member of the MNE group. It is especially important to ground the comparability and functional analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain." (Paragraph 37)

According to our experience, when performing the suggested analysis, it becomes quite clear whether an intangible does contribute to the value creation and to what extent.

As it is recommendable for associated enterprises to record in writing their decisions and intentions regarding the allocation of significant rights in intangibles, finally some kind of labelling will be necessary for the legal contracts. In that respect, section A "Identifying Intangibles" is helpful.

Explanatory changes to the definition of intangibles

The RDD takes a clear position that any definition of other disciplines is not decisive for transfer pricing, although it may be worthwhile considering.

“Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterisation for accounting purposes, but will not be determined by such characterisation only. Furthermore, 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, as, for example, an expense or an amortisable asset.” (Paragraph 41)

Although this disconnect is very much appreciated, it might still be necessary to answer certain tax accounting questions, if other methods such as the discounted-cash-flow method are applied and the tax effects of the transaction shall be taken into account: To determine the bandwidth of a two-sided method and to take into account the tax effects of the transaction itself, the hidden reserves of the intangibles to be taxed by the seller as well as the tax amortisation benefit for the buyer are defined by the tax accounting rules. Whether the tax effect of the transaction needs to be taken into account is not clear, as the current RDD remains silent on that topic. One might consider clarifying that issue, as otherwise we see a considerable risk for double taxation. Based on our experience regarding the valuation of intangibles, the consideration of the tax effect on the transaction will often lead to a situation where the price of the buyer will be below the price of the seller. Therefore we recommend excluding the tax effect of the transaction.

The principle of disconnect also applies vice versa:

“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) This includes Article 12 of the OECD Model Tax Convention focusing on royalties.

Overall, we believe this section including the principle of disconnect to be beneficial, if it is applied together with the special considerations for intangibles.

Revisions to Section B of the draft to adopt a more transactional approach while preserving a clear focus on the importance of functions performed, assets used and risks assumed

The revised version of Section B confirms in paragraph 65 “... that the ultimate allocation to those other members of the return attributable to the intangible is accomplished by compensating members of the MNE group for functions performed, assets used or contributed, and risks assumed in the development, enhancement, maintenance, or protection of intangibles according to the principles described in Chapter I-III.” According to that perspective (paragraph 73) “legal ownership is simply a reference point for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of the controlled group with respect to those transactions. As with any other type of transaction, the analysis must take into account all of the relevant facts and circumstances present in a particular case.”

To determine whether the legal owner is entitled to any intangible related return, "it is therefore necessary to determine, by means of a functional analysis, which member(s) performed and exercised control over development, enhancement, maintenance and protection functions, which member(s) provided necessary funding and other assets, and which member(s) bore or exercised control over the various risks associated with the intangible." (Paragraph 74 and 89)

Performing the described analysis should facilitate a clear assessment, which member is entitled to an intangible related return. For MNEs it will probably be in practice a less likely case, where all functions, assets and risks taken remain exclusively with one party. For all other cases, section B gives only guidance on how to determine the different owner of a certain part of the intangible related return. The question that still needs to be answered is: How to split the intangible related return. One possible way could be using a score card system when applying a profit split method.

Inclusion of a section on transfer pricing aspects of the use of company names

The RDD considers two scenarios regarding the use of company names. "As a general rule, no payment should be recognised for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership." (Paragraph 99)

"Where one member of the group is the owner of a trademark or other intangible for the group name, and where use of the name provides a financial benefit to members of the group other than the member legally owning such intangible, it is reasonable to conclude that a payment for use would have been made in arm's length transactions." (Paragraph 100)

In general, we agree with this distinction regarding the arm's length pricing of a company name. As this section is stressing the transactional approach and as the financial benefit of a company name is very often broad, e.g. not only for the sales market but also for the labour market of the company or for support of the local government, one might consider amending sentence one potentially in paragraph 100 as follows:

"Where one member of the group is the owner of a trademark or other intangible for the group name, and where use of the name provides a financial benefit [*regarding the specific transaction]* to members of the group other than the member legally owning such intangible, it is reasonable to conclude that a payment for use would have been made in arm's length transactions."

Reorganisation of the material in Section D of the draft providing supplementary guidance on methods and comparability analysis

Section D starts with general principles applicable in transactions involving intangibles.

"In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction." (Paragraph 129) "In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving intangibles." (Paragraph 130) As paragraph 129 takes reference to 9.64 it is important to stress that there is "... no requirement for an exhaustive search of all possible relevant sources of information."

Paragraph 132 discusses several consequences if "... situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options ...". As paragraph 196 is not giving guidance on whether to include the tax effects of the transaction, we expect not just a few cases where the prices do not match. As stated above we see arguments for not including the tax effects of the transaction.

"Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In making such determinations, it is important to consider:

- The functions, assets and risks of the respective parties to the transaction
- The business reasons for engaging in the transaction
- The perspectives of and options realistically available to each of the parties to the transaction
- The competitive advantage conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles
- The expected future economic benefits from the transaction
- Other comparability factors such as features of local markets, location savings, assembled work force, and MNE group synergies." (Paragraph 157)

Exploring the business reason at the beginning of the transfer pricing analysis helps to clarify options realistically available as well as competitive advantages of the intangibles and their respective future economic benefits. How successful the usage of the intangible will be after the transfer very much depends on the availability of certain tangible and intangible assets and the concept of the usage of the intangible. We therefore like to suggest adding another bullet point after the bullet point on competitive advantage:

- Define the concept of usage of the intangible after the transfer and determine the necessary complementary tangible and intangible assets

As cost based methods are regularly not a valid proxy for the value of an intangible, we agree with the statement in paragraph 161, last sentence: "Cost based valuations generally are not reliable when applied to determine the arm's length price for partially developed intangibles."

Under the heading "Application of the CUP Method" the RDD suggests a CUP "... even where the intangibles are acquired indirectly through an acquisition of shares ...". We have some doubts about this statement. As the RDD states correctly in different paragraphs (e.g. 41 and 173) accounting rules determine the prices of intangibles in a purchase price allocation. It seems disputable whether these prices cannot serve as a CUP as they are typically not determined by a third party transaction.

Where it is not possible to identify reliable comparable uncontrolled transactions, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles (paragraph 166). Following the criteria of section B (paragraph 89), the profit split will become an important tool in allocating the intangible related return to the respective parties. We see merits in the general applicability of the profit split as well as in Action 10 (ii) of the Action Plan on

Base Erosion and Profit Shifting (BEPS) to clarify the application of the profit split method. As mentioned before, a score card system could be beneficial in that respect.

When using valuation techniques, the arm's length price of an intangible "... should be evaluated from the perspectives of both parties to the transaction ...". "The arm's length price will fall somewhere within the range of present values evaluated from the perspectives of the transferor and the transferee." (Paragraph 175) We appreciate the wording "somewhere within the range" as this implies that not automatically the median will be the right answer.

We also appreciate the flexibility of the RDD in either applying a discounted-cash-flow method or a discounted earnings method (paragraph 175), as the discounted earnings method has a long tradition in Germany.

Paragraph 176 and 188 suggest that small changes in valuation parameters, such as the discount rate or the growth rate can lead to large differences in the intangible value the model produces. This statement might be somewhat misleading insofar as large differences will only occur, if the model assumes an indefinite or a very long lifetime of the intangible. As for many intangibles the lifetime will be rather short, the statement should ideally either be amended by explaining that connection or deleted.

In general, we appreciate the recommendation of paragraph 178 to apply "... some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted." As paragraph 175 suggests that, depending on the facts and circumstances, a two-sided method should be applied, i.e. a bandwidth needs to be determined; often a sensitivity analysis will already be part of determining that bandwidth.

Regarding the accuracy of financial projections "... it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense." We support this request and confirm that it is good valuation practice to do an in-depth plausibility check of the projections based on market and competitor analysis.

We also appreciate the flexibility of the RDD regarding defining the discount rate, either on a Weighted Average Cost of Capital (WACC) or by ways of equity financing as cost of equity (paragraph 189).

Under the heading "Form of payment", the RDD suggests a different discount rate if the payment is contingent on future sales (paragraph 198). We could conceive the following amendment to the respective sentence: "If a taxpayer applies a payment form contingent on future sales, the net present value of a lump-sum payment should be equal to the net present value of the licence payments based on the same financial projections as for the calculation of the lump-sum." In valuation practice such a calculation is derived backwards, i.e. the licence rate is the variable factor to be determined to end up with the same net present value as for the lump-sum.

Regarding arm's length pricing when valuation is highly uncertain at the time of the transaction, the RDD takes reference in section D.3 to Action 8 (iii) of the BEPS Action Plan involving the treatment of hard to value intangibles. We appreciate that this action will include a detailed review of the language and approach currently outlined in the TPG on this topic.

Transfer Pricing Aspects of Intangibles and BEPS

In the introduction of the revised discussion draft the Working Party No. 6 of the OECD also takes reference to several actions of the BEPS Action Plan. The work on intangibles is specifically listed as one of the BEPS actions (No. 8) in that action plan. Actions 8, 9 and 10 are combined under the heading: “Assure that transfer pricing outcomes are in line with value creation.” Action 8 focuses on intangibles, action 9 on risks and capital, whereas action 10 considers other high-risk transactions.

The task of Action 8 of the BEPS Action Plan contains: “Develop rules to prevent BEPS by moving intangibles among group members. This will involve (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.”

Regarding Action 8 (i), we believe that the RDD is fully sufficient and there is no need to start the discussion again. We support Action 8 (ii) and like to suggest, preparing an example which shows how to allocate profits according to the value creation also when using a profit split or valuation techniques including a score card system. Regarding Action 8 (iii), we assume that hard-to-value intangibles are intangibles not yet fully developed, where it is unclear whether they will be beneficial. Industries which are fully dependant on securing a successful pipeline (e.g. pharmaceutical industry) have comprehensive experience how to evaluate their pipeline. Following the approach of such companies might be a good starting point for developing special measures for transfers of hard-to-value intangibles.

Action 9 focuses among other aspects on “... adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation.” Regarding intangibles, Action 9 should make reference to section B of the RDD.

Action 10 considers among others “Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measure to: (i) clarify the circumstances in which transactions can be re-characterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; ...”.

Regarding intangibles, the RDD states clearly and correctly in paragraph 126:”Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate.” We therefore believe that a re-characterisation of transactions concerning intangibles according to Action 10 (i) shall be limited to very rare and exceptional cases. Regarding Action 10 (ii) we support to clarify the application of transfer pricing methods such as a profit split and valuation techniques by means of providing also combined examples. One example could be as follows: First determine the value of the transferred intangible with a discounted-cash-flow method. Second provide a profit split based on the criteria in paragraph 89 of the RDD.

Summary of our Recommendations

We appreciate the work performed by the Working Party No. 6 of the OECD regarding the Transfer Pricing Aspects of Intangibles. From our perspective the revised discussion draft provides a very useful tool for tackling with the characteristics of intangibles from a transfer pricing perspective. We are somewhat concerned that the current discussion regarding base erosion and profit shifting will turn back the wheel combined with a negative attitude towards using intangibles in a transfer pricing context. We therefore count on the OECD not to put at risk what has been achieved so far.

If we can be of any further assistance, please feel free to contact us.

PricewaterhouseCoopers
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft

WP StB Dr. Jutta Menninger
Partner Transfer Pricing

Bernhard-Wicki-Straße 8
80636 München
www.pwc.de
jutta.menninger@de.pwc.com