

BEP-VVA-Gallo

Comments on the scoping of the OECD future project on the Transfer Pricing Aspects of Intangibles

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Dear Mr. Owens,

as requested in your invitation letter of 2 July 2010, BEP-VVA-Gallo¹ is pleased to provide a preliminary set of comments and observations to contribute to the future OECD project on Transfer Pricing Aspects of Intangibles.

For the sake of simplicity, after a brief introduction, we outline some areas that, based our experience, are crucial, and, therefore, should be covered in any future work on intangibles.

1. Introduction

The three main constraints that affect transfer pricing analysis (i.e., the need for objectivity, lack of time and resources and the unavailability of data), have inevitably led to a misalignment between theory and practice that has laid the foundation for the application of oversimplified mechanisms that - and this is the major issue - are applied mechanically. Any qualitative reasoning grounded on the rationale behind the arm's length principle is confined to (or, rather, substituted by) the application of standard and basic statistical tools.

There is no doubt that intangibles represent one of the areas of transfer pricing that - also in light of the multidisciplinary nature of the issue - has a greater need for a detailed theoretical framework.

2. Selected issues in relation to the transfer pricing aspects of intangibles

2.1 Multidisciplinary nature of the topic

Transfer pricing is a multidisciplinary subject, and this is all the more true in the case of intangibles, where intellectual property law and specific economic capabilities play a crucial role.

We suggest therefore that the milestone of the new OECD project should be a multidisciplinary approach involving IP lawyers, economists and technology and marketing experts in developing a set of rules derived from the coordination of tax rules with the other relevant disciplines.

This may be the opportunity to introduce such an approach for all transfer pricing issues. In particular, the interaction of transfer pricing tax rules with the I.F.R.S. (i.e., fair value vs. arm's length value) and corporate governance regulations is an area that should be further explored.

2.2 Definition of Intangibles

It would be extremely useful to increase the level of details regarding the definition of the various types of in-

¹ BEP-VVA-Gallo is a exclusive alliance in the field of transfer pricing created by the Law Firm Bonelli Erede Pappalardo ("BEP") the Consultancy Economic Firm Valdani Vicari & Associati ("VVA") and Mr Graziano Gallo (former Director of the Italian APA Program).

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intangibles, by making reference to IP law and economic valuation standards.

In this respect, a first possible research pattern could be to investigate on the existence of internationally recognized IP law definitions (at least within the OECD Member Countries) and technology/marketing definitions. With regard to the know how, for example, the definition under Article 39 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS Agreement”)² could be considered.

In addition, reference may also be made to I.F.R.S. that devote particular attention to the definition of the various intangibles and to the definition of elements relevant for a comparability analysis.

2.3 Method selection and application

The application of the OECD methods (i.e., traditional and transactional methods) to transactions involving intangibles presents critical aspects in most cases. This is due to the fact that in the case of intangibles the principles behind a certain method need to be developed to take the peculiarities of this kind of assets into account. In light of this, the new OECD project could (a) carry out further analysis to define the applicability of the OECD methods to transactions involving intangibles (a specific section could be added to Chapter VI) and (b) explore other methodologies commonly used for economic evaluations. Reference could, for example, be made to (a) accounting standards and, (b) marketing best practice.

With regard to the first field of research, reference should also be made to the I.F.R.S (e.g. relevance of financial based methods, definition of “active market”, criteria used for the application of impairment tests or purchase prices allocation - “PPA”).

Similarly, the relevance of both the theories (e.g., the role played by tangibles and intangibles in influencing the customer purchasing process) and the techniques (e.g., the performance of structured and extensive surveys on customers) developed in the field of strategic marketing to assess the value of the intangibles from the customers’ perspective should be carefully evaluated with the purpose of identifying and selecting aspects and elements that are useful when applying the arm’s length principles to intangibles.

2.4 Comparability

In relation to the application of the CUP method in the case of intangibles, pushing forward and extending the work on comparability that was developed in the 2006 Draft on Comparability (for example on the contractual terms) would be of value. Also in this respect, the OECD should carefully explore (a) the usefulness of economic theories applied in the field of marketing to enhance the application of the arm’s length principle and, (b) the possible adoption of marketing techniques and methods. As an example of the first aspect

² The TRIPS Agreement is Annex 1C of the Marrakech Agreement Establishing the World Trade Organization signed in Marrakech, Morocco, on 15 April 1994.

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above, it can be mentioned the theory of the life cycle of an asset that may require the adoption of different transfer pricing methods according to the stage of the life cycle of the intangible asset. Conversely, marketing theory and practice developed methods and tools may constitute a valid support in both evaluating the relevance of some factors and characteristics affecting the comparability and in driving the application of possible adjustments (e.g., the conjoint analysis, aimed at providing a support to the evaluation of the utility that consumers associate to the attributes of a product or a service).

2.5 Economic vs. legal ownership of intangibles

The issue of economic vs. legal ownership of marketing intangibles arose in some jurisdictions, and needs to be properly addressed. In particular, this is the type of issue where IP law and economic theory must be taken into account.

We are of the opinion that - albeit in very exceptional cases where a re-characterisation of the type of transaction is grounded - the issue should be kept within the framework of determining the appropriate remuneration (i.e., income attribution) for a certain activity, without involving any type of ownership that would not have been conceivable in an unrelated party deal.

2.6 Group matrix organizational structures

Most of the MNEs have adopted fully integrated business models based on matrix type organizational structures. This type of organizational structure - under which a certain business function is managed by an organized group of people working in different countries and employed by different entities - gives rise to many issues if approached using current international tax principles (e.g., the permanent establishment issue). Although this topic is of a more general nature (i.e., it affects the way a proper functional analysis is to be carried out), with particular reference to the issue being examined, two main situations deserve further attention:

- (i) this type of structure frequently has the effect of determining the joint development of intangibles whose ownership may turn out to be unclear, and requires specific regulation within the group (agreements concerning the reciprocal provision of services vs. cost sharing agreements); and
- (ii) in many cases, this type of organization leads to the creation of many interrelationships - related to the creation of joint process intangibles between the companies of the group - which may have the effect of jeopardising the application of one-sided methods. In these cases, the only solution seems to resort to a contribution profit split.

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2.7 Relationship between trade and marketing intangibles

As highlighted by the Guidelines (see para. 6.4, 6.8 and 6.9), there are cases where the relationship between marketing intangibles and production intangibles (e.g., patents) may significantly affect the comparability analysis. Such situations may arise where “the patents, because of their outstanding quality, may also have a very strong marketing effect similar to a pure trademark” (see para. 6.9) but, in the long term, this “strong marketing effect” is shifted into the trademark. The issue has to be addressed by considering the specific situation in the context of (a) the legal characteristics of different intangibles (e.g., patents expire while trademark do not) and the timing when the comparability analysis is performed. In particular it is likely that independent parties owning similar outstanding patents would not enter into a standard type of license agreement with a producer and distributor with the effect of losing entirely its contractual rights at the expiry of the patent. In such a case the owner of the patent would have likely agreed upon either a partnership type of agreement or upon a long-term license agreement granting rights beyond the period of IP protection.

The practical difficulties encountered in trying to approximate the behavior of third parties under similar circumstances might suggest the OECD to explore the adoption of theories and methods simulating the possible outcome of the mentioned relationship, by taking into account the bargaining power of the negotiating parties. Moreover, the I.F.R.S. may also represent a useful reference, for instance with I.F.R.S. 3 on business combinations, where methods adopted for the PPA deal with the problem of determining the value of inter-related intangibles.

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We remain at your disposal for any further clarification.

Yours sincerely

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