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OECD Invitation to Comment Transfer Pricing Issues on Intangibles

Dear Mr Owens,

Thank you very much for the opportunity to comment on the OECD discussion on "**Transfer Pricing Aspects and Intangibles**". We would like to take this opportunity and share a few thoughts that are based on our practical experience in advising multi-national enterprises in matters of transfer pricing and intangibles.

For the sake of clarity, we have deliberately divided our comments into a first section dealing with more general aspects of this complex subject matter and a second section that contains some specific reflections on the already existing OECD Transfer Pricing Guidelines.

1. General Remarks

At first it has to be welcomed that intangible assets will be subject to a thorough analysis of the OECD, as intercompany transactions involving intangible property play an **increasing role** in disputes with tax and revenue authorities. The huge (and still growing) volume of intangible assets arising from the fast moving technology sector in national economies as well as the globalization of markets means that intangible assets nowadays are assigned a **key role** in the value chain of multinational companies.

Unlike tangible assets, intangible property is "non-rival" and can – in principle – be employed simultaneously by multiple users without diminishing its usefulness. The nature of intangibles enables them to act as a **major value driver** of business success in many business sectors today. In practice, the complexity of intangible assets specifically becomes visible when **identifying, determining and valuing** them. Given this, updated and of course more detailed international guidance is urgently needed.

From a more general perspective, the most relevant issues that should be subject to an in-depth analysis by Working Party 6 are, in our view, the following:

- **Proper definition** of the term "intangible asset" in a transfer pricing context (in particular with regard to intangible assets that are not legally protected by way of official registration (e.g. know-how));

- Description and determination of prerequisites of **legal and beneficial ownership** in intangible assets;

- Forms of **transferring** intangible assets and **related valuation** between related parties;

- Application of **transfer pricing methods** with regard to inter-company transactions that include intangible assets and impact of intangible assets on the **function and risk profile** of related parties;

- Specific **documentation requirements** for developing, administering and transferring intangible assets.

In light of these a.m. key issues, we would like to make the following brief remarks that specifically refer to selected paragraphs of the current version of the OECD Transfer Pricing Guidelines 2010 (hereinafter "OECD Guidelines"):

2. Chapter VI of the OECD Guidelines

2.1 Paragraph 6.2 – 6.4

Paragraph 6.2 and specifically paragraphs 6.3 and 6.4 contain an extensive description of the term "intangible property". These descriptions **only** include an **enumeration** of different **examples** of intangibles (e.g. commercial and trade intangibles or marketing intangibles) and their occurrence in business life. However, there is **no generic definition** of the term "intangible property" given which – specifically when it comes to the question of how to identify relevant key factors for the valuation of intangible property from a macro-level perspective – could provide **more clarity and practical guidance**. A generic definition should at least include the key features of an intangible asset, e.g. its non-physical nature, its (potential) ability to be separately identifiable from other business assets, its ability to be transferred between different (legal) entities, its ability to be legally protected or to be protected by legally accepted de-facto rights and, ultimately, its ability to produce benefit to a business activity.

Moreover, the OECD seems to split the definition of "intangible property" into the subdivision of "**commercial (or trade) intangibles**" – which e.g. are used for manufacturing products or performing services – and the subdivision of "**marketing intangibles**" – which are used for supporting the distribution of products and performance of services. Such differentiation seems to be largely based upon the theory of classical industrial production. However, in modern business life the differentiation between producing and distributing goods in the market becomes more and more **archaic**. A revision of Chapter VI of the OECD Guidelines should, for that reason, take into account **changed economic parameters** that have a significant impact on the importance of intangible assets in the value chain of multinational companies.

2.2 Paragraph 6.4

Paragraph 6.4 contains a **list of factors** that may influence the value of marketing intangibles (e.g. reputation and credibility of a trade name or a trade mark enhanced by the quality of the goods or services provided under the name or mark in the past, degree of ongoing R&D activities etc.). Such an illustrative list of valuation factors differs from paragraph 6.3, which does not provide a comparable description of relevant valuation parameters for commercial intangibles. As the **identification of factors influencing value** in general is one of the key issues in controlled licensing transactions, a **generic description** of valuation factors – both for commercial and trade intangibles – should be included either in paragraph 6.3 or in 6.4 containing the following typical elements: geographic range, exclusivity and extent of rights granted (e.g. right to sublicense), investments made in order to obtain the license right, extent and duration of potential legal protection from a legal and economic perspective, right to use future developments and improvements, market and competition environment, risk situation of licensee and licensor.

2.3 Paragraph 6.5

The OECD Guidelines treat intellectual property such as **know-how** (within the meaning of Article 12 OECD Model Tax Convention) and **trade secrets** as a specific form of intellectual property. However, know-how positions within the meaning of Article 12 predominantly relate to technology-based know-how. For this reason, commercial know-how seems to play a **less important role** in the OECD Guidelines, although in the last sentence of paragraph 6.5 the OECD admits that "know-how" and "trade secrets" frequently play a "significant role" in the commercial activities of related parties. The role of commercial know-how should consequently be strengthened in the OECD Guidelines, as in certain cases the exploitation of commercial know-how (e.g. marketing or customer retention expertise) can be of **similar importance** for the business success in comparison to the exploitation of technology-based know-how.

In addition, the OECD should pay more attention to the fact that the existence of know-how and trade secrets are, in many cases, **closely linked to the personnel or staff employed**. Hence, a company may only be in the position to exploit know-how or trade secrets successfully as long as the respective personnel is available. Such a notion is closely related to the concept of "**significant people function**" ("SPF") relevant to the assumption of risks and the attribution of (beneficial) ownership in tangible and intangible assets used as described in the recently finalized OECD report on the attribution of profits to permanent establishments. Although the SPF concept aims at identifying the relevant function and risk profile for an arm's length attribution of profits between a permanent establishment and its head office, its **fundamental idea** is also valid for analyzing functions and risks between separate legal entities under Article 9 OECD Model Convention. Accordingly, the fact that know-how positions or trade secrets are actually held by specific personnel of a related party must have an **effect on its function and risk profile** in controlled transactions and consequently on the overall transfer pricing characterization of related parties and their position in the value chain.

2.4 Paragraph 6.6 and 6.7

The insight described in paragraph 6.6 that care should be taken in determining whether a trading or marketing intangible **exists** is also true in cases where "**business opportunities**" are involved. Tax authorities tend to take the view that valuable business opportunities – for example – already exist, if an enterprise gives up "something of value", even if it is entirely unclear whether that "something" can be regarded as a right, a de-facto right or a (legally protected) position which has an intrinsic value. Therefore, further guidance is needed how to analyze **under which preconditions** "business opportunities" can be regarded as valuable intangibles. Particular attention should be paid to the newly introduced **Chapter IX of the OECD Guidelines**, which summarizes the results of the "Business Restructurings" discussion. In this regard, paragraph 9.65 (et seq.), which deals with reallocating "profit potential" in the case of a business restructuring, should also be taken into account.

Similar questions arise if **legally unprotected know-how positions** are concerned. If know-how, which is not subject to official registration (e.g. like this is, for example, the case for patents or trade marks which are registered) is made available either by way of transferring or licensing, remuneration cannot be due in any case. As a rule, in an arm's length situation a remuneration is only considered if the transferred or licensed know-how provides a **concrete and substantial economic benefit** that can be **separately identified**, **measured and documented**. This consideration has significant importance in secondment cases, as through the work of assigned experts, the receiving company usually also obtains their knowledge and working experience. However, as long as the assignment does not go along with a concrete granting of (separately identifiable) rights or legally protected positions like technical plans, samples, formulas (etc.), such making available of know-how would **not** be remunerated separately between unrelated parties.

Additionally, the consideration already included in paragraph 6.7 that the creation of intangible assets needs to be **reflected in the function and risk profile** of a company is of an **elementary nature** and should be analyzed in detail by giving more practical examples (cf. also paragraph 1.44 of the OECD Guidelines).

2.5 Paragraph 6.13 – 6.15

It is one of the key statements in the intangible property discussion that intangible property is – in the majority of cases – characterized by its **uniqueness,** which makes it difficult to value intangible property in controlled transactions. The OECD therefore also lays emphasis on a hypothetical arm's length test that comes very close to the "**prudent business manager standard"** which is used to reflect what unrelated parties (more precisely "two prudent business managers") would potentially agree.

The hypothetical arm's length test raises a variety of additional questions. At first, an economic benefit analysis has to be performed that takes into account the field of use of the intangibles and their assumed contribution to the value chain. For example, the use of a trade name or a trade mark that is identical to the company name can only be subject to a license in return for payment, if the trade name or trade mark has a **genuine economic value** that can be separately used by the licensee, e.g. enhancing sales potential in the market.

Moreover, when assessing the economic benefit deriving from a licensed patent a comprehensive analysis of the underlying economic circumstances is required. Such analysis has to consider what **alternative business transactions** might have come into consideration instead of the controlled licensing transaction. If the licensee generates ongoing losses with products manufactured by using the licensed patent, such licensing does **not automatically** contradict the arm's length principle. The loss situation may be caused by **various other factors**, e.g. by inefficient production or a lack of manufacturing quality or even by unskilled personnel.

The question whether other "**realistically available options**" (cf. paragraph 6.4 sentence 4) are available to the licensee is therefore **difficult** to handle in practice. It leads back to a "**commercial rationality behavior test**", which also touches the debate about "non-recognition" of controlled transactions. In the view of the OECD, the term "commercial rationality" will be measured on the basis of the "options realistically available" to a taxpayer. Paragraph 9.171 (et seq.) of the newly introduced Chapter IX of the OECD Guidelines, for example, states that in an arm's length situation independent parties would always evaluate the terms and the economic consequences of a potential transaction. The same thinking is also included in paragraph 6.4 of the OECD Guidelines.

The principle of "options realistically available" is – from an economic point of view – nothing but tantamount to a "**make-or-buy decision**". It is – in other words – a business decision that compares the costs and benefits of different business strategies. However, that does not answer what exactly can be regarded as "realistically available": Does that mean that only the **particular economic and commercial circumstances** of the taxpayer's situation (for example his business equipment, his financial resources, the human resources available and his willingness to take risks) have to be considered? Secondly, it remains unclear at what **point in time** such evaluation has to be conducted. Does "realistically available" mean that only the information available at the time the controlled transaction is entered into has to be considered or does that mean that the tax authorities may also be entitled to use "**hindsight knowledge**" which emerges in later years? Concerning this matter, paragraphs 6.14 and 6.15 of the OECD Guidelines should therefore come under close scrutiny.

2.6 Paragraph 6.16 – 6.18

In practice, it is very often questionable whether intangibles have already been transferred to a licensee by changing the beneficial ownership of these assets. The OECD Guidelines are rather vague in this regard, given the fact that the attribution of intangibles to one of the transaction parties **significantly impacts** their function and risk profile.

In traditional business models, legal ownership of intangible assets is often also the beneficial ownership of these intangible assets. Hence, the legal owner is also liable for maintaining and increasing the value of these assets. However, in many areas of today's business life **legal and beneficial ownership** of intangible assets **diverge,** and ownership may be dispersed among many group companies. It is therefore a major issue to clarify the impact on legal and beneficial ownership on the **function and risk profile** of related companies in intercompany dealings, as many intangible assets constitute considerable value and risks for a company, even though they have no book value in the company's balance sheet (cf. paragraph 6.2 of the OECD Guidelines).

Legal ownership is based on the concept of existing legal title and legal protection of an intangible asset. It therefore depends on the legal owner's right to deal with that asset at its sole discretion. In contrast, **beneficial ownership** is determined by the understanding that the party that bears the greatest share of development or "maintenance" costs of an intangible asset correspondingly holds its beneficial ownership. Hence, beneficial ownership is a common term when analyzing **license or even lease transactions** where the licensee or the lessee assumes the **benefits and risks** from using the licensed or leased asset, while the licensor or the lessor only retains legal title. Even though a transfer of legal title does not take place, according to that understanding, beneficial ownership of an intangible asset is already the case if the user bears the **economic costs and risks**, but also enjoys the respective **economic benefits**. The threshold for assuming beneficial ownership might therefore be significantly lower than for legal ownership, which usually requires legal transaction.

The OECD Guidelines (cf. paragraph 6.36 et seq.) seem to put a strong emphasis on the **concept of beneficial ownership** as far as marketing intangibles are concerned, still noting that such approach may lead to "significant transfer pricing problems" (cf. paragraph 6.36). However, many tax authorities have a divergent understanding of "ownership rights in intangible assets" and still emphasize that **legal title** is to prevail over the "nebulous" approach of taking over ownership by bearing related economic risks (cf. for example, the landmark case *DHL Corp. v. Commissioner* in the US). However, the remarks made in paragraph 6.36 of the OECD Guidelines, on the one hand, sound logical that taking over the "economic burden" of exploiting intangible assets must be properly reflected in the underlying remuneration the licensee has to pay to the licensor (e.g. by reducing royalty rates in cases of extraordinary marketing expenditures), as the licensee adds **additional value** to the intangible asset legally owned by the licensor. On the other hand, it remains unclear under which prerequisites taking over the "economic burden" of exploiting an intangible asset might cause a transfer of beneficial ownership (and thus to a potential realization of hidden reserves as a taxable event). This is obviously one of the key issues when discussing migration of intangible property from a tax and transfer pricing perspective.

Moreover, it is not clear whether the concept of beneficial ownership can be applied with regard to **trade marks**. A trade mark license agreement between related parties, once it is terminated, does not lead to the fact that the economic value of that trade mark is reduced; it is now simply with the licensor. The trade mark could – in principle – be licensed to another party **without sustaining a loss in its awareness** by market participants, while the former licensing party would be **legally excluded** from generating any further benefit from that trade mark. This situation – given the principles of the arm's length standard – would similarly occur between unrelated parties where the former licensing party would legally be prevented from making any further use of the trade mark.

Last, it has to be noted that in a situation described in paragraph 6.18, where a license is granted in respect of all industrial and intellectual property being bundled in a license package, the question may occur how to make a **clear distinction** between a "package license contract" and a "business restructuring" covering several (intangible) assets as defined in paragraph 9.1 of the newly introduced Chapter IX of the OECD Guidelines.

2.7 Paragraph 6.20 – 6.25

Calculating an arm's length consideration for intangible property leads to the question already touched upon whether intangible property is ultimately transferred (e.g. through an acquisition) or only licensed to a related party.

If a "transfer" of legal ownership (change of legal title) has taken place, comparable uncontrolled prices are – due to the uniqueness of most intangibles – usually not available. Nevertheless, in order to properly reflect the fair market value of intangibles transferred, comparable uncontrolled prices may be established under common valuation methodologies, in example (i) the **income based valuation approach** and (ii) the **cost based valuation approach**. The income based valuation approach is partly retrospective and partly prospective, as it both focuses on historical earning data and on forecasted earnings. In order to narrow down the future earnings potential usually discounted cash flow analysis is used with discounting that part of future cash flows that has to be attributed to the intangible assets used. In contrast, the cost-based valuation approach uses historical production costs (or even their replacement costs) for valuing intangible property. However, costs incurred for developing or producing intangible assets in many cases **weakly correlate with potential future earnings** so that a cost-based valuation approach may only come into consideration in few cases (cf. paragraph 6.27 of the OECD Guidelines). However, the OECD Guidelines give only little guidance how to apply a proper remuneration methodology in practice, as they only mention "expected benefits from the intangible property (possible determined through a net present value calculation)" as a suitable valuation parameter (cf. paragraph 6.20). A precisely described framework of accepted methodological valuation approaches would be supportive, as it would provide the taxpayer with guidance how to prepare internationally accepted valuation calculations and the respective underlying documentation in discussions with tax authorities.

If intangible assets are subject to **license agreements**, the determination of arm's length license rates reveals **similar issues**. Although paragraphs 6.20 and 6.21 of the OECD Guidelines provide the taxpayer with some examples of important factors relevant for determining an arm's length remuneration, the underlying methodological framework remains rather vague. The applicability both of standard and profit-based transfer pricing methods with regard to intangible assets has been discussed for quite some time in relevant economic and tax literature contributions and has recently been further elaborated – at least partly – in the revised Chapters I – III of the OECD Guidelines.

In particular, many tax jurisdictions accept profit-based methods in respect of intangible property with great reservation and make them subject to an intensive transfer pricing scrutiny, an "**orientation guide**" may also be discovered in the so-called "**rules of thumb**" which could serve as additional **plausibility checks.** Empirical studies have shown that a large percentage of royalty negotiations arrived at a royalty rate that was equal to approximately **one-quarter to one-third** of the licensee's anticipated (pre-tax) profits derived from the use of the underlying technology ("*Goldscheider Rule*"). Moreover, in terms of determining royalty rates, many industries´ negotiations between unrelated parties frequently yield a royalty rate of **around 5% of net sales** (which is extensively discussed in the relevant economic literature). Given this, "rules of thumb" can – **as long as no exceptional situation arises that would cause unrelated parties to determine different pricing ranges** – provide for a **reasonableness test** that might enhance the tax authorities' comfort with the arm's length character of royalty rates applied.

One further approach to performing a plausibility check might be to use an overall profit-orientated testing procedure, meaning that a royalty rate that leaves the licensee – at a company-wide macro level – **within the range** of identified arm's length margins derived from database analyses can usually be regarded as **reasonable**. This means that if the appropriateness of a royalty cannot be judged by using a comparable uncontrolled price, the starting point for examining the arm's length nature of the royalty should be the consideration that a prudent and diligent business manager would only accept a royalty, which leaves the licensee company with **sufficient profits** from exploiting the licensed intangible asset.

2.8 Paragraph 6.28 – 6.35

In cases of a **highly uncertain valuation** of an intangible asset one of the key problems is (i) the question whether the valuation was indeed "sufficiently uncertain" and (ii) which point in time has to be taken as being relevant for judging the existence of the "significant uncertainty".

In this regard, it should be clearly underlined in the OECD Guidelines that tax authorities are **not allowed to use hindsight knowledge** as this would contradict the arm's length standard (cf. paragraph 3.73 of the revised OECD Guidelines). Rather, stringent conditions are required under which tax authorities may challenge the taxpayer's valuation assessment, as otherwise a **backdoor for a "commensurate with income" standard** would be introduced. The evaluation performed by a taxpayer in respect of potential future events that may affect the value of intangible property has to be accepted by the tax authorities and cannot be replaced by its own commercial judgement, provided that it is based on sound economic analyses.

As a matter of principle, a retroactive pricing adjustment can therefore only be considered if the underlying valuation assumptions made by the taxpayer do not properly reflect the economic and commercial reality of the controlled transaction and such inappropriateness was so much **evident** at the point in time the related parties entered into the transaction that unrelated parties would have taken reasonable counter-measures (e.g. by agreeing upon royalty rate adjustment clauses or a variable royalty rate in general). To make it clear: Challenging the taxpayer's valuation assessment is the "great exception", not the rule and it can only come into question in cases of **evident misuse** of valuation leeway.

Moreover, the OECD Guidelines should clearly impose the **burden of proof** for the assumption that unrelated parties would have behaved differently on the tax authorities, provided that the taxpayer has prepared sufficient documentation (cf. also below).

2.9 Documentation Issues

Since intangible assets – as already mentioned – are in many cases not recognized in the balance sheet of a company, the existence and the value of intangible property is one of the **most sensitive issues** in transfer pricing. As the documentation of transfer pricing matters can be very onerous, particularly in cases where intangible assets have been created, a huge degree of additional documentation efforts seems to be burdened on the taxpayer.

In order to keep the documentation of intangible assets at a level that is **manageable in practice**, tax authorities should – as a rule – only be allowed to request data material that has already been prepared by the taxpayer in its ordinary business conduct (e.g. for business controlling purposes). The taxpayer should **not be forced** to prepare **additional data material** solely for tax purposes.

Moreover, taxpayers and tax authorities should explicitly **seek close cooperation** in this regard, in order to avoid excessive documentation requirements (cf. paragraph 5.29 of the OECD Guidelines).

It has also to be kept in mind that proper documentation of intangible assets, their creation and value determination provides the taxpayer with **massive support** to defend his position against the tax authorities, particularly with regard to legal and/or beneficial ownership of intangible assets, as tax authorities, once conclusive documentation has been compiled, are forced to conduct their own analysis.

3. Chapter VIII of the OECD Guidelines

3.1 General Remark

Our comments on Chapter VIII of the OECD Guidelines will be limited to the difficult question how to set up a cost contribution arrangement ("CCA") in cases where the future participants have already conducted R&D activities on a **stand-alone basis**, but now wish to **contribute their R&D results** into the cost pool sphere.

Multinational companies – considering their strategic planning how to manage their intangible assets – are free to choose an appropriate form of intangible property organization. Hence, in practice intangible asset ownership can be organized either as a **centralized** asset ownership (e.g. by implementing central "IP companies") or as a **distributed** asset ownership model (e.g. by using a CCA).

Since many multinational companies have an asset ownership structure due to historical circumstances (due to the way intangible assets have been developed or managed throughout the group), sound business reasons may cause multinational companies to **reorganize** its group-wide intangible property ownership and management. Setting up a CCA can therefore be a reasonable form of intangible property organization that helps to generate synergies or to obtain significant cost savings compared to stand-alone R&D activities.

3.2 Already Existing Intangibles in Cases of Setting Up CCAs (paragraph 8.32)

However, establishing a CCA leads to the question how to value intangible property that is brought in by the CCA members and that will subsequently be shared amongst them.

In a situation where a CCA is introduced and all pool members have to be regarded as "**new entrants**" that bring in already existing intangible property, the questions arises how to treat such **start-up contribution** of intangible property. Paragraph 8.31 and 8.32 of the OECD Guidelines principally state that any transfer of pre-existing rights are to be based "**upon an arm's length value**" which brings us back to the question how to determine fair market value of these intangibles.

Moreover, such guidance only aims at situations where a new participant enters into an already existing cost pool and does **not** answer the question how to determine balancing payments if a cost pool is established from scratch. Even paragraph 8.32 sentence 3 of the OECD Guidelines only focuses on the situation where a new entrant participates in already existing intangibles, but also brings in his own intangibles. In such cases the OECD Guidelines admit that mutual "balancing payments" may be netted. However, the question how to behave if **all pool members are new entrants** that bring in already existing intangibles developed on a stand-alone basis is not answered.

It has to be kept in mind that if the participants of the cost pool are obliged to conduct a **complex valuation** of their pre-existing intangibles – in order to determine fair market value –, such valuation procedure leads to a "**de facto prohibition**" of establishing new cost pools, as in practice it is hardly manageable to perform such difficult and extremely time consuming valuation exercises. Moreover, the realization of hidden reserves would trigger an enormous tax burden. Consequently, setting up CCAs in cases where R&D activities have already been conducted by the members on a stand-alone basis would effectively not be feasible.

Hence, in a situation where a CCA is to be established and pre-existing intangibles have to be brought in by the members, it could be reasonable – in order to facilitate the valuation procedure – to allow a **cost-based valuation approach**, meaning that the "arm's length value" of the intangibles brought in will primarily be derived from their historical development costs or even their reproduction costs.

Such approach could specifically come into consideration where pre-existing intangibles brought in by the participants of a CCA are of **similar type and quality** and are not characterised by their unique economic significance (e.g. **routine intangibles**).

We trust that these brief remarks may serve as a thought-provoking resource for the further discussion.

The OECD is hereby authorized to publish these remarks on the OECD website or in any other OECD publications dealing with transfer pricing issues and intangibles.

With kind regards,

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