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**To Messrs OECD CFA**

**Observations on second draft on intangibles and on white paper on documentation (July 2013)**

Dear Sirs ,

it seems longtime spent from the release of the first intangibles draft to the release of second one that we are going to comment now.

In the middle between the two documents the most important Report issued on transfer pricing is the OECD BEPS (base erosion and profit shifting); but what is really important is what occurred in the meanwhile in the "open society", that is the challenge by a lot of Governments and also the blame by public opinion and Newspapers (in USA are famous the Congressmen questions to Apple chief executive officer about Irish subsidiary) against some multinationals charged to avoid paying the right part of taxes in a moment where other taxpayers are asked to finance public deficits which are increasing more and more.

This is what happening in the "open society" while now also the OECD intangibles draft has been included in a wider action plan against so called tax elusion of multinational firms.

We do not understand concepts included in the second OECD draft on intangibles if we do not focus what is happening in the open society.

In July 2013 , OECD released a 15 point project to tackle tax evasion by the world's largest multinational firms . According to the OECD, the action plan is aimed to provide governments with "the domestic and international instruments to prevent corporations from paying little or no taxes".

We have one impression ,which is a little against mainstream, that Legislators in trying to challenge tax elusion may take a serious risk because it may happen that enforced rules are not able to clearly depict what is legal and what is illegal while the debate on new rules till now is often focused on what is ethical or on what was not.

What we understand to be as one of main conclusion of OECD BEPS report is the following[1]**:**

> *One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and vice versa. This therefore creates an incentive to shift functions/assets/risks to where their returns are*

1 OECD Beps report page 42

> *taxed more favorably. While it may be difficult to shift underlying functions, the risks and ownership of tangible and intangible assets may, by their very nature, be easier to shift. Many corporate tax structures focus on allocating significant risks and hard-to-value intangibles to low-tax jurisdictions, where their returns may benefit from a favorable tax regime. Such arrangements may result in or contribute to BEPS.*
> *Shifting income through transfer pricing arrangements related to the contractual allocation of risks and intangibles often involves thorny questions. One basic question involves the circumstances under which a taxpayer's particular allocation of risk should be accepted. Transfer pricing under the arm's length standard generally respects the risk allocations adopted by related parties. Such risk allocation and the income allocation consequences asserted to follow from them can become a source of controversy.*

While We share the analysis done till this moment we (humbly) do not fully share the following part of BEPS report [2].

> *The evaluation of risk often involves discussions regarding whether, in fact, a low-tax Transferee of intangibles should be treated as having borne, on behalf of the MNE group, significant risks related to the development and use of the intangibles in commercial operations. Such arguments put stress on the ability of tax administrations to examine the substance of such arrangements, and determine whether the results of such arrangements, viewed in their totality, are consistent with policy norms (i.e. avoidance of inappropriate base erosion).*

Here it's introduced the role of Low Tax Jurisdictions; but the introduction at this moment of this concept may induce to give focus just to the tax rates applied in a specified Country while we think that the evaluation of risk must be a concept to be defined in any case , regardless if are involved companies located in Tax Heavens**, being connected with the essence of the arm's length principle**.
We also note that the BEPS report sentence, that we do not fully share and that we above mentioned , is contradictory with what is affirmed in the current text of OECD Transfer pricing guidelines (extracted from 2010 OECD TP G for MNEs and TAs para 9.182)

> *Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings.*

Obviously Governments , and OECD, may change the above rule or limit its the enforcement when no transactions with Low Tax Jurisdictions are involved but ,as we drafted before, we think that in so doing Legislator is going to modify the essence (and not a marginal part) of the arm's length principle.
Risk assessment is at the core of the arm's length standard.
Are firms allowed to freely locate risk among entities ?
We think that the arm's length standard implies the freedom of firms to locate risks as above mentioned and the real problem is that the allocation of risk must be **a true allocation of risk** ; therefore the allocation of risk has to be done at a moment when events which determine the different possible results (losses or profits) of the integrated business are not occurred ( the risk is already current at the allocation moment).
More, the problem in front of Legislator is to rule about the asymmetric information on business events between firms and Governments : firms have full availability about information of their

2 OECD Beps report page 42

business while Governments do not have ; Governments may only observe some facts but have no access to projected results of the business and so same Governments are not able to evaluate business risks; furthermore when they ask to firms to display risk conditions they may think that those information are displayed only to elude an heavy tax burden. Governments might be sure that before of Tax audits (generally managed years after the transactions , and so when risks are over) the multinational business audited was a risky business (in the economic sense of the term , where more results are possible events) .

All these problems are at the core of the arm's length standard and intangibles project of OECD might, at the end of the project, might come to enforce clear rules to be applied by firms and Governments. Some days ago is dead Nobel professor Ronald Coase , who was a master in illustrating which is the nature of the firm (suppressing market and implementing hierarchy) : groups are often nothing other that a sole firm performing an integrated business.
Let us call back what we wrote in a recent paper (with Andrea Fusaro) about artificial versus arm's length allocation of risks.[3]

> OECD Report on base erosion and profit shifting focuses risk allocation as a key transfer pricing problem: without circumlocution a group may locate low risk profile affiliates in High tax Countries and high risk profile affiliates in Low tax Countries[4].
>
> Measures are already current against what Governments might consider an artificial risk shifting: high tax Countries enforces for some jurisdictions (classified as Tax heavens) Controlled foreign corporation legislations which generally prevail on transfer pricing rules, further measures are against corporations owning intangibles via cost share and targeted to license them, chapter IX of Guidelines asks some specific conditions for "validating" the taxpayer risk exposure (i.e. the company must hire key staff in managing risks, the company must have financial capacity to bear risks ) debt – equity ratios ,sometimes ,might prevent financial fiscal arbitration ,and so on .
>
> If the measures are not sufficient others can be taken but that must be done in a clear mode in a way firms and Administrations are able to understand, before of making-auditing a business, which is the artificial risk shifting in contrast to the risk allocating which is classifiable as structured in ALP (arm's length principle) compliance.
>
> **Entrepreneurial (in the sense above mentioned) risk exposure , reward to affiliates in compliance with risk exposure and possibility to freely allocate risks between affiliates ,as independent parties would do, are basic features of ALP[5] . In locating firms (affiliates for Groups) ,**

[3] Andrea Musselli and Andrea Fusaro, Profit shifting and certainty on allocation of intangibles 04/13 Transfer Pricing International Journal ,BNA ISSN 2042-8154

4 So explicitly the BEPS Report , "There are a number of examples of risk allocations that can be undertaken under the arm's length principle between members of an affiliated group (*e.g.* low-risk manufacturing and distribution, contract R&D and captive insurance). Under each of these models, the principal/insurer could be located in a low-tax jurisdiction, and the service provider/insured located in a high-tax jurisdiction" (see Report , page 42).

5 Extracts from current (2010) OECD Transfer pricing guidelines for MNEs and TAs

9.181. Under Article 9 of the OECD Model Tax Convention, the fact that a business restructuring arrangement is motivated by a purpose of obtaining tax benefits does not of itself warrant a conclusion that it is a non-arm's length arrangement [As indicated at paragraph 9.8, domestic anti-abuse rules are not within the scope of this chapter.] The presence of a tax motive or

**investments and risks pertinent to those firms, independent parties would also consider (maybe not only) the level of income taxation.**

**Is it true that into the social institution called capitalism entrepreneurial profit is the reward, first of all ,of assumed risks and not of material asset investments or of expenses incurred (like it would be if a fixed formula was current)?**

**The fact finding about which level of risks are in front of businesses may become questionable between firms and Administrations an so administrative rules may simplify that assessment but we are going to doubt that is coming at stake a philosophical deliberation : do Countries still want to agree the ALP?**

**Clear rules are enforceable for stopping what is considered an abusive allocation of risk but Governments seriously must think about their willing to still agree ALP , because peculiarities added to the general and basic ALP rule , as we resumed it above, are becoming more and more** for that we can question if a general ALP rule still exist and if it still will exist given future taxation projects.

The playing field is quite complicate for tax experts too but we repeat that the fundamental feature a (an international) taxation system must grant to firms and to Administrations too is certainty of rules application. Legislators have full right (that's self evident) crack down some behaviours qualified as artificial risk shifting but they have also the burden that this ban ends to becomes a proper list of banned behaviours which are clearly specified in advance of making a business (for firms) and an audit (for Administrations).

Now We make a simple example of what we fear on respect of the intangibles draft which is at focus . Web multinationals are severely scrutinized by Governments because they pay a so low global amount of taxes.

This target (it has been historically proved) was reached by intermediating (like ham in a sandwich) some companies located in European Countries (strictly "connected" with other ones located in a Tax Heaven) between mother company ,inventing products or services and distribution companies ,selling those products.

But when clear rules will be enforced in banning the role of low tax companies in the middle of the integrated business of producing and selling goods or services[6] the Legislators will have to give a clear answer to the question : where the profits are? Are profits of web multinationals firms generated in selling jurisdictions or in mother company jurisdiction?

We try to analyze what intangibles draft provides (obviously in our humbly opinion) about this answer: the concept for distribution - marketing companies is that if they act as an agent without taking risk in penetrating new markets the profits are generated outside selling markets.

But why , if this is the rule, some European Governments are studying measures for that selling market companies will be able to share part of global profits of the business at less for web

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purpose does not of itself justify non-recognition of the parties' characterisation or structuring of the arrangement under paragraphs 1.64 to 1.69.

9.182.Provided functions, assets and/or risks are actually transferred, it can be commercially rational from an Article 9 perspective for an MNE group to restructure in order to obtain tax savings. However, this is not relevant to whether the arm's length principle is satisfied at the entity level for a taxpayer affected by the restructuring (see paragraph 9.178).

6 Is this case we are projecting a forced (but necessary) interpretation of the arm's length standard just planned to prevent location of companies in Tax Heavens (aimed only to reduce global level of taxation) ?

businesses? Do these rules create conflicts with Governments allowed to tax inventing companies of web business?
But now we come to what we see to be another problem in front of legislator and which is equally dangerous ,in our opinion, as to the one above mentioned : we allude to the fact that when a clear rule for marketing companies is enforced (abstract rule), the part of the intangibles draft providing examples must give solutions and guidance not to rare cases but to frequent cases that will come to attention of firms and Administrations and which needs to be subsumed to the abstract rule that we mentioned before.
We better explain what we want to say: examples seem tailored on specific assumptions that are seldom current in real cases to the attention of firms and Governments, while they do not give a clear rule for most of cases current in reality when distributor remuneration is calculated with a profit measure extracted by comparables, and full information about marketing arrangements between producer and distributor are not available. Here we say again what we commented for the first draft[7].

*The first target is to give a clear rule for the* ***marketing agent distributor (also when are not available comparable arrangements).***

*Here it's possible a simple rule whose compliance with is tested also ex post transactions during an Administration audit managed years later those transactions.*

*When a "normal" net profit return (maybe tested to what is gained by independent "normal" distributors or also by a provider of "similar services" extracted by databases) has been left in the hands of the distributor for each audited period , the Administrations have an i**ncontrovertible evidence** that marketing expenses (if any have been assumed) have been borne not at the risk of the distributor . This assessment becomes an (historical) question of fact (irrespective of contracts) and is able **to solve a lot of real cases** , where eventual returns (profits or losses) from name (intangible) development, if any, are attributable to foreign producer and not to distributor. This will avoid litigations in a case where the plain application of ALP can come only to mentioned conclusion. Example 3 [this is the number used in the first draft on intangibles] must give a solution not only when comparable arrangements of distribution are available but also when they are not.*

*The **fact that in example 3** the Legislator specifies that marketing expenses have enhanced the group commercial name may create misunderstandings : the rule about the marketing agent correctly might conclude that distributor remuneration is irrespective of what happens about the promoted name and so the same rule would have been applied also if the name exploitation would have resulted in a failure.*

- *When comparable independent arrangements on distributor are not available and the distributor is not a mere marketing agent of the producer the role of normal marketer versus the* ***abnormal marketer*** [8] ***must be depicted with more details in reference of what is present now in the draft which seems to base that partition on presence of comparable independent distributorship agreements.***

[7] See Andrea Musselli observation on OECD public consultation on the first intangibles draft

8 A lot of litigations between firms and Administrations and between Administrations of different countries currently are just due to different interpretation of the excessive versus normal level of marketing expenses of the distributor ; clear words also when comparable independent arrangements are not available are necessary…….

*I think that if these details are not provided firms and Administrations and also Administrations of different Countries will litigate a lot about the notion of "excessive marketing" of the distributor (**just when comparable independent agreements are not available** and about the identification of normality or abnormality of marketing).*

- ***We think that in the draft regulation is also absent an example of when distributor cannot develop marketing intangibles just cause marketing may be managed without risk (further cases of periodic adjustments**)! This is an analysis ending to (periodic adjustment concept) necessity to agree only short terms contracts between producer and distributor.*

*We allude to cases where the value is on side of the patent producer and when challenges to eventual sharing of value between producer and distributor should be moved (when income is not appropriately assigned to him) just by Administrations charged to tax that foreign producer. The starting point of such an analysis must be the detection of the situation when real risks are in front of integrated business and when they are not , so to understand if marketing presents those purported risks which are considered current only with the sentence , included in examples, that the "commercial name is not known in the distributor market"[9] (and then the positive effect of marketing is current with the sentence that " the name has become well established") ……… also when the name is not known is possible to manage marketing ,under an integrated business, in a way to reduce risks[10]!*

- *We think also that OECD might run in detail a new fundamental example with another case where it is not appropriate, similarly to previous point of view, to refer only to the distributor's activity when determining an appropriate transfer price[11] and where intangibles on producing side are valuable and to be taken in account! **Here I must give a pattern about how to value marketing intangibles (when some authors even consider they do not exist!) in the context of an integrated business for that without a valuable product , marketing can do nothing (or , that is the same thing "marketing is a routinary activity , aimed only to inform customers about product features").***

*The starting point must be an assessment of risks assumed by a distributor related to risks already assumed by the manufacturer (or, with same results, the total risks of the integrated business): one estimator is faced with an eventual marketing intangible to be developed by distributor that must be connected to the intangibles developed on the production side. **This must be a clear pattern, able to divide cases when it is sufficient to look at the sole distributor side to project a remuneration rule and when this is not correct .** Concepts to build such a rule are identifiable in assessing that when marketing costs are put at risk, many times ,valuable bottleneck inputs have been created on production side **just because , usually,***

9 For details about the fact that the name was not known (and then successfully developed) see back point 26.

10 I newly call back (I beg your pardon) that Horstmann and Markusen, *[Exploring New Markets: Direct Investment, Contractual Relationships, and the Multinational Enterprise*, 37 Int'l Econ. Rev.1 (1996)] suggests real behaviors of multinational enterprises in order to limit risks in exploring new markets ; the name is not known but some behaviors are targeted to limit risks in the new market (companies which will enter foreign markets in the presence of uncertain demand might prefer to explore the new market through "independent" licensees rather than affiliates, in order to avoid fixed set-up expenditures; an incentive remuneration must be granted to that licensee for inducing a truthful revelation regarding the state of the demand in the particular market)

11 In example 5 [number referred to the old draft on intangibles] of the draft Administration is allowed to split combined profit of producer and distributor but I think that just the example may give more details in that

***marketing is performed at the end of whole investment process and when the market value of the output is going to be disclosed.***

*This is the sole way to have coherence between the implied profit allocation rule included in Guidelines and the case at focus!*

*Profits (or losses) , in an integrated business, are due to "uncertainty and risks " , and are generated by the fact that resources are to be committed before **of having information** about output value[12] and so when time for having disclosed the output value is short (marketing at the end of investment process) **most of risks are to be supposed , at that moment, over**[13].*

*I repeat that the rule above is also the model to share integrated profits between associated units that is implied in OECD Guidelines current text , and that I am able to derive from **best method rule (and other parts of Guidelines)** ; if I want to change this rule and to apply another one I might explain and motivate the change to have coherence between specific rule and general principles.*

*Details about the right way to proceed provided in an example would have the sense of giving certainty with a safe behaviour (for firms and Administrations) by some simplifying assumptions ; **the target is just to allow a solution in difficult cases when available data do not consent a more rigorous analysis ;** that rigorous analysis is indeed a live option of Guidelines when available data consent it.*

*The example 5 [number referred to the old draft] correctly concludes (between allowed options) about a profit split , but without the details and concepts We drafted here this cannot be a secure guidance to avoid litigations and leaves open the way to unending discussions!*

On white paper on documentation we have some simple comments : it's quite impressive to see how Countries enforce documentation rules and how International "Organisation" (European Union , OECD , Association of Pacific Tax Administrators and so on ) try to level national rules ; the result is that it remains complicated for firms to understand what is really requested.
In any case We think OECD is now going to modify the rules on consequence of BEPS report and aiming to give answer to some "behaviours" of web firms we quoted at the beginning of these comments ; each Government is interested to know actual global tax level related to the whole integrated business of the group and to know how this level is reached , to say, where each subsidiary is located , what is the amount of taxes paid and if Tax heavens are involved.
This could be a real change in respect of previous rules but we think that problems are not on documentation side but on transfer pricing rules to be applied.
A simple example related to question we mentioned at the beginning of the paper for web businesses : where the profits are ? Are they located in selling markets on in producing -inventing companies jurisdictions? If we are able to answer that selling market companies perform routinary functions (also in compliance with OECD intangibles draft rules) why we have to know the whole group structure when the transfer pricing rule is frequently based on comparables of selling companies? There would be an excess of information (creating a burden for firms) while the taxing rule is quite simple and based on routinary comparables of selling companies. Maybe it's important to understand how marketing function is developed in the group structure but it is this kind of

12 See J. Hines, *The Transfer Pricing Problem: Where the Profits Are*, NBER Working Paper w3538 (December 1990)

13 Please consider that I use the term risk in the sense given by economics and so the fact that a risk is over means (simplifying) that a single result is possible (now near to be actual) , that may be positive result (a profit) but also a negative result (a loss).

information which is relevant for choosing and applying the transfer pricing rule and not another one. Therefore Legislator must be careful to ask to firms the minimum level of information requested to apply the correct (at arm's length) taxing rule : it's the taxing rule which determines the level of requested information to provide to Governments and not the contrary.
Further information projected to be requested by OECD (and G20 Governments) seems only to be relevant to prevent existence of no functions companies located in Tax heavens.
Obviously this is a well deserving target for most industrialized Countries but in any case we have to minimize burden for firms.

Many thanks for attention , we send our best regards.

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