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UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL

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Re: Comments on the OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

Dear Mr. Saint-Amans,

Comments on Revised Discussion Draft on Transfer Pricing Aspects of Intangibles / Comments on White Paper on Transfer Pricing Documentation

On July 30, 2013, the OECD's Working Party No. 6 issued a Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (the "Revised Discussion Draft) and a White Paper on Transfer Pricing Documentation (the "White Paper), with comments requested on both documents on or before October 1, 2013. These documents were issued shortly after the release of the OECD' Action Plan on Base Erosion and Profit Shifting (the "BEPS Action Plan") on July 29, 2013. A substantial portion of the BEPS Action Plan is devoted to transfer pricing issues. We thus note the interrelationship of the three documents, although the OECD has indicated that work on certain transfer pricing issues will continue as part of the BEPS Action Plan after the Revised Discussion Draft and the White Paper have been finalized, which is expected to occur by September 2014. Also, please note that due to the short time frame for submitting these comments, our comments may be further considered and revised after October 1, 2013.

USCIB appreciates the opportunity to provide comments on the Revised Discussion Draft. USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

General comments:

We appreciate that the Revised Discussion Draft and the White Paper are interim drafts, and as such certain positions may not reflect consensus among all members at this point. However, we are concerned that positions taken in both documents and in the BEPS Action Plan, as well as public statements by OECD officials, indicate a growing willingness to abandon the arm's length principle as a basis for transfer pricing rules. Our overarching message in these comments is that such a decision should not be made in haste and merely to satisfy perceived "political pressure," and without consideration of the consequences to international trade and investment that such a decision would entail. The arm's length standard has worked reasonably well in practice in the vast majority of cases. More importantly, no matter what flaws exist in the arm's length standard, no alternative methodology for allocating profits has been devised which would come anywhere close to aligning taxable income with economic income and not be easily manipulable by taxpayers.

As discussed in our separate comment letter, with respect to the White Paper we are concerned that the introduction of so-called "country-by-country" reporting requirements represents a significant movement towards a formulary apportionment system for allocating profits among group members of a multinational enterprise ("MNE"). The White Paper suggests that a comparison of a taxpayer's global allocation of income against its global allocation of employees, assets, or sales may be a useful tool in assessing transfer pricing risk. The comparison envisioned would essentially ask if a taxpayer's global reporting of profits is in alignment with how its profits would have been allocated under a formulary apportionment system. Accordingly, we believe that while such a "big picture" analysis could in some cases lead to further audit questions, we believe that it has too much potential to lead from "useful audit analysis" to "self-fulfilling directive."

Similarly, the Revised Discussion Draft appears to move towards formulary apportionment with the introduction of the concept of "return attributable to an intangible" or "intangible related return." The discussion of this concept is not entirely clear, but it appears to deemphasize the role of contractual allocations of risk and ownership of intangibles and other assets, in favor of more emphasis on certain "important functions" and where people are performing those functions. That concept thus seems consistent with single-factor formulary apportionment on the basis of headcount or payroll expense.

That theme is echoed in the BEPS Action Plan, which seeks to improve transfer pricing rules by determining in which jurisdiction "value creating" activities occur and to create a realignment of taxation and relevant "substance." No definition of "substance" is provided, but the implication appears to be that value is created and substance exists in the jurisdictions where people are performing certain important functions. Inadequate recognition is made of the role of capital, and the value created in the real world by providing intangibles and other assets and assuming and bearing risk. The BEPS Action Plan also explicitly mentions the possibility of abandoning the arm's length principle, noting "special measures" for "hard to value intangibles" which may go "beyond the arm's length principle." The OECD has also publicly stated that such special measures inconsistent with the arm's length standard will "only" target risks, capital, and intangibles. We would suggest, however, that those three areas are of such fundamental importance to transfer pricing that any "special" rules for them will essentially eviscerate the arm's length principle.

A corollary of the arm's length principle is that taxpayers are allowed to choose their business structure, and it generally cannot be imposed upon them by tax authorities. The arm's length principle does not require related parties to replicate the behavior of unrelated parties or to only enter into transactions which unrelated parties would have. It recognizes that, because of their common control and common interests, unrelated parties can and do enter into transactions which unrelated parties would or could not. It generally respects those transactions (as long as they have economic substance) and merely seeks to find the price unrelated parties dealing at arm's length would have. Any work designed to prevent related parties from engaging in transactions which would not, or would only very rarely, occur between third parties is inconsistent with the arm's length standard and would seem very likely to lead to an untethered ability for tax authorities to interfere in legitimate business structures.

Finally, we are also concerned that the Revised Discussion Draft appears to deem certain pricing rules to be arm's length in contravention to how unrelated parties actually price their transactions. Particularly relevant in that regard are the role of ownership of intangibles and other assets, and the role of providing financing and assuming risks. In the real world, ownership of intangibles and other assets and the provision of financing and assumption of risks receive substantial compensation, sometimes the bulk of the profits from certain business transactions. We believe they should also receive appropriate compensation in the transfer pricing world, as consistent with the facts and circumstances as determined for a thorough functional analysis.

We provide more detailed comments below, but all our comments are animated by a concern that the OECD Transfer Pricing Guidelines remain consistent with the arm's length principle, both in name and in fact. As long as the existing foundations of the international tax rules are maintained and separate legal entities are generally respected, transfer pricing will continue to be about valuation; about pricing transactions between related parties. The arm's length principle, by definition, is the only principle which seeks to align taxable income with economic income. There are no shortcuts, no "special measures," which would obviate the need to engage in a difficult, facts and circumstances valuation exercise. We believe that any measures which are inconsistent with the arm's length standard would create distortions between taxable and economic income and lead to irreconcilable claims between tax authorities in different jurisdictions to tax the same income, ultimately creating double taxation and barriers to cross-border trade and investment.

1. Location Savings.

USCIB supports the general analytic framework laid out in paragraphs 1 through 4. We agree that there may be differences in arm's length prices for goods and services in different markets. Most importantly, paragraph 4 of the Revised Discussion Draft notes the importance of evidence based on comparability analysis to determine if locations savings exist and how they are allocated: *"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 5 suggests, however, that in the absence of comparables, existence and allocation of location savings "should be based on an analysis of all the relevant facts and circumstances, including the functions performed, risks assumed and assets used,,, ," Such a vague description of appropriate analysis gives no guidance as to what type of evidence or method could be used to determine the existence or allocation of location savings. One characteristic of the Arm's Length Standard is that it is implemented on the basis of evidence. However, there are portions of the Revised Discussion Draft in which the need for empirical evidence is treated rather cavalierly.

If the OECD is going to posit that there could be situations in which location savings can exist and yet be undetectable through standard comparability analysis because of a lack of "reliable local market comparables", the OECD should provide more complete guidance on how location savings can be properly determined and allocated. Given our experience that location savings are typically "competed away" by rival firms and passed on to customers, one would imagine such a discussion would begin with a theoretical discussion of the situations in which one might expect an enterprise to be able to retain the advantages of location savings. Since we are dealing with a situation in which there is a lack of comparables, discussion of the types of evidence and transfer pricing methods that could be reliably applied would also be necessary. Otherwise, in the absence of a usable method, a tax jurisdiction's (or multiple tax jurisdictions') presumption that location savings exist and are captured in that jurisdiction's (or each jurisdictions') tax base, becomes practically irrefutable.

2. MNE Group Synergies

USCIB generally agrees with the treatment of synergies set forth in the Revised Discussion Draft. We believe, however, that the treatment of financial guarantees requires further study. Given that the treatment of interest, financing transactions, and risk is being studied by the OECD as part of the BEPS project, we believe that the examples concerning credit support and guarantee fees ought to be deleted and those issues ought to be considered along with other issues relating to interest, financing transactions and risk.

3. Identifying Intangibles

a) Assembled Workforce

We welcome the recognition that assembled workforce is a comparability factor and not an intangible, and that the value of a transfer of assembled workforce may be limited to essentially the recruiting and training costs of hiring a new workforce, and may in some cases be negative when the transfer of such a workforce creates potential liabilities. However, we are concerned with the statement in paragraph 17 that the transfer or secondment of one or more employees may in certain situations result in the transfer of valuable know-how. Our concern lies in the fact that MNEs need flexibility to transfer or second employees around the world without having to consider whether a transfer pricing adjustment will be imposed every time a worker visits an office outside his or her home jurisdiction. We believe it would only be a very limited number of circumstances where a transfer of one or more employees results in a transfer of valuable know-how and that where it does, the medium is not important. Know-how may be transferred by an employee being transferred to a new office and divulging orally certain knowledge resulting in a transfer of know-how. But it may also be transferred over the phone, by fax, by email, by disk, by flash drive, by mailing important documents, etc. All that is necessary to impose a transfer pricing adjustment is to determine that know how has been transferred, not the medium through which it has been transferred. Because of technology and IT networks the notion that the physical transfer of an employee is relevant to the determination of whether there has been a transfer of know-how is simply outdated. It is unnecessary to single out transfers of know-how by transfer or secondment of employees, and doing so risks the danger that those transfers and secondments will always be suspect in the eyes of tax examiners.

b) Definition of intangible assets

An intangible is defined as something that is not a physical asset or a financial asset which is capable of being owned or controlled for use in commercial activities. Although it may be implied from this definition that an intangible asset must be separate from the services of one or more individuals, we suggest that the definition specifically exclude value that is merely attributable to the services of one or more individuals[1]. Individuals have knowledge and expertise which they provide to an enterprise for

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[1] We have used the plural "individuals" rather than the singular "individual" because assembled work force in place is not an intangible.

which they are compensated at arm's length. An individual may be a particularly good engineer as a result of the individuals training and experience. The fact that the individual uses the training and experience in his activities for enterprise is not an intangible. Given the potentially broad definition of intangibles, the failure to specifically provide that an intangible is separate from the value of services provided by individuals could potentially lead to assigning intangible returns to returns that simply arise from employing qualified individuals.

c) Goodwill/going concern value

We agree that in a transaction between unrelated parties that "goodwill" may be transferred along with the underlying assets including intangible assets. However, the fact that "goodwill" may be transferred in those situations does not relieve tax authorities or taxpayers from the obligation to identify the "goodwill" and separate the "goodwill" from other activities and assets that may create value in the future. Otherwise, the existence of "goodwill" can be imputed by hypothesizing the existence of expected cash flows that may have little basis in reality and do not fully account for the functions performed and the risks assumed subsequent to the transfer. Although Par. 46 requires that intangibles be identified with specificity and Par. 62 cautions against using residual business or other valuation methods to determine the value of goodwill, nevertheless, in our experience, tax authorities' measures of goodwill tend to be non-specific and simply rely on residual valuation methodologies. If goodwill is to be compensated, we recommend that the burden should be on the person asserting the existence of goodwill to prove with specificity the existence of goodwill in each period that goodwill is alleged to exist and that other value drivers are not reasonably responsible for the value created in that period.

d) Legal ownership

We believe the current discussion of whether legal, contractual, or other protection is a necessary condition for an item to be characterized as an intangible for transfer pricing purposes is confused. Paragraph 42 states that such protection affects only the value of an item, but that the existence of such protection is not necessary for it to be considered an intangible. And yet paragraph 40 states that an intangible must be "capable of being owned or controlled." We believe that, except in rare cases, in order for something to be "capable of being owned or controlled" the something would have to have legal protection. Certainly, registered patents and trademarks would have legal protection. Even if unregistered, trade secrets and know-how would in most cases be protected by contract. If in a rare case, an MNE chooses not to protect its intangibles, then it is very likely that such intangibles are less valuable, otherwise it is likely that the MNE would seek to provide at least contractual protection from others making use of its intangible property.

The advantage to emphasizing legal protection is to avoid discussions about vaguely specified and undifferentiated intangibles or cash flows being included in the valuation of intangibles. An example of the difficulty in not focusing on legal ownership is paragraph 100 which states that payments may be required for goodwill associated with an "unregistered trademark". Although unregistered trademarks may exist, one has to question whether an MNE would ever use an unregistered trademark. The trademarks of MNEs are extremely valuable properties and companies are very careful to protect their interest in their property. Thus, the notion that trademarks would be unregistered in these circumstances is likely incorrect. If tax authorities are free to argue that some vague trademark has substantial value, then that will likely lead to increased disputes and double taxation. If the Discussion

Draft is to keep the notion of intangibles that are not legally protected, it should make clear that this would be a rare case, and the value associated with such an unprotected intangible is likely to be small.

With respect to goodwill and going concern value, they cannot be transferred without transferring other legal protected property, for example fixed assets and a registered trademark. See paragraphs 42 and 60. Goodwill and going concern value could be considered legally protected if the property that it attaches to is considered legal protected.

4. Return related to an intangible and the issue of "Risk."

A significant source of confusion in Section B is the confused treatment of the concept of "risk" in Section B.2. Risk is a result of uncertainty about future events. If actual results were always the same as expected results, there would be no risk. However, in practice, there is often a very wide gulf between actual and expected results in business. This is particularly true for intangible assets, particularly when dealing with developing intellectual property for commercial application. The arm's length standard requires that taxpayers determine the amount that unrelated parties would pay (or be paid) at arm's length to enter into a transaction. It is, therefore, an "ex ante" standard based on the information that is available at the time a transaction is entered into. Consequently, transfer prices are based on expected results. However, actual results are also significant. Income taxes are paid on the basis of actual income not expected income.

The failure to distinguish between actual and expected results runs throughout section B.2. There is a very strong tendency to make statements that may be correct if one is referring to expected results but not if one is referring to actual results. Although this tendency may simply reflect a failure to distinguish between the two, it results in language that often seems to try to limit taxpayers to an expected return and ignores actual results (even though there is no legal support for such a limitation). This problem is particularly noticeable when applied to financing.

For example, in paragraph 84, we are told that "Bearing a funding risk, without the assumption of any further risk, and without any control over the use of the contributed funds or the conduct of the funded activity generally would entitle the funder to a risk-adjusted rate of anticipated return on its capital invested but not more." This is a correct statement about expected return (and the use of the term "anticipated return" may suggest the author is aware this is a statement about expected return). It is not a correct statement about actual return. If the financier takes on risk, the financier's actual result can be very different (in either a positive or a negative direction) from the expected risk-adjusted return. And, of course, there would be no legal basis on which to limit the financier to its expected return.

Paragraph 82 is similar. It states that "in arm's length transactions, a party that provides funding, but does not control the risks or perform other functions associated with the funded activity, generally does not receive returns equivalent to those received by an otherwise similarly–situated investor who also performs and controls important functions and bears and controls important risks associated with the funded activity." The statement is correct only for expected returns; actual returns can be very different. For example, both the first-mentioned financier and the second-mentioned financier may agree to purchase an interest in an "in-process" technology intangible for a lump sum payment and bear some of the costs of developing such technology intangible in return for rights of commercial exploitation. In addition, the second financier may agree to perform certain additional functions such as carrying out research and development directly rather than paying for some other related party to carry our research and development. Assuming equivalent levels of risk, costs and revenue in both cases, one would expect the second financier to be compensated for performing additional functions by receiving higher total income than the first financier. However, it is entirely possible that the first financier has backed an extremely successful technology development project while the second financier has backed a failure. Then, the actual return to the first financier can far exceed the actual return to the second financier.

As we noted in our comments last year, the transfer pricing rules should not attempt to restrict the way taxpayers conduct their business; they may move functions and assign risks for legitimate business reasons. Transfer pricing rules respect those transactions (subject to having economic substance) and the transfer pricing rules only require that those transactions are priced at arm's length. It is inconsistent with the arm's length principle to limit a financing party to entering into a risk-limited debt-like financing arrangement; equity investments are commonplace and can result in large returns or losses to the financing party depending on the commercial success of the project. The risk-adjusted returns for investors in intangible development, including returns for "blue sky" R&D, are available and can be quite high:

- "Adjusting in this way for the selection bias of firms that go bankrupt, the mean return on VC investments is 57 percent per year, still very large but less dramatic than the 700 percent mean before correcting for selection bias."[2] Successful projects have high returns.[3]
- Pepperdine University publishes interquartile ranges for various types of investor classes depending on the amount of risk borne by the investor. Such strata illustrate risk-adjusted returns in our opinion. See appendix A.[4]

5. The Discussion Draft overly emphasizes the returns to people functions

As noted above, Par. 80 misunderstands the role of financing and risk in determining the intangible returns and focuses primarily on people functions. In addition, Par. 80 suggests that it is highly doubtful that an enterprise would be entitled to returns associated with risk if they fail to exercise the control measures identified in Par.79 even though those control functions go well beyond the control

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[2] "How High are VC Returns?" by Andrew Balls, 3 September 2013, The National Bureau of Economic Research. Copy available at http://www.nber.org/digest/may01/w8066.html.

[3] In The Risk and Return of Venture Capital (NBER Working Paper No. 8066), Cochrane includes those companies that stay private -- the losers as well as the winners-- so as to more accurately estimate the returns on VC investments. His analysis is based on 17,000 financing rounds in 8,000 companies, representing $114 billion of VC dollars, between 1987 and 2000.

Before controlling for the selection problem, Cochrane finds very large average returns among companies that go public or are acquired. The average return is almost 700 percent. Returns in this sample are also very volatile, with a standard deviation of 3,300 percent. Underlying these averages, however, there are a few companies with astounding returns, and a much larger fraction with modest returns. About 15 percent of companies that go public/are acquired achieve returns greater than 1,000 percent; yet 35 percent of the companies achieve returns below 35 percent; and 15 percent of the companies deliver negative returns. The most probable return is only about 25 percent.

[4] 2013 Capital Markets Report, by Dr. John K. Paglia, Pepperdine Private Capital Markets Project, a copy is available at http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/content/2013PPCMPcapital-markets-report.pdf.

function discussed in Par. 9.22 through 9.32 generally and 9.26 specifically. See also Example 15 Par. 278 and Example 17 Par. 285 which seem to state as facts that control was not exercised without any analysis or factual predicate. As was carefully considered in the drafting of Chapter IX, the control functions discussed in 9.26 should be adequate, in the absence of specific third party transaction information, to permit a provider of capital to assume and manage the risks of the projects or activity. Obviously, the parties could decide that a party other than the provider of capital could bear some of the risk, assuming the other party met the standards of Par. 9.18 through 9.32.

We note that the two-sided transfer pricing analysis required by Pars. 81 and 131 may result in significant intangible returns going to the owner of capital. In some cases the Par.79 functions are not unique or particularly valuable and are widely available in the market. Similarly, if one applies the two-sided analysis as provided in Par. 131 the realistic alternatives available to the owner of capital would be to hire the control individuals to perform the Par.79 functions (mere lack of resources is not prohibitive in determining realistic alternatives). We think in many cases, a proper two-sided analysis considering realistic alternatives would allocate significant expected returns to the owner of capital.

As an example, certain types of software development and legal protection activities are widely available from third parties. In those cases, the scarce resource may be capital and the owner of capital could obtain the Par. 79 services from multiple third parties. If the resources provided by the associated enterprise are unique and valuable, the owner of capital may not be able to replace the resources in the open market. See Par. 97 that discusses the unique skills and experience of the research team. We believe Par. 80's overly broad assertions are inconsistent with other paragraphs and the arm's length standard.

6. Supplemental guidance for determining arm's length conditions in cases involving intangibles

USCIB believes that the Revised Discussion Draft inappropriately requires the use of profit splits to price intangibles and disregards the outcome of the comparability analysis before it has taken place. For example, although paragraph 154 states that any of the five OECD transfer pricing methods may be the most appropriate transfer pricing method, the draft quickly dismisses all of the methods other than the profit split method thereby disregarding the general guidance in paragraph 2.2 of the TPG on finding the most appropriate method to the circumstances of the case.

Paragraph 156, for example, states that it will "often be the case" that reliable comparable uncontrolled transactions cannot be found in matters involving transfers of intangibles. We have seen an increasing willingness by tax authorities to disregard comparable uncontrolled transactions in pricing intangibles, although courts have routinely accepted CUTs. All pricing methods may have serious limitations in pricing intangibles, and sometimes determining the "most reliable method" will turn out to be a search for the method that is "least bad." We believe that each transaction stands on its own and that no hierarchy of methods should be established for intangibles.

Paragraph 159 suffers from the same problem, stating that one-sided methods (including the resale price method and the TNMM) will generally not be reliable methods for pricing intangibles. Experience suggests that TNMM may be appropriate in a number of situations. Whether TNMM is appropriate will depend on the functional analysis and the comparables that are being used. For example, if the functions of the party licensing the intangible is performing are fairly routine manufacturing or distribution functions and the terms of the license do not impose a significant risk on the licensee, TNMM may be an appropriate method to determine an arm's length charge whether a two-sided or single-sided analysis is used. We suggest that TNMM may be appropriate if one party to the transactions is providing routine functions that are widely available in the market place and does not own and use valuable and unique intangibles.

We also believe that if tax authorities default to using profit splits for every transaction involving intangibles, compliance will become extremely difficult because there is no agreed formula or method to split profits. The guidance provided on profit splits is inadequate and makes it impossible to fully evaluate the Draft. However, the Draft provides no new guidance on how to apply profit splits. The Draft primarily relies on existing guidance in Pars. 2.108 and 2.145. Those paragraphs are intended to apply profit splits in situations in which one party has developed an intangible and the other party is using the intangible in its business. Those paragraphs provide little guidance on how to split profits when two parties "co-develop" an intangible and then license another party to use the intangible. For example:

- No guidance is provided on how to split profits if one party performs some of the functions in Par.79 and another party provides other Par. 79 functions.
- No guidance is provided if one party provides capital and the other party provides the people.
- No guidance is provided if one party exercises "control" and therefore, is considered to bear "risk" with respect to the development of intangibles.

Any profit split should not primarily be driven by the relative number of people performing a given function or their compensation.[5] People and their compensation are primarily driven by market forces. In general, experience suggests that an individual is able to capture a significant amount of the individuals profit generating capacity. To the extent the firm can generate returns in excess of the individual's compensation generally depends on the ability of the firm to combine capital or intangibles with the services of an individual. Therefore, any profit split would need to provide a method to take capital and other intangibles (valuable and unique) into account.

If the profit split method is intended to be used more frequently, it is important to provide clear guidance so that double taxation can be avoided. See comments on Par. 84 below. We suggest the inclusion of several examples showing how profit split would work in practice. Without clear guidance, taxpayers and tax administrators may take very different positions with respect to how profits should be split resulting in a substantial increase in mutual agreements procedures and potential double taxation. In addition, given the lack of consensus in the transfer pricing field on how to compute a profit split analysis, in particular defining the integrated profit of a transaction and selecting and applying the profit split criteria, there is a significant risk that OECD encouragement on the use of this method will lead to formulary apportionment.

7. Recharacterization/disregard of transactions

[5] In limited circumstances, especially in the context financial institutions and global dealing, countries have determined that compensation is a reliable method for allocating trading profits.

Footnote 5 of the Revised Discussion draft indicates that some country delegates believe that fact patterns like those reflected in Examples 13 and 14 could be appropriately addressed by disregarding or recharacterising transactions under paragraph 1.65 in some instances because such transactions would not normally occur between independent enterprises. Further work will be done as part of the BEPS Action Plan to "clarify the circumstances in which transactions can be recharacterised". (Action Plan Item 10.) MNEs need certainty thus recharacterisation ought to be a last resort. Further, it is difficult to understand the implications of the changes to Chapter VI if the foundation of the chapter – what transaction is being analyzed – is unclear. If additional changes to rules relating to recharacterisation are to be proposed, then all of the changes need to be considered in relation to one another and therefore additional consultation would be required.

As we have yet to see any indications of where this work is headed, it is hard to comment at this point. However, as noted previously, it is the role of transfer pricing to ensure that related party transactions occur at an arm's length price. It is not the role of transfer pricing, or of tax administration, generally, to dictate to business enterprises how to structure their commercial activities. We would also caution that any guidance on recharacterisation should be consistent with the guidance in Chapter IX of the TPG, which says that only in exceptional circumstances will it be legitimate and appropriate for a tax administration not to recognize, for transfer pricing purposes, a transaction that is presented by a taxpayer. Determining arm's length pricing is often a difficult exercise, but we believe it will only create uncertainty, confusing, and increased disputes if the circumstances in which recharacterisation is appropriate are expanded.

8. Arm's length pricing when valuation highly uncertain at time of the transaction

Section D.3 of the Revised Discussion Draft states that one area for future BEPS related work involves the transfer pricing treatment of hard to value intangibles. That work will include a detailed review of the language and approach currently outlined in the Transfer Pricing Guidelines on this topic.

This is another area where it is hard to comment in the absence of any specific proposal. We note that section D.3 of the Revised Discussion Draft already includes rules which would appear to allow OECD member countries to adopt rules similar to the U.S. "commensurate with income" rules. Leaving aside the question of whether those rules are consistent with the arm's length standard, we believe it would be impossible to devise any new rules for pricing "hard to value intangibles" which would still be consistent with the arm's length standard and also give tax authorities greater powers than they already possess under section D.3. We would exercise caution in this area, and emphasize the threat to the arm's length standard of creating any "special measures" to deal solely with "hard to value intangibles."

More specific paragraph-by-paragraph comments are provided below:

Par. 73 states that states that return ultimately retained by the legal owner depends on the contributions it makes to the anticipated value of the intangibles through the functions performed, assets used and risks assumed and upon the contributions of other MNE group members. The paragraph states where the legal owner makes no contributions that are anticipated to enhance the value of intangibles, the legal owner will not ultimately be entitled to retain any portion of the return attributable to intangibles. What Paragraph 73 fails to take into account is that the legal owner in many cases controls who gets to use the intangibles and the period of such use. This right to determine use may have significant value as illustrated in Example 6. In Example 6, X enters into a "long term contract" with S with respect to the sale of trademarked watches in Country Y. The trademark is not known in

Country Y. S is obligated under its contract to "develop and execute the marketing plan for Country Y without detailed control of specific elements of the plan…" The Example concludes that based on the fact that S marketing activities including its bearing of marketing expenses are not significantly different from those performed by independent persons, no separate compensation is required to be paid to S. Although the Example does not state what happens at the end of the contract, it appears that at the end of the contract, the legal owner of the trademark would have full rights to market the trademark in Country Y without further compensation to S. This situation is similar to many third party contracts in which a distributor has exclusive rights to a market for a period of time and at the end of the contract the rights revert to the legal owner. This Example illustrates the value of the legal owner's right to determine use of the intangibles and that the key is not who performs the Par. 79 functions but whether the persons performing those functions are paid arm's consideration.

Par. 99 states that no compensation shall be paid for use of a group name or trade name if the only purpose is recognition of group membership. Par. 99 refers to Par. 7.13 which states that passive association should be distinguished from active promotion of the MNE attributes that positively enhances the profit making potential of a member. Virtually all MNEs actively promote their group or trade name and attempt to associate positive attributes with the name. Virtually all MNEs have corporate marketing and communications departments that promote their group or trade name. We think Par. 99 should be limited to the use of corporate name in the legal name of the company. Any other use, which is likely to occur in most situations, should not be considered passive association.

Par. 131 should be edited from: "Similarly, a transferee should not be expected to accept a price for a transfer of rights in one or more intangibles that would make it impossible for the transferee to anticipate earning a profit using the acquired rights in the intangible in its business."
To: "Similarly, a transferee should not be expected to accept a price for a transfer of rights in one or more intangibles that would make it impossible for the transferee to anticipate earning a **risk-adjusted return** using the acquired rights in the intangible in its business."

Pars. 160 and 161 put limitations on the use of the cost method. These restrictions should generally be limited to valuable and unique intangibles. The market place is full of examples where competitors have developed competitive technologies without the assistance of the original innovator. MNE routinely make "make vs. buy" decisions with respect to intangibles and all of those decisions do not end up being "buy" decisions. In situations where the resources to "make" the intangible are readily available in the market place and timing is not critical, an arm's length party would generally not "buy" the intangible at a price substantially in excess of the cost of "making". The realistic alternative would be to "make" the intangible.

Par. 196 and Example 24 assume that the actual tax rates of the controlled parties should be used in determining their realistic alternatives. We believe that the tax rate that should be used in analyzing the parties' realistic alternatives should be the "market participant" tax rate. MNE are subject to a variety of different tax rates overall and for specific projects because of local laws and accumulated tax attributes. In general, we agree that MNE's do consider their effective tax rates in making an investment decision or deciding whether to purchase or license an asset. However, at arm's length, a potential purchaser or licensee will consider the effective tax rate of the other bidders. If everything else is equal, a purchaser or licensee would determine the tax rate of next highest bidder and bid slightly above that price, retaining any tax advantage that the purchaser or licensee would have over the next highest bidder. In related party transactions, it is not possible to determine the tax rate of the next highest bidder (unless one was to assume the seller's tax rate was the tax rate of the next highest bidder). Therefore, as an alternative, it makes sense to use a market participant tax rates i.e. the tax rates of other potential bidders in the industry. This approach is widely used by valuation professionals.

The Draft and examples contain a number of unsupported factual conclusions. We believe it is inappropriate to make broad based factual statements in the draft. Examples include:

Par. 156 states it will “often” be the case that comparables cannot be found for intangible transactions. We believe it would be better to simply state if they cannot be found.

Par. 160 states that there “rarely” is a correlation between cost and value. We believe it would be better to state that if there is not a correlation between cost and value.

Par. 179 makes a number of statements with respect to discount rates that may not be helpful and depending on the circumstances may be incorrect. For example, comparing the discount rate on merger and acquisitions to the discount rate on intangible development may only be relevant if the asset acquired in the acquisition are similar to the proposed project or have a risk profile that is similar to the proposed project. Similarly operational discount rates may be useful only if the proposed project has characteristics and a risk profile similar to the project to which the operational discount rate relates.

Example 6

The conclusion in Example 6 for the first 3 years does not necessarily follow. Startup losses are plausible. The legal owner is the residual owner of the rights in intangible and as the residual owner may under normal commercial practice be entitled to intangible returns.

Example 7

Option 3 in example 7 should not be an option as it disregards the parties’ transaction.

Additional consultation will improve the final revisions to Chapter VI

USCIB believes the open process adopted by OECD in developing new language for Chapter VI has been very fruitful and will ultimately result in more robust rules that will be consistent with the arm’s length standard and avoid double taxation. Although USCIB does not agree with everything in the current Draft, we recognize the OECD has made great strides in updating the rules. The OECD acknowledges that important parts of the Draft are not complete. These sections relate to other parts of the BEPS project that have just begun such as:

- Action 8 in which the OECD will develop transfer pricing rules or special measures for transfers of hard-to-value intangibles;
- Action 9 in which the OECD will develop rules relating to the allocation of risk and returns to capital; and
- Action 10 in which the OECD will develop transfer pricing rules or special measures with respect to transactions that rarely occur between third parties, which could include recharacterisation of certain transactions and the application of profit split methods.

USCIB believes that the decisions on these sections could have a profound effect on the current Draft. As mentioned above, the suggestions in these comments, if adopted, would benefit from additional discussions. For these reasons the USCIB strongly recommends that the OECD releases another draft including the additional sections discussed above and changes adopted after this consultation in order that a final consultation can be conducted before these important rules are finalized.

Sincerely,

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