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SHORT COMMENTS ON OECD PROJECT ABOUT TRANSFER PRICING ASPECTS OF INTANGIBLES

Dear Sirs ,

We appreciate OECD invitation to comment on intangibles , considering that on comparative analysis OECD already produced useful further clarifications to 1995 General Guidelines ; the intangibles work is essential since on comparative analysis “misunderstandings” may lead to small litigations between Administrations and Taxpayers while misunderstandings on intangibles lead to relevant litigations.

Moreover we think that is very important what is quoted in paragraph 9.11 of new OECD business restructuring document :

Accordingly, it would be a good practice for associated enterprises to document in writing their decisions to allocate or transfer significant risks before the transactions with respect to which the risks will be borne or transferred occur, and to document the evaluation of the consequences on profit potential of significant risk reallocations .

Risk allocation set up before that uncertain events are occurred is the base to understand which affiliate (or independent firm) is going to develop (or to fail in developing) valuable intangibles.

Therefore OECD is aimed to further clarify how firms are going to develop , hold and value (economic and/or/versus legal) intangible assets.

Scholars and practitioners are welcomed to express what they see as the most significant issues in relation to the transfer pricing aspects of intangibles; what shortfalls, if any, they identify in the existing OECD guidance; what the areas are in which they believe the OECD could usefully do further work; and what they believe the format of the final output of the OECD work should be.

Here are our comments.

We already expressed several opinions on transfer pricing at arm’s length and on OECD Guidelines in academic seats ¹, in specialized journals ² and also as public comments to OECD draft documents ³.

¹ [Musselli, A.](#)

[_Arm’s length intragroup intangible transfers: economics, regulations and actual behaviours - UNIVERSITÀ COMMERCIALE LUIGI BOCCONI - MILANO -ECONPUBBLICA -WORKING PAPER SERIES n.108/2006, in Bocconi University website but also on website of SOCIAL SCIENCE RESEARCH NETWORK – <http://www.ssrn.com/abstract=878443>](#)

² [Musselli, A. Marchetti Hunter, D.](#)

[United States: Glaxo transfer pricing case : economic rationale, legal framework and international issues](#) IBFD-INTERNATIONAL TRANSFER PRICING JOURNAL (ITPJ) Volume 14, 2007, No. 3

[Musselli, A. Musselli, A.C](#)

[Comparative Survey on OECD discussion draft on transfer pricing aspects of Business restructuring: Italy](#) IBFD-ITPJ Volume 16, 2009, No. 2

[Musselli, A. Musselli, A.C](#)

[Observations on OECD Discussion Draft on Business Restructuring: Is the Notion of Control over Risk at Arm’s Length?](#) IBFD- ITPJ Volume 16 , 2009 , No 4

[Musselli, A. Musselli, A. C](#)

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We specially focused on which are conditions for assessing the existence of intangibles in integrated economic activities and specific investments contexts and particularly on marketing performed by firms not owning trade names.

Here is not the place to recall same ideas and we write only short considerations putting ourselves at OECD disposal for further clarifications that we expressed in works quoted in footnote. We are ready to explain concepts if requested or *de visu*.

1) We think that OECD should clarify how ,at arm's length , affiliates become owners of Intangibles or "of something of value" , irrespective of its characterization as intangible asset.

On marketing expenses the starting point must be a clear guidance on why and how it's at arm's length that economic functions are performed under the scheme of Principal- Agent and the service (agency) agreement in distributor case.

In fact ,on the production side , Guidelines well explain the notion of contract manufacturer and new chapter IX (2010 Guidelines) explains more deeply the last notion and that one of the contract researcher.

Indeed ,on the distribution –marketing- side, there is a short passage in OECD Guidelines about the "contract distributor", (that is the service provider for distribution-agency functions to whom is assured , ex ante, the covering of costs, including marketing costs) , but this is not sufficient : in fact Administrations do not apply consistently ,in different Countries, this Guidelines passage.

We note that Guidelines affirm that "one relatively clear case is where a distributor acts merely as an agent, being reimbursed for its promotional expenses....." (OECD 1995 version- paragraph 6.37).

Guidelines continue that not assuming any risk "the distributor would be entitled to compensation which is appropriate to its agency activities alone and would not be entitled to share any return attributable to marketing intangible" (OECD -1995- paragraph 6.37 which is consistent with the end of paragraph 2.24- note that we refer to paragraphs as numbered in 1995 version of Guidelines).

Now OECD should clear the guidance on when marketing function is considered as actually performed by firms, given which is the affiliate assuming related risks and on base of new concepts about hiring the key people targeted in managing those risks (concepts introduced with chapter IX of Guidelines – Business restructuring document).

In some spectacular cases around the world marketing has been deemed a "special function" , able to create intangible properties in the hand of the distributor , even in the case distributor marketing expenses were reimbursed ex ante with guarantee ; that is , the marketing intangible property has been considered as developed by marketer/distributor also when was current –ex ante transactions- an agreement assuring to distributor a full expenses reimbursement in nearly every possible state of the world.

Is it sufficient for a clear guidance on marketing function the new concept introduced by OECD in the document on business restructuring that for assuming risks of any performed function the firm must hire executive employees able to manage risks sourcing by performing the function?

OECD should clarify that rules enforced for contract researcher and contract manufacturer are eligible for contract (agent) distributor too; for instance , imagine the case that key marketing managers are in force to distributor in local market but that all costs for marketing function – including salaries of local entity- are

[Stripping the functions of affiliated distributors](#) IBFD-ITPJ Volume 15, 2008, No. 6

Musselli, A. Musselli, A. C

[Stripping the functions of producing affiliates of a multinational group : addressing tax implications via economics of contracts](#) IBFD-ITPJ Volume 15, 2008, No. 1

Musselli, A. Musselli, A. C

[The arm's length standard in multinationals' taxation: economics, regulations, firms' and administrations' behaviour](#) BNA INTERNATIONAL - TAX PLANNING INTERNATIONAL TRANSFER PRICING , OCTOBER 2007

³ Musselli , A.

[Public comments to OECD on the Transfer Pricing Aspects of Business Restructurings, at www.oecd.org/dataoecd/1/49/42266748.pdf](http://www.oecd.org/dataoecd/1/49/42266748.pdf)

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reimbursed from producer -ex ante- to distributor ; is still possible to characterize the distributor as an agent or is the distributor the party who is eventually going to co-develop marketing intangibles?

Reading new chapter IX of Guidelines it seems that for considering the producer as the sole developer of eventual marketing intangibles when marketing expenses are reimbursed to distributor it must be that producer hires employees able to decide whether to continue or terminate the contract with that particular marketer-distributor ,to set a target to the marketing activity , to evaluate the success or the failure of marketing activities and to decide the marketing budget allocated to distributor. (Agent) Marketer must report to (Principal) producer about activity.

The above mentioned decisions are the similar decisions that a Principal must take about a contract researching agreement as requested in paragraph 9.26 of chapter IX -2010 Guidelines - (business restructuring document):

“the decision to hire (or terminate the contract with) that particular contract researcher, the decision of the type of research that should be carried out and objectives assigned to it, and the decision of the budget allocated to the contract researcher.

Moreover, the contract researcher would generally be required to report back to the principal on a regular basis, e.g. at predetermined milestones”.

Is this the right exegesis of Guidelines about trade names not owned by distributors?

And which could be a mode allowed by OECD for valuing marketing contribution of the distributor in the opposite case of the one above depicted when expenses are not reimbursed to same distributor and given the presence of pre-existing intangibles in the hand of the producer?

2) More generally we think that the right path to have a clear guidance on intangible issues is to go on the “something of value” concept (as OECD is going on) like a more wide notion in contrast to the target to “approve” a list of intangible properties.

But this path must be limited and clarified into the approach of economics of contract.

Mrs Silberztein worthy discussion in BNA Transfer pricing report (dated July 1 2010) underlines that OECD is aimed to focus the notion of unprotected marketing intangibles , business opportunities , workforce in place and similar concepts in lieu of an exhaustive list of intangible properties.

We share this opinion but we think that the work could be really enhanced by using concepts developed in “economics of contract”.

Economics of contract concepts allow to limit and well define the list of values to be included in the notion of “something of value” : if OECD doesn’t limit that notion the list becomes or too wide or very similar to a (purported exhaustive) list of intangible properties.

In our opinion OECD must base outcomes related to “something of value” concept on a logical pattern able to explain those outcomes but so logically surrounded in a way to rule also (future) cases which have not been specifically dealt with.

We are referencing to economics of contract notions about investments aimed to a locked trade relationship , complete contract and asset ownership.

We repeat that this is not the place to deep the mentioned notions (these notes would become too “large”, eventually see works in footnotes) and our target is only to underline some key aspects: the party who is planning to make specific investments (locked into a trading relationship) must agree for a complete contact in order to prevent moral hazard of the counterparty and when that’s not possible must agree for a particular asset ownership.

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In this way we are going to overcome the notion of intangible property and the source of the notion of “something of value” for the specific investor is to be found just in “actions” aimed to prevent/limit counterparty moral hazard leading, and finally preventing also, the hold up of specific investment.

More up : in business restructuring contexts the termination of the relationship which occurs before of the planned contractual term is nothing more that a breach of the current complete contract and the breaching party must restore the specific investor for missing profits (allowed in using assets developed during the relationship)

We would like to recall short passages and the table of content of a written comment we sent to OECD about “2005 Business restructuring roundtable”, which is consistent with concepts included in chapter IX of new Guidelines and also includes ideas about the general model to be enforced in ruling the arm’s length principle and in line with economics of contracts.

We think that it’s the right line to follow.

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1 The benchmark economic model

- 1.1 Which economic model is inbuilt in OECD Guidelines ?*
- 1.2 The efficiency rule : sharing extra profits or losses of integrated business among units on base of assumed risks*
- 1.3 Topic to comply with efficiency rule*
 - 1.3.1 The need of detecting business risks and the burden to share them before uncertainty is solved*
 - 1.3.2 The contract role*
 - 1.3.2.1 Independent parties sharing of risks by proper agreements*
 - 1.3.2.2 Affiliates sharing of risks by proper agreements to show arm’s length conduct to Fiscal Administrations*
- 1.4 The problem of Government audits, arranged when transactions are already carried out and uncertainty is solved*

2 Solving “stripping of function” issues by the proposed model

- 2.1 Focus not only on prices but on whole agreement included, among others, relationship termination clauses*
- 2.2 Analyzing a case related to roundtable papers.*
 - 2.2.1 Distributor turned into a commissionaire when, in the past, it has assumed name developing risks and now are known strategy results.*

We quote other short passages of our 2005 comments about the need that whole agreements are consistent with the purported risk configuration. We underlined a notion of control (of the Principal about Agent activity when this last doesn’t share entrepreneurial risks) consistent to the one depicted in chapter IX of 2010 Guidelines.

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I point out that Taxpayers have to fix arm's length conditions before uncertainty is solved, and they must look not only at prices but at the whole agreement, considering all provided clauses relating to their duties and rights , on occurrence of future and uncertain events.

The notion of agreement is wider than that of price: price is only one of conditions , together with other clauses , constituting the whole agreement.

For instance consider a case, several times mentioned in the roundtable, where a foreign producer is assuming the most important part of entrepreneurial risk of activity and a local distributor is charged to market the local Country.

Assume the remuneration for the distributor is set in a way that is consistent with reward of independent parties performing similar functions.

Till now I have considered only prices and returns of the distributor but conditions are to be considered at arm's length only when they are evaluated together with other clauses ruling the relationship, i.e.:

➤ *The degree of control of the foreign producer (Principal) on distributor business activity; i.e. a low risk distributor, that loses inventory risk and buys products only when same products are already sold to final customers, earning a little commission on selling price , has no or little incentive to render an efficient service for growing foreign producer revenues.*

Principal - Agent theory⁴ notices that the foreign producer (Principal) countermove is to impose a detailed distributor conduct in the agreement and a relevant penalty for any breach.

The heavy subjection of the low risk enterprise to its commitment is a result to be taken in mind in our analysis and that may be useful also discussing stripping of function issues . Obviously, ex ante, we must not forget that in a group context avoiding distributor moral hazard is not difficult, cause the control on business activity of all group companies is enforced by a hierarchic subjection to mother company guidance, even with mother company power of electing other companies directors, and so without any need of Judicial intervention .

The utility to consider such a type of contract benchmark is to evidence to minority shareholders, stakeholders and Fiscal Administrations the "nature" of negotiation that must be at arm's length .

➤ *The contractual term of the relationship (contract life); i.e. a contract between a foreign producer and a low risk distributor may be terminated with a short period notice. But when a fully fledged distributor, or better, when a distributor is trying to enhance the name of the producer in the local market by investing in marketing more than a "normal" distributor, the contractual term must be ruled.*

Here, arm's length dealing, an economic operator would have not invested for years in a trade name without having assured, ex ante, at the beginning of its investment plan a way, had the penetration strategy success, to recover costs and to gain an adequate profit .

So the arm's length negotiation must involve a critical period to carry on investments, and to try to adequately recover them.

In this perspective the eventual contract termination must be ruled.

We would be glad to explain in more detail to OECD working party members some applications of these point of views related to all issues on focus, like marketing distributors , workforce in place , profit

⁴ See , Salaniè – *The economics of contracts – Mit Pres –1997*

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potential and how the economics of contract pattern can be powerful in giving a consistent approach both to intangibles and business restructuring issues. We are also ready to explain *de visu* some of the concepts already developed in works quoted in footnote.

In conclusion and answering to OECD questions:

- a) We appreciate that OECD is willing to deep which are conditions for that independent parties are going to develop intangible properties or “something of value” , given a specific investment locked into a trading relationship ; the discussion could target issues like workforce in place , profit potential but we think it’s essential to deal with those individual cases basing outcomes under the consistent pattern characterized as “economics of contract”.
- b) On marketing undertaken by firms not owning trade names just OECD Guidelines seem to express a guidance but we know that Administrations in various Countries have different approaches about it ; we think that also this issue could be solved as mentioned in previous point a) , irrespectively of specifying the notion of marketing intangibles. We share the notion of “something of value” overcoming the list of intangible properties but we warn again that this notion, for reaching an economic sense, must be limited and fully developed under economics of contract theory. It must be cleared whether rules depicted for contract manufacturer and researcher are eligible , *mutatis mutandis*, also for contract (agent) distributor.

The OECD work might lead in a revision of 1995 (now 2010) Guidelines in the part related to intangibles and to services and could unify ,in a consistent project , also guidelines on business restructuring.

We put ourselves at OECD disposal also to further clarify these short notes: we would be glad eventually to better explain our point of views (that we already expressed in works quoted in footnotes) in a future meeting.

We thank OECD giving interested parties opportunity to explain their points of view and we think it’s important that , before of ruling with sovereign decisions , OECD has an open discussion just to improve final decisions.

Kind regards.
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