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To Jeffrey Owens, Director of the OECD Centre for Tax Policy and Administration

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From KPMG's Global Transfer Pricing Services Practice

Ref Memo to Jeffrey Owens on Scoping of the Transfer Pricing Aspects of Intangibles.docx

cc Clark J Chandler
Washington National Tax

Reply to OECD's request for comments on the scoping of its future project on the Transfer Pricing Aspects of Intangibles

Overview

The OECD has indicated that it is considering starting a new project on the Transfer Pricing Aspects of Intangibles which could result in revisions of Chapters VI and VIII of the Transfer Pricing Guidelines, and has asked for comments with respect to the following:

- What are the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles;
- What shortfalls are there in the existing OECD guidance?
- What areas warrant additional work on the part of the OECD?
- What should be the final output of the OECD work?

Professionals in the Global Transfer Pricing Services practice of KPMG LLP and certain member firms of KPMG International (hereinafter referred to as KPMG) believe that this would be an interesting and worthwhile project for the OECD to pursue and welcomes the opportunity to comment on the scoping of its future project on the Transfer Pricing Aspects of Intangibles.

What are the most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles?

The single most significant practical issue that taxpayers encounter with respect to intangible transfer pricing is the inconsistent treatment and analysis of intangibles carried out by different tax authorities with respect to such basic issues as:

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* Definition: Is the definition of intangibles for transfer pricing purposes limited to intangible “property” that can be transferred separately from overall business operations, or does the definition extend to attributes that cannot be separated from the business such as work force in place, goodwill and going concern? The OECD’s Transfer Pricing Guidelines (“Guidelines”) sometime suggest that intangibles include functions, assets and risks while Paragraph 6.2 adopts the term “intangible property” (which can be interpreted more narrowly than “intangible assets”); however, then limits its use to Chapter VI through the words “For purposes of this Chapter …”.
* Ownership/Entitlement/Right of use: Often multiple legal entities have claims on profits that are dependent upon a given intangible. Issues often arise because of confusion between the rights of the “owner” of the intangible (e.g., the licensor of a trademark) and the rights of another legal entity that is responsible for exploiting/using that intangible in a specific market (e.g., the licensee).What factors determine which legal entity has economic (co-)ownership of an intangible (i.e. rights to the income resulting from the intangible) -- the entity that carries out the activities that lead to the development of the intangible (e.g., R&D) or the entity that pays for and bears the financial risks associated with the development of the intangible? Is there a necessary relationship between economic and legal ownership? One aspect of this is the lack of consistent approaches for differentiating between activities that are necessary to sustain business such as sales and marketing expenses and activities that contribute to the development of valuable marketing assets.
* Differentiating between transfers of intangible assets between associated enterprises and the contribution of an intangible asset by an associated enterprise in relation to a controlled transaction (e.g. where the means by which the intangible asset is contributed does not involve the transfer of some or all of the property rights in the intangible asset between the associated enterprises). The same issue arises in the context of “local intangibles” which the OECD Guidelines now address in paragraphs 9.89-9.90.
* Characterization: What factors determine whether a controlled transaction should be characterized as a transfer of an intangible asset or as a provision of services?
* The inconsistent approaches taken by tax authorities in interpreting the Guidelines regarding “use of hindsight.” The Guidelines regard the use of hindsight as inappropriate; however, certain tax authorities have implemented rules that explicitly rely upon the use of hindsight in dealing with the inherent uncertainty involved in valuing transactions which depend on future events (e.g., U.S. and Germany look-back rules).

The differing views of tax authorities on such issues have led to very substantial disagreements that taxpayers on occasion have been unable to resolve in competent authority. In addition, these disagreements frequently take many years to resolve.

From a procedural point of view, KPMG notes that it is very important to bring non-OECD countries into the discussion, and to the extent possible seek their concurrence with the approaches adopted by the OECD.

What shortfalls are there in the existing OECD guidance?

The shortfalls in the existing Guidelines can be split into (i) technical issues and (ii) procedural issues.

Technical issues: the current Guidelines are based on a fairly simple and straightforward view of the world: legal entity X owns certain commercial intangibles and licenses those intangibles to legal entity Y. They do not address the complexities that taxpayers now have to face on a day to day basis as a result of the combination of new developments that have occurred since the mid-1990s and the sharp increase in tax authority interest in intangible transfers. Some of the technical issues that need to be addressed include:

- Developing approaches to mitigate controversy over the issues identified above as causing practical problems in the area of intangibles.
- The relationship between at-risk investments and the development/ownership of intangibles with appropriate consideration to the risk control concept discussed in Chapter IX. This discussion should evaluate the relationship between the OECD view that the use of hindsight is not appropriate, and the inherent uncertainty involved in valuing transactions which depend on future events.
- The fact that intangible transactions often span multiple years, often with losses associated with investments in early years and potentially high profits in later years. This implies that profits in one year may depend upon profits/activities that take place in other years, which may require changing the types of measures that have to be taken into consideration (e.g., discount rates), may require detailing the risks inherent in intangible development, and may involve the use of pricing methods that differ from the traditional OECD methods.
- Determining the most appropriate pricing methods for valuing transfers of intangible assets and addressing how such methods relate to the methods currently set forth in Chapter II of the OECD Transfer Pricing Guidelines. The OECD should also consider evaluating how the current methods should be adapted for dealing with intangibles whose development and use spans multiple tax years.
- Examining the impact of the internet, e-commerce and complex supply chains on ownership and economic substance. There are a number of intangible issues that arise as a result of technology and business practices that did not exist (at least to the same degree as today) when the present Guidelines were developed. In particular, the internet and e-commerce did not exist, and global supply chains have become increasingly complex. The present Guidelines are not well suited to provide guidance on issues that have been generated from such new developments.
- Dealing with the practical issues that arise out of the fact that many multinational companies want to manage their supply chains and intangible ownership centrally, but may have dispersed economic/legal ownership of intangibles. What is the role of cost contribution agreements in

such arrangements, and should "buy-in" and "buy-out" issues be treated any differently in the context of such cost contribution arrangements than in other IP transfers?

Procedural Issues: developing effective procedures for facilitating consistent interpretation and application of transfer pricing rules and providing taxpayers with reasonable levels of certainty and prompt relief from double taxation that inherently arise from differences in tax authority views on intangibles, is as important as addressing the technical shortfalls listed above. While the need for effective procedures is not limited to intangibles, it is particularly important in the case of intangibles due to both the current lack of consensus among tax authorities and the magnitude of the adjustments that can arise – in some cases, the dollar value of adjustments makes it very difficult for tax authorities to resolve issues in a principled way.

Procedural issues that should be addressed include:

- Developing protocols for including non-OECD countries in the dialogue on the development of guidance with respect to the treatment of intangibles in transfer pricing;
- Developing procedures for allowing tax authorities to share their views and reach consensus on issues on an ongoing basis, as the issues develop. This should be done outside of formal competent authority discussions dealing with specific taxpayers, and should incorporate business input into this process;
- Improving current procedures for getting up front agreement between multiple tax authorities on how the intangibles issues faced by taxpayers will be addressed. Currently, one of the only resolution options is the APA process which often takes too long (and thus, in the case of intangibles involving multiple years and large dollar amounts, allows the dollar value of issues to become very large) and covers too few years to address many intangible issues effectively.

What areas warrant additional work on the part of the OECD?

Per the discussion above:

- Definition;
- Examining how intangibles impact transfer pricing – impact on price, volume, costs. Can the intangible be easily replicated or does it create a significant barrier to entry? Differentiating between intangibles that are necessary to be in business but which do not lead to high profits and those that convey a significant competitive advantage, generally by creating a significant barrier to entry.
- Differentiating between transfers of intangible assets between associated enterprises and the contribution of an intangible asset by an associated enterprise in relation to a controlled transaction (i.e., where the means by which the intangible asset is contributed does not involve

the transfer of some or all of the property rights in the intangible asset between the associated enterprises);
- Characterization;
- Ownership, and the relation between at risk spending and ownership;
- Valuation methods;
- Implications of the developments that have occurred since the mid-1990s, particularly with respect to the internet and e-commerce;
- Dealing with intangible transactions that cover multiple years;
- Developing appropriate procedures to facilitate the development of common practices and interpretations among different tax authorities, including non-OECD tax authorities, and to facilitate more direct structural involvement of business and advisory stakeholders.
- Development of practical examples illustrating the principles developed in the Guidelines. Specifically, examples would be particularly useful in the area of marketing intangibles.

What should be the final output of the OECD work?

Transfer pricing issues relating to intangible assets raise complex technical issues and often result in differing views between tax authorities and taxpayers and between competent authorities. In light of this, KPMG encourages the OECD to prepare an initial issues paper or discussion paper for comment followed by a discussion paper setting out the proposed revisions to the OECD Guidelines similar to the process followed for the recent revisions in Chapters I-III and Chapter IX of the Guidelines.

KPMG believes that it would also be very useful for the OECD, either on its own or in conjunction with other organizations, to develop an ongoing process/program in which the OECD facilitates an exchange of views among tax authorities (including non-OECD tax authorities) on their approaches to intangible transfer pricing issues. Taxpayers and other tax professionals should also be included in such discussions. The objective of this process would be to continually update views in this area in response to new developments and to get a stronger practical consensus among different tax authorities on how intangibles should be treated in a transfer pricing context.