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Mr Jeffrey Owens
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Dear Mr Owens

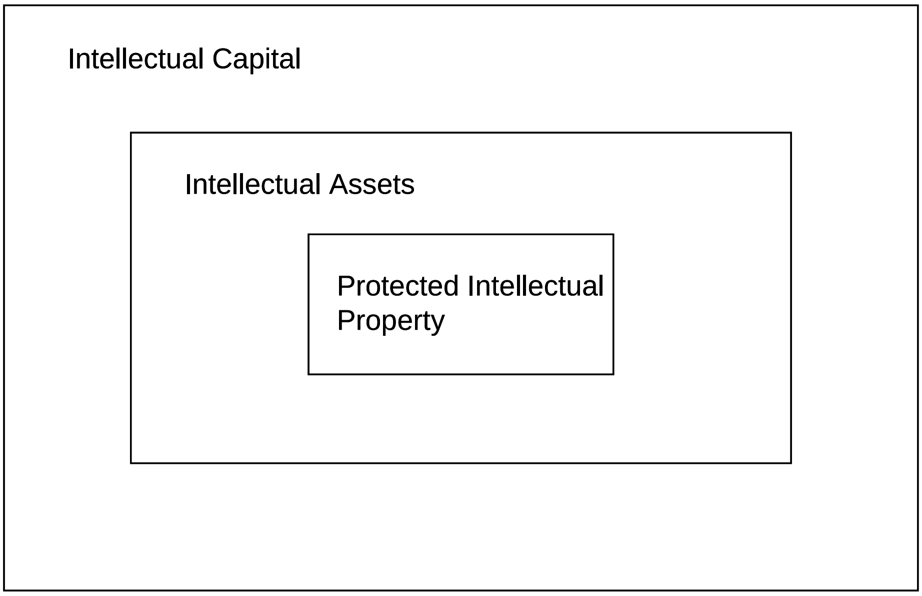
OECD Invites Comments on the Scoping of its Future Project on the Transfer Pricing Aspects of Intangibles

NERA Economic Consulting welcomes OECD's invitation to provide views on scoping a new project which could lead to revision of Chapters VI and VIII of the Transfer Pricing Guidelines. The work on these Chapters is a necessary and important complement to the valuable work of previous years that led the updated Chapters I – III, and to the inclusion of Chapter IX, which reflects the discussion on Business Restructurings.

While we believe that there numerous useful improvements and considerations in both Chapters VI and VIII, as they are, we believe that a key dimension that may currently be lacking from the TPG in the context of intangible assets and cost contribution arrangements is the consideration of transfer pricing from a total value chain perspective. The relative involvement of group entities in the process of joint value creation for the enterprise, as defined by their roles and responsibilities therein, is decisive for the relative bargaining positions in the process of establishing terms and conditions for specific intergroup transactions. This value chain perspective is necessary when taking into account more explicitly the commercial and financial relations between the transacting parties.

In our view, intangibles need to be understood in the context of the total value of the enterprise, consistent with a value chain framework. By being silent on these concepts, the TPG concentrate too heavily on merely « testing » specific transactions or profits of entities involved in certain specific activities, be it before or after the fact. The TPG should, rather, concentrate on what the arm's length principle is meant to be: a reflection of how independent companies would, in similar circumstances, behave in the open market, indeed, but in similar commercial and financial relations. In practice, when "relation" is being mentioned, this often refers to the shareholder relationship. In identifying or analyzing what constitutes "arm's length," abstraction should be made from shareholder relations *per se*, and the commercial and financial relations have to be taken into account *as they are*. By dealing lightly with the relational dimension, the TPG tend to ignore a fundamental characteristic of an enterprise, namely, that its aim is to make profits in order to promote the continuity and success of the enterprise. The "related" parties that we are investigating in their dealings are generally involved in a long-term cooperative relationship. Comparability analysis that focuses merely on transactions and/or entity profits delivers potentially useful indications (usually), but misses the essential point that third parties are only comparable in their behavior in the context of a similar type of relationship, i.e., in similar commercial and financial relations.

Taking the total value chain perspective will necessitate changes to Chapter VI. In particular, we believe that the TPG would benefit from focusing on an enhanced definition of intangibles. Doing so will require addressing the total universe of intangibles, including, for example, goodwill, going concern value, workforce in place, etc. as well as conventional marketing and technical Intellectual Property intangibles. In this respect, the diagram below may provide a helpful illustration of the nature of intangibles that need to be considered from a transfer pricing perspective.



We note that the broadest category of intangibles, referred to as "intellectual capital" in the above chart, is not being seriously considered in the current TPG despite the fact that it is in many cases at the heart of the value creation process of MNEs. Intellectual capital may include knowhow, processes, ways of doing business, workforce in place, and many other intangibles that are generally not referred to in other disciplines that have to deal with the value of intangibles.

The recognition that the type of intangibles that need to be taken into account for transfer pricing purposes is different, and surely broader than the intangibles that are addressed in other areas such as in accountancy or from a legal perspective, is important. It implies that an agreement or legal definition *per se* may well not be a reliable starting point for a transfer pricing analysis dealing with intangibles. The proper starting point is in the relationship between the transacting parties, in the role of intangibles in the value creation, and in the roles and responsibilities allocated to the parties involved in value creation according to the business model defined for the enterprise. Only then do we have the ability to identify how this behavior would translate on the open market, i.e., between parties without shareholder relations *per se* but otherwise engaged under similar commercial and financial relations.

From the perspective of applying the methods, we believe that the valuations determined in applying the arm's length principle need to recognize the overall value chain and the relative contributions of the different intangibles, together with the roles and responsibilities for risks of the value chain participants.

Finally, the current Chapter VI limits its discussion of intangible ownership to a discussion of marketing investments undertaken by enterprises not owning the trademarks or trade names. The principles articulated there need to be expanded to apply to other comparable situations such as when R&D legal ownership differs from economic ownership due to the roles and responsibilities for risks of the participants. The U.S. regulations have changed numerous times with respect to these considerations, and a broader international consensus seems needed. Such a consensus could most appropriately be developed by the OECD.

In conclusion on Chapter VI, we are of the opinion that the TPG would fail if the changes concentrate exclusively on developing a toolset for facilitating the testing of individual transactions. Instead, the TPG should concentrate on insuring that the starting point of the analyses and valuations performed take into account the perspective of the total value chain and the role of intangibles defined in a broad sense. In this respect, we wish to stress that improvements in the availability of financial data in general has made it possible to apply techniques that in the past could not be reliably considered.

We view Chapter VIII as a practical application of Chapter VI: dealing with intangibles (defined in a broad sense) in a context where the MNE members have decided to share risks and benefits associated with investments to develop intangibles. The test of the arm's length character of the transactions involved does not primarily concern the question of whether, in similar circumstances, third parties would apply a CCA or, alternatively, a centralized ownership model. Rather, the appropriate question is whether, given the choice of model by the enterprise, the terms and conditions thereof would be negotiated with a similar result between independent parties, given their relative bargaining positions. This means that, in our opinion, Chapter VIII should concentrate on applying in the context of CCAs the principles that have been developed in Chapter VI. In this respect, while we believe that the discussion in the current TPG of what is a CCA is most helpful, Chapter VIII would benefit greatly from a more robust discussion of risks as well as well illustrative numerical examples to show practical applications. This discussion will ideally constitute an elaboration of the concept of “control over risks” introduced in Chapter IX.

As an aside, while we believe that reconciling Chapter VIII of the TPG with the recently issued temporary U.S. Cost Sharing regulations is neither possible nor necessarily desirable, it would nevertheless be helpful if at least the TPG would recognize explicitly the main differences in views, so that practitioners can at have something to reference when addressing cost sharing involving jurisdictions following seemingly conflicting guidance in this respect.

Yours sincerely

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