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Working Party 6
OECD, Committee of fiscal affairs
2, rue André Pascal
75775 Paris Cedex 16
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Date: 30 September 2013

Subject: **Comments on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles**

Dear Sir/Madame,

TPA is pleased to contribute through this representation to the valuable work performed by the OECD on the "revised discussion draft on Transfer Pricing Aspects of Intangibles", published on 30 July 2013.

TPA and its Global Alliances would like to congratulate the OECD with the progress being made on the revision of Chapter VI of the OECD Guidelines.

TPA sees some areas of concern as well, especially how other OECD publications do interact with the current work on Chapter VI. Recent publications – like the BEPS Report and action plan – with a media and/or political background approach have confused corporates and practitioners, as well as other stakeholders.

TPA has structured its comments and our suggestions as follows:
- An introduction acknowledging the new concepts on Intangibles (see Section I);
- Comments on the identification and labelling of intangibles (see Section II) ;
- Comments on the ownership concepts being used (see Section III);
- Comments on valuation aspects of intangibles (see Section IV).

TPA global and its alliances would be pleased to participate in the 12-13 November 2013 public consultation in Paris. We look forward on a constructive collaboration between all stakeholders.

Yours sincerely,

Steef Huibregtse
On behalf of TPA Global and its Alliance Partners

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TPA GLOBAL'S COMMENTS ON THE REVISED DISCUSSION DRAFT ON TRANSFER PRICING ASPECTS OF INTANGIBLES.

I. Introduction

I.a Context of Chapter VI – Components A, B, and C

1. MNE's do engage in business and risk management activities that generally would employ 3 categories of assets; (A) Fixed/Tangible Assets, (B) Intangible Assets and (C) So called non-intangible premiums, such as "location savings", "assembled workforce", and "synergies".

2. The return on Fixed/Tangible Assets (Category A) can be determined through a cost plus, TNMM and/or a return on assets, while the intangibles (Category B) would attract a return on investment, typically in the form of a royalty or lump-sum payment.

3. Category C, the non-intangible premiums, often are addressed through geography specific features, and bargaining theory and practices to determine how such premiums get allocated between group companies.

4. Based on how each of the Category of assets A, B or C is being owned and/or controlled by each of the group companies, the overall MNEs results will be allocated. The required portion of ownership/control per Category of assets, and per group entity, can only be determined by qualifications/quantifications of such positions.

5. Since Category B is only capitalized in a group entities' balance sheet to the extend such intangible asset is recognized for accounting purposes, the "economic value" of intangibles as defined by the draft Chapter VI needs to replace the original accounting entry.

6. Category C will almost always be off balance, given the rules of accounting have not yet developed standards for capitalizing such non-intangible premiums, except for the entry of "goodwill". An example would be a R&D workforce in place in India.

7. In order to capture the impact of Category C, the OECD draft seems to suggest to work the corresponding compensation into a comparability adjustment to be applied to the group entities owning or controlling the categories A and/or B assets.

8. Example:

   Year 1
   A French group entity is involved in producing goods for associated enterprises against a cost plus 10% compensation. The COGS equals Euro 10 million.

   Year 2
   The production being moved to a Chinese group company leads to recurring savings of Euro 3 million in COGS.

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Question: what is the appropriate compensation for the Chinese group entity in relation to Category A, B and C assets (i.e. being labelled as “location savings”)?

COGS Chinese entity	Euro	7,000,000
Profit uplift to compensate for ownership of Category A (10%)		700,000
Profit uplift to compensate for ownership of Category C (assume 50% of savings can be allocated to Chinese group company, i.e. Euro 1.5 million) Euro 1.5 million x 10%		150.000
Total intercompany charge		7,850,000

Uplift percentage on COGS:
(on A and C combined) 850/7000 x 100% = 12.1%

I.b Balancing between the interests of taxpayers and tax authorities

9. The exercise where, after an allocation or ownership or control over the Categories of assets (A, B or C), the operating results of an MNE on intercompany transactions get allocated is of a complex nature.

10. The fluid ownership definition (entitlement) to Category of asset B carries – once the legal ownership is taken as a starting point – too many variables, which allow multiple interpretations leading to double, or no taxation, in this Category.

11. The absence of any ownership/control definition to Asset C Category makes it impossible, without more explicit guidance by the OECD, to deal with this Category in practice. The questions are obvious, e.g.

   a. Which group entity benefits from recurring “location savings”?
   b. Which group entity benefits from the return on an “assembled workforce”?
   c. Which group entity can claim a major portion of “synergies” realized?

12. The departure by the OECD away from the accounting reality for the Categories B and C, without transparent and practical guidance on how the ownership/control over such assets allows a group entity to claim a bigger piece of the operating margin, seems to leave MNEs with limited guidance and a higher risk of double taxation on a major portion of its intercompany transactions.

13. TPA recommends that OECD, based on its current state of consensus on the draft of Chapter VI amongst members and observing contracts, to continue a direct dialogue with the business community on the practical steps and hurdles to be dealt with.

I.c Comparability factors and application to non-intangible premiums

14. The table below visualizes how the 5 comparability factors will interact with the non-intangible premiums (Category of Assets C).

	Location savings	Assembled workforce	Synergies
Characteristics of Product/Service			
Functional Analysis			
Contractual Terms			
Economic Circumstances	X	X	X
Business Strategies	X	X	X

X = Impact could be significant, unless full competition erodes such premiums within a period of 1 year/ 12 months. This makes a proper industry and company analysis a pre-requisite for determining the qualitative and quantitative impact (if any).

15. The application of comparability adjustments in Category C to the entities owning and/or controlling the Categories A and B will have to be addressed by the OECD. An underlying question is whether a group entity owning/controlling Category B assets has relatively more “bargaining power” than a group entity owning/controlling Category A assets.

16. How would the OECD deal with “negative location savings”, e.g. where a MNE would relocate from a lower cost location back to China, to allow the “corporate social responsibility” of such MNE to be the prevailing factor.

I.d Scope of TP Guidelines and focus on specific topics

17. TPA suggests, however, to be more neutral on:
    a. Anti-abuse provisions.
    b. Explicit statements which seem to suggest a higher portion of the operating margin should be allocated to the MNE operations in countries facilitating the MNEs to achieve benefits from: (i) location savings (ii) an assembled workforces and/or (iii) synergies.

II Identification and Labelling

18. TPA understands OECD's position to avoid classification and labelling of intangibles. Instead the OECD created a generic definition, which however provides only limited guidance to MNEs to properly classify Assets into Category A, B or C.

19. TPA has indicated in its previous representation that the threshold of eligibility requires lots of qualitative guidance on what constitutes an intangible (see point 20 below), after which the eligibility needs to be determined for each of the associated enterprises (see point 21-28 below).

20. TPA has developed a decision tree to – in the absence of clear cut lists of assets qualifying as intangibles – determine whether an asset constitutes an intangible for Chapter VI purposes (see appendix A).

III Ownership

IIIa. Ownership versus control

21. Ownership is understood as the most comprehensive disposal regarding any tangible/intangible asset, including the entitlement to any corresponding revenues incurred. The use of the term 'ownership' does suggest that returns are linked to assets, owned by MNE group entities, whether legally or economically.

22. Paragraph 65 explicitly states "although the legal owner of an intangible may initially be entitled to receive the proceeds from exploitation or transfer of the intangible other members of the owner's MNE group may have performed functions, used or contributed assets, or assumed risks that are anticipated to contribute to the value of the intangible and for which they must be compensated under the arm's length principle." TPA is of the opinion however that the primary significance of legal rights and contractual arrangements ("the basic rule"), as referred to under paragraph 67, should be respected as a starting point.

23. The basic rule is attenuated in subsequent paragraphs with a broad-based reference to the functional analysis observing the principles laid down in Chapters I to III of the TPG. The final statement, embedded in paragraphs 89 and 90, i.e. that compensation to the legal owner is, depending on the facts and circumstances, limited or even zero, should preferably be treated as an exceptional case.

24. TPA would appreciate if the OECD is able to clarify the "tipping point" for neutralizing the "eligibility claim" by the legal owner. In that connection it would be interesting to investigate to what extent a third party licensor confers value- creating opportunities to its contractual licensee or at least to search for 5 to 10 court cases in which such attribution of value creation is being recognized. How realistic is the OECD position if in a 3rd party dispute, only in exceptional cases the licensees claiming a co-owner position (legally or economical) will be honoured by the courts. Mostly licensees will limit the claim dispute to the level of the royalty rates and/or other terms and conditions vis-à-vis the legal owner of an intangible.

25. Contrary to other types of ownership/control only legal ownership arrangements are de jure established between independent parties. However de facto value- creation relationships do occur between associated parties too. In this perspective the creation of a multi-layer entitlement structure between legally independent parties may, depending on facts and circumstances, end up into a partnership or some kind of profit-sharing setup.

IIIb. Important functions.

26. Paragraph 79 reiterates the significance of certain *important functions*, to be considered in assessing prices and premiums to be paid for functional contributions and the corresponding allocation of returns attributable to intangibles among members of the MNE group.

27. TPA would like to obtain more clarification about the nature of such "important functions". TPAs view is that *important functions* are similar to or at least the major categories of, the development, enhancement, maintenance and protection reference base.

28. In particular TPA would recommend explaining the scope and extent of such important functions. In this connection a further explanation of the wording used by the OECD "special significance" as a weighting factor would be appreciated. TPA would also recommend clarifying the "special significance" in relation to the Industry & Company Analysis, required as part of standard transfer pricing analysis.

IIIc. Outsourcing important functions.

29. Paragraph 80 sets focus on the specific problems to be encountered concerning outsourcing of the important functions. The paragraph underlines that based on the significant contribution of these important functions to intangible value it is difficult to find comparable transactions involving the outsourcing thereof. As a consequence the recommendation is to make use of Profit-Split or Valuation techniques to appropriately reward the performance of the outsourced functions.

TPA is of the opinion that further detailing and clarification of this indicative conclusion might be necessary.

In the same perspective TPA are afraid that disregarding the actual structure in accordance with the principles described in paragraph 1.65., in itself cannot be tantamount to disregard the actual commercial behaviour of the parties concerned.

30. A typical illustration of an outsourcing structure, as frequently occurring within the sector of the pharmaceutical industry, is set out hereunder:

The development of a lead medicinal preparation crosses a number of stages from basic research to testing on animals and humans. One of these stages, called "Clinical Development Phase", often is outsourced to specialized agencies, which are testing drug substances according to a severe roadmap. In such occasion the compensation for the testing agency is based on a service fee model ignoring the value-creating aspects as well as the functions, assets and risks, aligned with the on-going testing process involved. Therefore reconsideration as to the comparable set must be made before taking recourse to alternative modes of profit (re)allocation.

IIId. Loan funding by Investor

31. Paragraph 84 provides an overview of the key questions regarding the determination of the compensation, notably the risk-adjusted rate of anticipated return risk, accruing to investors which are funding one or more of the four main functions – development, enhancement, maintenance and protection – without participating in the functional performance of these main functions. Apart from the 5 key questions set out in this paragraph it would make sense to give a rough picture of the different modes of 'funding-related' participation by equity/investor groups concerned.

Next to the investor position as a shareholder, such investment can amplify the scope of participation in decision-making of the shareholder/investor. According to corporate law principles shareholders are authorized to (dis)approve important policy decisions of the board in their capacity as direct or indirect shareholder or, depending on domestic law concerned, as member of the supervisory board and/or non-executive member of the one-tier board of directors. In that capacity investors might be involved in functions, assets and risks on an entrepreneurial level.

32. TPA would recommend to apply a more detailed approach, an illustration of which is given in the following Matrix:

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Loan Funding by investor[1]

	Functions	Risks	Assets	L (fixed)	L (performance)
Type I	_	_	_	X (% RAROC)[2]	_
Type II	_	_	_	_	X(% of OM)[3]
Type III	X	_	_	_	X(% of OM)
Type IV	X	X	_	_	X(% of OM)
Type V	X	X	X	_	X(% of OM)

In this manner, the sequence of the decision tree crosses four stages:

A) The determination of relevant risk/asset/functions framework with regard to the investor;

B) The determination of the fixed or performance-related character of the envisaged compensation;

C) The determination of the correlating percentage of the operating margin;

D) The determination of the ultimate figure taking into consideration the data from A), B) and C).

[1] The Ultimate revenue left to investor through dividend, capital gains/losses in shares are not being addressed in this section. Please note that a loan funding by shareholders/investors under circumstance could for tax purposes be a hybrid between loans and capital.

[2] Risk adjusted return on capital

[3] Operating margin

IV Valuation

IV.a Sets of accounts (cash-flow vs income based)

33. TPA considers that the footnote in paragraph 175[4] conflicts with paragraph 179, which mentions that valuations made for business decisions, may be more reliable than valuations made for tax purposes only; and, paragraph 182, which mentions that projections made for non-tax business planning purposes are more reliable than those for tax or transfer pricing purposes.

34. By stating a preference towards different type of accounting standards and measurements, the OECD is providing conflicting guidance in terms of the source of information used for the valuation analysis under those circumstances.

35. It is natural to consider that any method which is considered the more accurate measurement would be used by both tax-payers and tax authorities, the distinction over valuations made for business purposes (i.e., cash-flow based valuations) and the valuations made for tax or TP purposes relies particularly on the fact that valuations for business purposes will rely on cash-flow based accounting rather than in income based accounting.

36. Since it is not a common practice for corporates to keep a cash-flow based accounting system, the natural point of departure usually is from accrual based accounting (income base accounting). To achieve a cash-flow based approach, some modifications are done to the projected income base accounting.

IV.b Perspective of the transferee and transferor

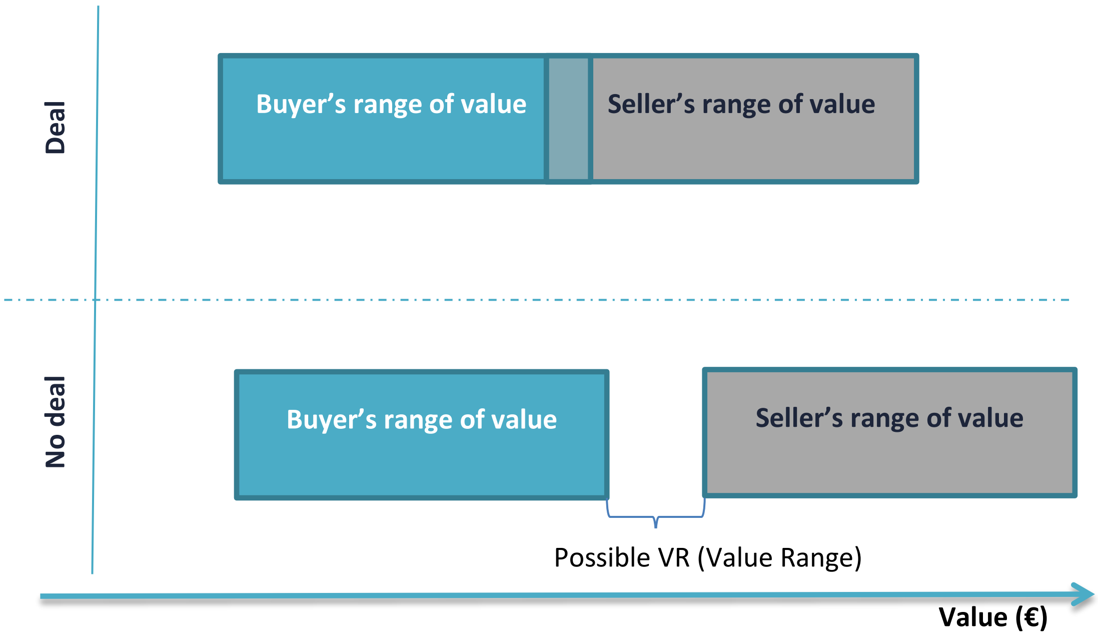
37. In paragraph 175, it is mentioned that the perspective of both parties when a transaction takes place should be taken into consideration when performing the determination of the arm's length price. The OECD may provide further guidance into what is considered to be the perspective of the transferor and the transferee.

38. It is understood that the perspective of both the transferor and the transferee would consider how the intangible asset would affect the expected cash-flows and income

[4] The footnote contains the following text: "In the case of a financial valuation based on projections, the analysis will often be based on projections of cash flows. Accrual based measures of income, such as those determined for accounting or tax purposes, may not properly reflect the timing of cash flows which can create a difference in outcome between an income and a cash flow based approach. However, in light of a number of considerations, the use of income projections rather than cash flow projections may, in some cases, yield a more reliable result in a transfer pricing context as a practical matter. Care must be taken, however, to assure that either income or cash flow measures are applied in a consistent manner and in appropriate circumstances. References to cash flow in this document should therefore be read broadly to include both cash flow and income measures, appropriately applied."

generation power of the business; nevertheless, the OECD may consider that under Arm's length circumstances the access to information plays an important role when determining the value of an asset from both parties' point of view. Given the full access to information and correlation factor between the related entities, a higher degree of information could be provided to determine what elements or components are to define the point of view of both the transferor and transferee.

39. Additionally, both the perspectives of the transferor and the transferee may include a range of values and not necessarily a specific value. Due to the latter, it is important to consider the following bargain positions for an arm's length transaction to take place:



When determining a value, third parties would give a range of possible values for each of the entered positions (e.g., buyer or seller). A deal would occur when the highest possible value for the buyer is in line with the lowest possible value for the seller; in circumstances when both values do not meet, the two entered positions may not lead to a sale or "deal" (as depicted in the previous image.

The OECD may provide guidance for what is to be considered "the position of the buyer and the position of the seller", taking into consideration the "No deal" circumstances that could arise even if a range between the two positions is established (as depicted by possible VR).

40. Finally, when providing guidance to transactions with both a low and high levels of uncertainty, it would be important to determine that due to the future nature of expected cash-flows or unexpected outcomes and the unpredictability of the future (*ante-circumstances*), as well as the historical review of data in a tax environment *(post-*

circumstances), the possibility of hindsight clauses or revaluations would not occur in arm's length circumstances unless stated previously or not done in "good faith". A restatement done in post-circumstances would have more information and deemed certainty given that it is performed on past information rather than on projections. It is also common to see that valuations for business purposes can have unexpected outcomes and not always reflect entirely the reality of the corporate at a later stage.

APPENDIX A – DECISION TREE FOR THE IDENTIFICATION OF INTANGIBLES