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14 September 2010

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Re: *Transfer Pricing Aspects of Intangibles*

Dear Mr. Owens:

On 2 July 2010, the Committee on Fiscal Affairs (CFA) of the Organisation for Economic Co-operation and Development (OECD) announced that Working Party No. 6 is considering a new consultation project on the *Transfer Pricing Aspects of Intangibles*. The project will review, among other issues, whether Chapters VI and VIII of the Transfer Pricing Guidelines (TPG), which set forth the primary OECD guidance on transfer pricing for intangibles, should be revised.[1] According to the announcement, Working Party No. 6 is currently "at the stage of scoping" its new project. On behalf of Tax Executives Institute, I am pleased to respond to the OECD's request for comments on the scope of its project.

TEI Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organisation has 54 chapters in North America, Europe, and Asia. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,000 of the largest companies in the United States, Canada, Europe, and Asia.

[1] Other OECD guidance on the treatment of intangible property is in the commentary on Article 12 of the Model Tax Convention and in the *Report on the Attribution of Profits to a Permanent Establishment* (17 July 2008).

Project Background and Objectives

The OECD's guidance on the transfer pricing treatment of intangibles was updated in March 1996 with the release of Chapter VI of the TPG and in March 1997 with the release of Chapter VIII on cost contribution arrangements. Even with that guidance, disputes between taxpayers and tax administrators about transfer pricing for intangibles have increased in frequency, amount, and scope. In addition, during the OECD's review of the comparability and profit methods of the TPG[2] as well as its consultation on business restructuring,[3] the challenges associated with the definition, identification, and valuation of intangibles for transfer pricing purposes were noted by tax administrators and taxpayers alike. As a result, Working Party No. 6 has initiated this consultation in order to solicit stakeholder input and identify:

- The most significant issues encountered in practice in respect of the transfer pricing aspects of intangibles;
- Shortfalls, if any, in the OECD's current guidance;
- Areas ripe for further work; and
- The format of the output from the consultation.

In addition, subsequent to the adoption of the OECD's current guidelines, the domestic transfer pricing rules of Member States have evolved with some issuing new or revised rules affecting the treatment of intangibles. For example, the United States revised its temporary cost-sharing regulations on 31 December 2008.[4] In addition, Germany has adopted legislation that can tax unrealised or potential gains or future profits relating to assets and activities transferred outside of Germany when a business function is transferred. Such domestic rules supplement, overlap, and occasionally conflict with the OECD's guidance, thereby creating an increased risk of double taxation. Thus, this consultation might consider whether or how changes in Member State domestic rules can or should affect the TPG or other OECD guidance, such as the model treaty's rules for resolution of double tax cases among associated enterprises or the allocation of profits to a permanent establishment (PE). Finally, business practices have evolved since the guidelines were issued and the rules may need to be updated to address those new or changed practices.

A public consultation with invited commenters is scheduled for 9 November 2010.

Reaffirm Fundamental Principles of the Current Guidelines

TEI commends the OECD for seeking public input on the scope of its project. For most multinational enterprises (MNEs), intangibles — whether of the "hard" trade intangible variety

[2] *Review of Comparability and of Profit Methods: Revision Of Chapters I-III Of The Transfer Pricing Guidelines* (22 July 2010).

[3] Chapter IX of the Transfer Pricing Guidelines (22 July 2010). *See also Transfer Pricing Aspects of Business Restructurings* (19 September 2008 to 19 February 2009).

[4] *See* U.S. Treas. Reg. § 1.482-7T.

(as the term is used in Chapter VI of the TPG) or softer "marketing intangible" variety — are a significant component of the value of the business's products or services.

Regrettably, the amorphous and often unique nature of intangible property makes it challenging for taxpayers and tax administrators to identify comparables in order to properly value the contribution of the intangible property separately from the contributions from tangible property, capital, labour, or service components of a business. Despite the challenges, the consistent application of the arm's length principle, which underlies current international norms, helps ensure that (i) the taxable profits reported by MNEs in the countries where they operate reflect the economic activity undertaken there and (ii) taxpayers can avoid the risk of double taxation that may result from a dispute between two countries about the level of remuneration for cross-border transactions. This is because the arm's length principle provides the closest approximation of the open market where goods and services are transferred between associated enterprises. As such, the arm's length method achieves the goal of correlating taxation with economic activity with less risk of double taxation. It also better reflects the economic realities of a controlled taxpayer's particular facts and circumstances. Hence, we recommend that the consultation affirm the OECD's commitment to the arm's length principle as a fundamental basis of transactions between affiliated enterprises. The OECD should resist the calls urging the use of formulary apportionment for determining the remuneration on non-arm's length transactions (whether sales, licenses, or business restructurings) involving intangibles.

In addition, MNEs are organised in myriad entities and forms. Some companies have centralised their most valuable and legally protected intangibles (patents, formulae, trademarks, *etc.*) in one or a few entities in a global supply chain restructuring whereas others have intangibles dispersed throughout the group. The current TPG, including new Chapter IX on Business Restructuring, acknowledges that taxpayers are entitled to structure (or restructure) their business operations and transactions as they see fit:

> Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. MNE groups cannot be forced to have or maintain any particular level of business presence in a country. They are free to act in their own best commercial and economic interests. . . . *In making this decision, tax considerations may be a factor.*[5]

TEI recommends that this fundamental principle — that businesses are free to organise their business structures and transactions through contractual allocations of risk — also be affirmed in the consultation. Each taxpayer is in the best position to determine which transfer pricing method produces the most reliable results when applied to its unique facts and intangibles. Unless the taxpayer's results fall outside an arm's length range, tax administrators should not be permitted to adjust the taxpayer's results or method.

[5] *See* paragraph 196 of the report on *Transfer Pricing Aspects of Business Restructurings* (19 September 2008 to 19 February 2009) (Emphasis added.) See also paragraph 9.163 of the Transfer Pricing Guidelines as approved on 22 July 2010.

In applying the arm's length principle, *i.e.*, determining the conditions and prices that independent enterprises would have established for a transaction, it is critical to focus on the conditions that exist at the outset of the transaction. Thus, tax administrators should look solely to the information available to the taxpayer at the time of a transaction and determine whether the taxpayer acted reasonably based on that information. In addition, independent arm's length enterprises generally set prices based on *expected* or *projected* costs, volume, profitability, *etc.* In very rare cases, independent enterprises may agree to renegotiate or reset prices but, if so, only where strictly negotiated conditions that are *determined at the outset* of an agreement are satisfied. Independent enterprises do not use hindsight to adjust pricing terms and do not make adjustments retroactively.[6] Thus, we urge the OECD to refrain from adopting a standard that effectively mandates the use of hindsight — *e.g.*, the commensurate-with-income standard used by the United States for intangibles — in evaluating how taxpayers set transfer prices.

Finally, this consultation should strive to identify ways to improve the mechanisms for avoidance of, or resolution of, cases of double taxation involving intangible transactions. For inbound investments, tax administrators are more aggressively asserting the existence of both permanent establishments and intangible rights requiring local compensation or return. For outbound transfers or investments, tax administrators are increasing their scrutiny of the level of payments received for the real (or perceived) transfer of intangible rights. With the increased scrutiny and adjustments, the risk of double taxation will grow. Hence, the OECD should use the consultation to urge the Member States to update their treaties to include provisions similar to Article 9, section 2 and the newly revised Article 7, section 3 of the OECD's model treaty. In addition, the Member States should be urged to include mandatory arbitration provisions to settle disputes where the competent authorities cannot reach agreement in a reasonable time frame.

Significant Issues with Intangibles

1. Definition of Intangibles. Chapter VI of the TPG discusses the special considerations involved with transfer pricing for transactions involving intangible property. During the Business Restructuring consultation, considerable time was devoted to discussing the interrelated issues of (i) the treatment of intangibles, (ii) whether a compensable transfer of assets, including intangibles, had taken place, and (iii) what the most appropriate transfer-pricing method might be (since the methods for intangible and tangible property may differ and the transfer may include a mix of tangible and intangible property). Because the thorny issue of valuing an intangible property right is inseparable from the question of whether an intangible exists at all, TEI recommends that the OECD clarify the current definition of intangible.

[6] Where independent enterprises employ an actual cost or results standard for compensation, there may be a brief period following the close of a fiscal year during which the parties "true up" their projected costs or results to actual. Enterprises under common control also employ such arrangements. The key point is that the true-up occurs within a very brief period following the close of the relevant fiscal period. There is rarely, if ever, a multi-year assessment of the profits earned by each of the parties to determine or reset prices or results retroactively. Any reset of prices between independent enterprises, if negotiated in advance, would generally be prospective.

The term "intangibles" is currently undefined in the guidelines except by way of a list of examples of various business and commercial rights to which the guidance applies. Thus, intangible property includes (i) rights to use industrial assets such as patents, trademarks, trade names, designs or models; (ii) literary and artistic property rights; and (iii) intellectual property such as know-how and trade secrets. These "commercial" intangibles are subdivided into "trade" intangibles, which consist of all non-marketing business intangibles, and "marketing" intangibles. Chapter VI provides special considerations for marketing activities by enterprises that do not own the trademarks or trade names and thus may contribute value to the owner of the marks or names.[7]

Regrettably, the definition of trade intangibles includes the statement that they "often are created through risky and costly research and development (R&D)," which confuses the analysis by seemingly limiting the scope to R&D related intangibles when no such limitation is intended. Moreover, the guidelines' use of the term "intellectual property" to refer to forms of specialised knowledge such as know-how or trade secrets is at odds with most taxpayers' broader use of the term as encompassing legally protectable rights or assets such as patents, copyrights, contracts, and trademarks as well as softer rights such as know-how relating to technical services or sales, marketing, and promotion.[8]

The scope of the OECD's exercise in updating the definition could range from providing criteria for what constitutes intangible property (or providing exclusions or "negative" criteria for what is *not* an intangible), to supplementing the list of intangible property types in the current guidelines, to redrafting paragraphs 6.2 to 6.12 for improved clarity. For example, to distinguish between intangible property and services the OECD could helpfully include a statement that intangible property includes rights or assets that have "substantial value independent of the services of any individual"[9] or group of individuals.

TEI recognises that the challenge of issuing timely guidance may require limiting the scope of the project, which, in turn, may preclude the OECD from developing a more explicit definition for intangible.[10] On the other hand, in order to address the fundamental transfer pricing issue whether "something of value" has been transferred (and whether or how much compensation should be provided), it is important to know *what* is being transferred (tangible or intangible property or services) and *how* the property or services are being transferred. Moreover, once a determination is made that a property right or value *is* transferred between

[7] *See* paragraphs 6.36 to 6.39 of the TPG.

[8] In many industries, know-how is as important as patents or trademarks.

[9] *See, e.g.*, U.S. Treas. Reg. § 1.482-4(b).

[10] *See Silberztein Discusses OECD's Proposed Project To Update 1995 Guidelines' Treatment of Intangibles*, Tax Management Transfer Pricing Report (July 1, 2010) ("For transfer pricing purposes, the relevant question does not seem to be whether a payment is made for an intangible or for something else (*e.g.*, a service), but rather whether there is a transfer of 'something of value' that should be remunerated at arm's length, and how to value it, irrespective of its characterisation as an intangible asset or as something else.)"

non-arm's length parties, the treatment of any payment or compensation will differ under both domestic transfer pricing laws and the applicable treaties (including the OECD's model treaty), depending whether the payment is characterised as for services, a sale, a licence (royalty), or "other" remuneration.[11] For example, a payment for services or goods may not be subject to a withholding tax whereas a royalty payment often is. For a mixed payment, the proper allocation of value between services or property is even more challenging.[12] Hence, the OECD should provide more explicit definitions for and illustrations of intangibles as well as guidance on allocating payments for mixed payments for products (or tangible property), services, and intangibles.

2. Transfers and Ownership of Intangible Property. Another issue that goes hand in hand with the definition of intangible property is whether that property can be transferred, which in turn necessarily involves discussing beneficial (or economic) and legal ownership of an intangible. In order to minimise potential conflicts between taxpayers and tax administrators, especially over the creation of PEs or business restructurings, the OECD should limit the intangible property capable of being transferred to *legally protectable or commercially enforceable rights* such as patents, models, and know-how that drive manufacturing and production as well as the trademarks, contracts, brands, and tradenames that drive sales. Under the arm's length standard, the value of an intangible is the amount arrived at by a willing buyer and seller. Inherent in that concept is that the owner must have an "enforceable right."[13] This right often takes the form of a legally protected right but may take other forms. Although TEI's recommended approach may seem restrictive, especially compared with some Member State domestic laws, only intangibles that are capable of separate legal or other enforceable recognition and protection can be characterised as an asset capable of being transferred for compensation. In other words, not all valuable intangibles are assets that can be transferred for value. An intangible may have value in the hands of the current owner but if that owner has no means to restrict another's use, then there would be no arm's length payment for the transfer of that intangible.[14]

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[11] The OECD may inevitably be required to address "other" forms of compensation, especially in connection with cost contribution arrangements in Chapter 8 of the guidelines. Some countries have revised their domestic guidance relating to buy-in fees (or platform contribution transactions) whether in the form of lump-sum payments or royalties and balancing payments. To minimise the risks of double taxation, the OECD should consider providing uniform guidance so that countries know what is or is not acceptable under international norms.

[12] In addition, payments made under a profit-split methodology (*e.g.*, balancing payments) are not always susceptible of easy characterisation. Moreover, to the extent a payment is attributable to mixed components, such as a royalty for an intangible as well as a payment for services rendered, the allocation of the payment between the consideration for intangibles and other compensation may have VAT implications as well as withholding tax implications.

[13] Chandler, Blough & Williams; *Reconciliation of Purchase Price Allocation and Transfer Pricing*, Tax Management Transfer Pricing Report (22 April 2010).

[14] *Id.* ". . . [T]he owner of the intangibles must have some means — whether legal or other — of preventing the other party from using the intangible without any payment. For example, trade secrets have value even if they are not legally protected, and there may be economic attributes (such as the cost of finding alternative reliable suppliers) that pose a practical impediment that is similar to an 'enforceable right.'"

At a minimum, the OECD should provide examples of intangible property that is *not* capable of being transferred *per se* and thus should not require compensation in connection with a business restructuring or other transaction. We believe that such items include employees (including a workforce in place), location of strategic or managerial functions, business opportunities, and profit potential.

a. *Employee knowledge.* Technical or marketing know-how is generally embodied in the knowledge and experience of employees. The assignment or re-assignment of employees on a temporary or a permanent basis from one location to another, however, has never been the basis for asserting the transfer of a separate intangible property right requiring compensation to the transferring location.[15] This principle should be affirmed in the consultation.

Similarly, the use of an assembled workforce of researchers is not — despite a commitment to conduct research — a separately transferrable intangible property requiring compensation. Companies frequently change the direction of their research teams and the individuals within the research teams also frequently change. To treat an assembled workforce of researchers as an intangible requiring a buy-in payment — as the 2008 U.S. cost sharing rules do — would potentially saddle cost contribution arrangements with a substantial administrative burden to recompute buy-in payments every time the duties or composition of the research team is modified.

b. *Location of strategic or managerial functions or decision-making.* Just as the location of marketing or research functions — and the workforce that engages in those activities — does not create a separate intangible asset or right for that location, the exercise of managerial or strategic decision-making authority by MNE personnel does not create a separate intangible asset or right ("something of value") in a location that is capable of being transferred. The consultation should confirm that principle.

c. *Business opportunities.* Absent a specific contractual right of protection (*e.g.*, a covenant not to compete or an exclusive right to distribute products or market services within a particular geographic area), "business opportunities" in and of themselves are not legally protected intangible property because no one can preclude another from pursuing business opportunities. As important, absent a contractual agreement with such protection, business opportunities are not transferrable. As a result, we do not believe business opportunities *per se* should be treated as intangible rights or property.

d. *Profit potential.* Paragraph 9.65 of the TPG states:

> An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The arm's length principle does not require compensation

[15] Similarly, the mere transfer of an employee to a new location (or Permanent Establishment) does not transfer to (or create in) the new location (or PE) an intangible property or right. The OECD should confirm, especially in the context of Art. 7 on the allocation of profit to a PE, that pre-existing intangibles are not considered transferred to a PE along with the transferred employee.

> for a mere decrease in the expectation of an entity's future profits. When applying the arm's length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets) . . . that . . . would be compensated between independent parties in comparable circumstances.[16]

TEI agrees that "profit potential" is not in itself a separately transferable intangible asset or legally protected right. To the extent profit potential plays a role in transfer pricing, it is in the valuation of (or compensation paid for) *identifiable* rights or assets transferred by a taxpayer, including potentially goodwill or going concern value. The consultation should confirm this. The notion that "something of value" — *i.e.*, profit potential separate and apart from identifiable rights or assets — has been transferred and should be compensated should not be the basis for compensation.

3. Review of Comparability of Transfer Pricing Methods. The OECD recently concluded its review of the comparability of transfer pricing methods and approved changes to Chapters I-III of the TPG.[17] One of the goals of the review was to create more flexibility in the determination of the method for an arm's length price by replacing the strict hierarchy of methods with a rule that emphasises the most reliable method. As a result, although the transactional comparable uncontrolled price (CUP) method is preferred where the comparability of the transaction is clear, the revised guidelines afford greater flexibility to use the cost-plus or a profits-based method, including the transactional net margin method (TNMM) and profit-split methods. TEI recommends that the guidance on the valuation of intangibles in Chapters VI and VIII of the TPG be updated to reflect this flexibility in pricing methods. In addition, where the profit-split method is used to establish the transfer price for intangibles, additional guidance about how to determine the appropriate allocation keys for the profit split would be useful.

Since intangibles are often unique, the OECD should consider whether there are other methods that should be considered in determining the value of an intangible. For example, under certain limited circumstances, independent enterprises *may* employ the discounted cash-flow (DCF) method to determine the value of intangible property. If the conditions under which arm's length parties might use the DCF method were properly incorporated in the guidelines, we believe it would be appropriate to use such a method. A considerable challenge of applying a DCF method, however, is allocating a single cash flow among the value drivers such as marketing effort, a patent (or uniqueness of a product or service), a technical know-how intangible, labour, location savings, *etc*.[18] As another example of valuation methods, arm's length parties often use income, cost, or market-based approaches to establish the value of

[16] *Report on the Transfer Pricing Aspects of Business Restructurings: Chapter IX of the Transfer Pricing Guidelines* (22 July 2010).

[17] *Review of Comparability and of Profit Methods: Revision Of Chapters I-III Of The Transfer Pricing Guidelines* (22 July 2010).

[18] In any set of facts and circumstances, the discount rate applied to the cash flow will also be crucial in establishing the value and may well prove to be a contentious issue.

intangibles. The OECD should establish guidelines or conditions for when these approaches might be used.

Finally, depending on a taxpayer's business model, the value of intangible property can be embedded in the prices of its products or services or may instead be reflected in a more visible licensing or franchising arrangement. Regrettably, the two models have not always been treated consistently by tax authorities. Indeed, a royalty or franchise fee frequently draws more scrutiny than a higher product or services fee. Where possible, the guidelines should attempt to ensure that no business model is discriminated against simply because the charge for the intangible property is more explicit in one transaction than another.

4. Other Issues for Consideration.

a. *Relative importance of intangibles — routine vs. non-routine.* Assuming the OECD retains the broad definition of intangible property in the current guidelines, guidance about how taxpayers and tax administrators should determine the relative value and returns for different types of intangibles would be helpful. Clearly, some forms of intangible property, rights, or functions are more valuable than others. The key is determining how independent parties would determine the value. Tax authorities and taxpayers alike struggle with the distinction between the "routine functions or intangibles," which should only require limited compensation, and "non-routine functions or intangibles," which may require more substantial compensation. For example, while the marketing activities of the sales force of a pharmaceutical company merits fair compensation, the uniqueness of the product being sold often drives the market and the price. In a pure commodity business with basic raw materials, the sales efforts or the efficiency of the distribution channel may be the critical driver. Consequently, TEI recommends that the OECD provide guidance on the consequences of the distinction between "routine intangibles" and "non-routine intangibles and between "routine functions" and "non-routine functions."

b. *Incremental intangibles.* Another challenge for taxpayers and tax administrators is determining whether or when research or development activity leads to a new or incremental intangible that might require an independent valuation (or separate cost contribution arrangement) from the original base or platform. The OECD should provide guidance on the circumstances where a separate valuation or agreement is necessary.

c. *Exclusive vs. non-exclusive license.* The importance and effect of an exclusive vs. a non-exclusive license agreement should be illustrated.[19]

d. *Marketing intangibles.* Paragraphs 6.36 to 6.39 of the current guidelines provide guidance where marketing activities are undertaken by enterprises that do not own trademarks or tradenames. The principal question posed in these paragraphs is whether the marketing entity should be compensated as a service provider or whether the marketing entity

[19] The effect of exclusive or non-exclusive rights is important in determining the value of marketing intangibles under distribution and marketing agreements as well as technical licenses.

should share in any additional return attributable to the marketing activities (or intangibles) that it performs on behalf of the owner of the trademark or tradename. Where an additional return should be afforded to the marketing entity, another question is how the return should be determined.

Some tax administrators have been very aggressive in asserting the existence of marketing intangibles in a local distribution company.[20] To provide greater certainty and clarity for taxpayers and tax administrators alike, the OECD should clarify the guidelines to determine what "marketing intangibles" are and when and how they should be considered in the valuation process.

Whether a local distribution company bears the costs and risks of developing a market is critically important to the analysis of who owns the related marketing intangibles. For example, a distributor may provide detailed and valuable sales and marketing support for an MNE's products that may be covered by a trademark owned by the MNE group. (This could include cases where technical services are provided to the customers of the distributor's customers, applying a "pull-through" approach.) Through its local sales and marketing support activities, the distributor may even create a dominant local market share for the MNE group's products. Notwithstanding the local market activities in building the customer base and product recognition, possibly over many decades, the distributor may have been shielded from risk because it was reimbursed on a cost-plus basis for sales and marketing support (or technical services) or the group used TNMM for valuing the selling services. In such cases, the valuable marketing intangibles likely are not "owned" by the local distributor.

The contributions of local distributors to group intangibles have implications for business restructuring as well. If a distribution agreement of a local affiliate and another group company is terminated and the function is assumed by another affiliate within the group, tax authorities in some countries have demanded compensation for the imputed transfer of local customer lists, selling know-how, and other marketing intangibles. Although each case turns on its individual facts and circumstances (*e.g.*, in some cases a customer list is a valuable asset in others it is not), the method through which the local distributor is compensated may affect whether any valuable right has been transferred. As noted in the previous paragraph, if the local distribution company is compensated on a cost-plus basis (or a guaranteed fixed commission) for the sales and marketing (or technical) services rendered to the distributor's customers, no value is transferred by the local distributor when the contract is terminated.

Finally, the OECD should clarify that the mere execution of a global (or regional) marketing policy, *i.e.*, incurring advertising, marketing, and promotion costs in a particular local jurisdiction, in accord with the policies or guidelines established by the global (or a regional) marketing office does not lead to the development of a local marketing intangible. The expenses

[20] *See, e.g., GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, T.C. Nos. 5750-04 and 6959-05, in which the IRS assessed a $4.6 billion tax deficiency against the U.S. distribution subsidiary of a U.K.-based pharmaceutical manufacturer based on the purported value of marketing intangibles developed and used by the subsidiary.

may help create or expand a local customer base, but if the entity is merely executing a global marketing policy and is benefiting from an international marketing campaign in selling a globally standardised product, it is unclear whether a local intangible has been created.[21]

e. *Research & development (R&D) centres.* Some MNEs have developed centres of technical excellence and restructured their businesses to concentrate the funding and management of valuable intellectual property in a single, or series of, regional holding companies for intellectual property. Other MNEs maintain R&D centres at the parent level while still others concentrate "blue sky" research in one or more centres while the technical development (or application or adaptation) of the product to specific customer uses is left to the individual subsidiaries. Still other MNEs use cost sharing or cost contribution arrangements to jointly fund and share the risk of developing intangibles while affording each subsidiary participant a separate right to exploit the intangible.

The myriad ways of organising global research activities makes it challenging to make specific recommendations for the scope of the consultation. On one hand, the guidance must be flexible enough to accommodate various organisational structures where the ownership of, and return on, the intangibles is concentrated in one or a few companies. On the other hand, the guidance should not inhibit the utility of cost sharing, cost contribution, or similar arrangements where commercial rights of exploitation or beneficial or economic use are divided among the participants. At a minimum, the OECD should confirm that companies can structure their operations as necessary to maximise their efficiency.

Although there are many detailed issues that need to be addressed in connection with research activities and the exploitation of the resulting intangibles, the following issues arise frequently and should be considered for potential clarification.

1. Under any particular arrangement, taxpayers may outsource the actual research or development activity through service agreements. In such cases, the service provider is often compensated on a cost-plus basis. As long as the principal (whether the parent, an IP holding company, or some other combination of entities) retains the burdens and risks of research or development, that entity or entities should be considered the owner of any developed intangible and entitled to the return on the intangible property. This should include the funding of concept-based research conducted with the assistance of a university or similar private research facility.

2. The United States takes the position that stock-based compensation incurred by any controlled participant to an employee or independent contractor involved in the development of intangible property should be taken into account in the cost-sharing pool and borne by all the participants in proportion to each participant's reasonably anticipated benefits. Taxpayers and other countries disagree, arguing that independent arm's length parties do not share their stock-based compensation costs. To prevent double taxation, it would be helpful if

[21] Even if an intangible asset is considered created, its life would likely be extremely attenuated thereby diminishing the value that an arm's length party would pay for its transfer.

the OECD were to provide a uniform rule against including such costs in the cost-sharing pool. At a minimum, the OECD should explore how it can promote the resolution of double tax cases where the countries disagree on the treatment of stock-based compensation.

3. Paragraph 8.1 of the current guidelines notes that "further guidance may be needed on measuring the value of contributions to CCAs, in particular regarding when cost or market prices are appropriate, and the effect of government subsidies or tax incentives. . . ." Thus, this may be the appropriate time to consider the proper determination (or valuation) of buy-in (or platform contribution transaction) payments as well as the proper treatment of government subsidies or tax benefits.

4. The treatment of cost contribution arrangements may need to be revisited in light of guidance issued by the Member States since the guidelines for cost contribution arrangements were issued. In addition, any changes to Chapter VI or VIII should also be coordinated with the guidance in Chapter VII (*Special Considerations for Intra-Group Services*) to ensure that MNEs can continue to share services, costs, and expertise across the group as long as an appropriate arm's length charge is made.

f. *Subsidiary and plant shut down costs*. With the global recession, MNEs are cutting costs by transferring functions to subsidiaries that produce or sell at lower costs and thus are more efficient. There is considerable uncertainty about how to treat the transfer of certain "soft" intangibles such as a customer list associated with the local subsidiary's business. Indeed, depending on the industry, a customer list may be very valuable (*e.g.*, an insurance business) or have little or no independent value because the customers are widely known (*e.g.*, retail stores for the distribution of consumer products). More important, if the subsidiary has been compensated on a cost-plus basis for its marketing costs, there is arguably no residual local value for the marketing intangibles.

A similar issue arises in connection with the shutdown of a redundant plant. Assume Company A in Country A is a subsidiary of a MNE and has been operating a profitable plant over many years, manufacturing and selling products as part of the worldwide integrated business within the MNE. Company A pays a license royalty to its parent company for use of manufacturing know-how. There is another production facility in Company B in Country B operating separately within the integrated global business making the same products. A recession leads to a downturn in the demand for the products worldwide, creating production overcapacity. To stay profitable, the MNE must address the overcapacity because only one plant is needed. For various reasons, Company A has higher unit production costs than Company B.

The MNE decides to close the production facility at Company A and sources the product from Company B. No transfers occur between A and B. The directors of Company A receive a license termination notice and find they have no realistically available alternative option other than to close the plant. Company A incurs plant closure costs, redundancies, and asset write offs but continues to sell products manufactured by Company B to its Country A customers.

Questions:

1. What payment, if any, should be made to Company A for the agreement to close the profitable production operation? Unless Company A developed a specific manufacturing process or know-how that differs from intangibles initially licensed or transferred to it, there is likely no intangible right transferred on the shut down that requires compensation. TEI recommends that the OECD clarify this. In addition, the tax administrator where the plant is closed will often assert that the compensation should include reimbursement of closure costs. TEI disagrees. More important, the tax administrator in the payer's jurisdiction is likely to disagree, thereby increasing the risk of double taxation to the payer. TEI recommends that the OECD clarify the matter.

2. What intangible, if any, did Company A own that should be reimbursed? TEI does not believe that an intangible was transferred when the manufacturing operations were shut down. Given the overcapacity in the industry and the higher unit production costs in A, Company B would, in an arm's length situation, eventually drive Company A out of the manufacturing business. By being part of an MNE group, A's manufacturing inefficiency is diagnosed and addressed earlier.

TEI recommends that the OECD provide guidance on subsidiary and facility closures.

g. *Documentation and administrative burdens.* Under paragraph 5.4 of the TPG, "prudent business management principles" require a taxpayer to document the basis for the arm's length nature of its transactions. We concur. Under the current standards, taxpayers are *not* required to prepare or retain documents that they would not otherwise prepare or retain in the ordinary course of managing their business. This principle accords taxpayers flexibility in managing their affairs.

TEI encourages the OECD to keep this principle in mind as the consultation progresses. All too frequently, tax administrators conclude that every shortcoming or challenge in the administration of transfer pricing rules is attributable to a lack of sufficient taxpayer records or documentation and have responded by imposing even more (and ever-more onerous) rules. The growing, overlapping, and increasingly divergent documentation guidelines of the Member States in respect of transfer pricing is a severe administrative burden on companies. Hence, we encourage the OECD to refrain from proposing new or increased documentation burdens during this consultation. At a minimum, any guidance on documentation relating to transfers of intangibles should confirm that a taxpayer is *not* required to document all potential transaction structures (or realistically available alternatives) and explain why it chose the transaction that it did.

Conclusion

TEI appreciates this opportunity to present its views on the scope of a potential new project on the Transfer Pricing Aspects of Intangibles. These comments were prepared under the aegis of TEI's European Direct Tax Committee whose Chair is Anna M. L. Theeuwes. If you

have any questions about the submission please contact Ms. Theeuwes at +31 70 377 3199 (or An.M.L.Theeuwes@shell.com), or Jeffery P. Rasmussen of TEI's legal staff at +1 202 638 5601 (or jrasmussen@tei.org).

Respectfully submitted,

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