Mr Jeffrey Owens

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Paris September 15, 2010

Subject: Invitation for comments on Transfer Pricing Aspects of Intangibles

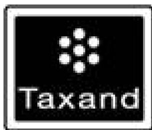
Dear Mr Owens

We are please to enclose comments from Taxand's Global Transfer Pricing Team on the new project on the Transfer Pricing Aspects of Intangibles. We thank you for this opportunity.

1. PRELIMINARY COMMENTS ON THE CREATION, USE AND VALUATION OF INTANGIBLES ASSETS WITHIN MULTINATIONAL ENTERPRISES

Use of intangible property has been a source of competitive advantage for companies developing and maintaining IP assets. This at times allows them to obtain high returns and maximize their profits.

In most cases their creation requires a lot of resources and capital investment through a long period of time, as well as to incur in other costs related to their legal protection and their improvement to respond to subsequent challenges of other market players.



In relation to MNEs, such circumstances often make it necessary to develop these type of assets by several companies within the same group, since a single entity cannot by itself bear all the costs, thus raising several issues affecting the ownership of the intangible property created, the valuation of the efforts made by the participating entities, and the price to be paid as a compensation by the entities using the IP created.

In other cases, especially as regards the so-called “soft intangibles”, MNEs operate with decentralized structures where intangible property is developed even in a spontaneous manner, as a consequence of sharing ideas and experiences by employees located in different jurisdictions and working for different entities of the same MNE.

In addition, MNEs may develop increasingly sophisticated operating structures whereby the ownership of those assets is held by one company which licenses its use to the other group entities. This practice is usually aimed at achieving greater economic and organization efficiency, although it often incorporates significant tax planning opportunities.

This may give rise to a number of cross border transactions relating to the creation and use of IP assets within MNEs, and the way in which they are implemented in practice. This has a clear impact on the determination of the arm's length remuneration for the companies involved as it may be affected by the fact that it may be difficult, if not impossible, to identify similar transactions between unrelated parties, especially given the specific nature of this type of assets.

Although these issues may seem evident, it may be worth considering them as a starting point in order to establish the framework in which the OECD should carry out the work to be performed on the transfer pricing aspects of intangibles.

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2. CLEARER AND MORE EXPLICIT DEFINITION OF INTANGIBLES

Recognition of different categories and types of intangibles should be the foremost and basic requirement that OECD should address. Current OECD TP Guidelines only provide a general definition of traditional intangibles like patents, trademarks etc

However, in light of the current business dynamics the definition of intangible needs to be reconsidered. It is important to appreciate that intangible assets are non-physical assets such as trademarks, patent rights, copyrights (known collectively as intellectual property), franchise rights and non-compete agreements, as well as unquantifiable assets often referred to as goodwill or deferred costs, such as corporate culture and strategy, customer satisfaction, and employee loyalty. Therefore, OECD should consider recognizing all intangibles and provide detailed definitions / characteristics.

Globally, non-conventional intangibles like human resource, satisfaction, knowledge, relationships, and business opportunities are gaining importance but not much literature is available (not even for their identification). Further guidance is required on definition of embedded intangibles, soft intangibles, and super intangible. OECD should recognize the business dynamics and provide insights on circumstances wherein intangibles can be created.

3. GUIDANCE ON DETERMINING LIFE AND DECAY OF DIFFERENT CATEGORIES OF INTANGIBLES

All intangible assets have both a finite economic useful life, as well as erosion in value over that life. In other words, intangible assets do not contribute to the profitability of a business enterprise indefinitely, and the extent to which they contribute to profitability will tend to decrease at some measurable rate over time. Regardless of how the intangible asset is being used in an intercompany transaction (whether the asset is transferred outright or certain rights to the asset are licensed from one related party to another), in order to establish an arm's length intercompany charge, understanding the life and decay of the intangible asset is paramount.

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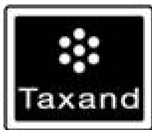

The time period defined as economic useful life needs to be defined both with a beginning and an end. The moment in which an intangible is deemed to come into existence can be as difficult to ascertain as the moment in which it ceases providing a benefit. This becomes an even more complex process when intangibles arise in a joint development program amongst related parties.

In the case of an outright transfer of an intangible asset from one related party to another, common valuation practices would look to the free cash flow (or profits) attributable to the exploitation of the intangibles. Developing business forecasts to estimate profits over time is a relatively straight forward task. Then assigning forecasted profit to a specific intangible asset is relatively more difficult. In order to assign profits to an intangible, one must first conclude how long that intangible is expected to contribute to the forecasted profits, and to what extent its contribution declines over time.

In the case of a license of certain rights to an intangible asset from one related party, the question of life and decay is still important. Compensation for use of the licensed rights should coincide with the period of time over which the rights are being exploited, and it should correspondingly decline if the value of the rights in the marketplace is declining.

There are many complexities that arise in trying to quantify life and decay. The extent to which an intangible asset either increases revenues or decreases costs associated with a business enterprise can be a subjective matter. When posing the question to executives making critical business decisions to steer a taxpayer's operations, it is not uncommon to hear disagreement about the relative importance of different categories of intangibles. Even to the extent that there is a clear consensus on the contribution of an intangible asset, subjective opinion on the value of an asset is sufficient for quantifying life and decay.

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It would be useful to have guidance on the types of methodologies that can be used to quantify life and decay for different categories of intangible assets. As part of the quantification process, guidance is needed to identify the components of different products with embedded intangibles that are most indicative of life and decay. For example, within a software product, one might look to the properties of the modules or even the written code. Within a hardware product, one might look to the properties of physical components, such as a processor. Guidance is also needed with respect to specific metrics that would be applicable for different types of intangibles. For instance, research and development spend might yield indicative metrics when analyzing technology related intangibles, while advertising spend might yield more appropriate metrics when analyzing brand intangibles.

4. OWNERSHIP OF INTANGIBLES

Determining the ownership of an intangible in a transfer pricing analysis is relevant as to determine what party to a transaction is entitled to income (i.e. both earnings and losses) attributable to the intangible. In this regard one can distinguish between legal and economic ownership of intangibles.

Legal ownership can be distilled from the legal protection that an intangible obtains from its registration based on domestic intellectual property law. The legal ownership can be shared under a co-own agreement in which more companies are registered as owners. In case of non-legally protected intangibles it is more difficult to determine the legal owner. This is especially the case when several companies are involved in developing and maintaining the intangible. In practice ownership in such case is determined by means of assessing which party controls or manages the intangible and the respective contribution (i.e. costs) of each party. For practical purposes it would be useful if the OECD Guidelines could provide further and more specified guidance in this respect.

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For transfer pricing purposes much often the more relevant ownership to take into account is the economic ownership. Economic ownership refers to the right to exploit an intangible and thus an economic owner can deny the legal owner the economic exploitation of the intangible. Economic ownership also implies that expenses related to the development and maintenance of the intangible are incurred. In general, reward follows the amount of risk taken, therefore, due regard must be given to assessing which party carries the risks related to the value changes of the intangible.

For transfer pricing purposes economic ownership may override the legal ownership if this better reflects the reality of functions performed by each party in the transaction. Given the importance of determining the owner of an intangible for tax purposes as well (i.e. double taxation issues may occur if different qualification is made by tax authorities) it would be useful to have more specified guidance on this topic.

In addition to the above, we note that documenting the relationship between parties to the transactions involving intangibles is critical in order to be able to determine ownership. Specific guidance on documentation requirements with regard to intangibles would therefore be useful.

5. GUIDANCE ON USE OF TRANSFER PRICING METHODS FOR ESTABLISHING ARM'S LENGTH REMUNERATION

Generally transfer pricing methods for establishing arm's length remuneration fall into two categories: transactional based methods and profit based methods. While there can be clear cut rationale for using one versus the other, often reliance on some combination of the two is required. In cases where the two types of methods provide vastly different results, placing heavier reliance on one versus the other is critical in establishing a result that is deemed to be arm's length.

In selecting a specific method for valuing an intra-group transaction involving an intangible, there are numerous comparability factors to be considered. Comparability factors can be general, applicable to the evaluation of any method, and also specific

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the evaluation of an individual method. Additionally, specific methods may be more appropriate than others for specific categories of intangible assets.

There are numerous valuation methods that are common in practice, but not specifically provided for in the Guidelines, and as such are considered "other methods". Both recognition and guidance with respect to application of these additional valuation methods would be helpful. Examples of such approaches include:

- Cost approach – based on replacement of investment costs
- Market approach – based on comparable market transactions and multiples
- Income approach – based on future estimates of income

These approaches are not only common in the tax valuation community, but they are also common in the financial statement reporting valuation community. Recognition of these methods would help to align valuations surrounding common intangibles in these two different settings. These methods typically make use of a number of variables that are common to all applications. For instance, an income approach will generally require the construction of discount rate. Guidance on setting assumptions or values for the major variables common to these traditional valuation methods would provide for consistency in the tax valuation community.

6. SALES AND MARKETING INTANGIBLES:

Sales and marketing intangibles have been a focal point of arguments between tax officers' and MNCs world over. In this respect detailed guidance is required on activities which give rise to creation of marketing intangibles and clarification should be provided on treatment of marketing expenditure i.e. when such expenses give rise to a marketing intangible. Specific guidance should be provided to distinguish between routine and non-routine expenditure / services incurred in relation to advertisement and sales promotion activities.

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Tax authorities have been relying on the theory of “bright line limit” and drawing conclusions based on the same. In view of the same, OECD should provide comprehensive explanation on the theory of bright line limit. Also, some practical implication should be provided with examples to explain the bright line test and to draw differentiation between the routine and non-routine activities performed by distributors/service providers.

Further, in case of determining the arm’s length price to benchmark the non-routine functions performed by an enterprise, OECD should throw some light on the comparability aspects. Following points needs to be taken into consideration:

- Guidance on scientific methodology to be adopted
- Precise steps, criteria and assumptions to be considered to select appropriate comparables
- Basis of quantification for comparison purposes (eg use of ratios, margin etc)
- Whether any adjustments can be carried out to mitigate differences (eg differences on account of risk, scale of operations, geography, time of entry into the market, technology, competition in market etc)

Also, OECD should highlight the composition of advertisement and sales promotion expenses, i.e. what all expense heads should be considered as a part of advertisement and sales promotion expenses. To illustrate the same, a position may be taken that sales team travel is part of travelling expenses, while another position can be it should be part of sales promotion. Thus, making a comparison wherein only few expense items are taken into account may influence the same owing to differences in accounting policies and may render the same unreliable.

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7. *TRANSFER OF INTANGIBLES*

Identifying arrangements made for the transfer of intangibles

Paragraphs 6.16 to 6.19 of the OECD Guidelines deal with identifying arrangements made for the transfer of intangibles in. The importance of this topic lies in determining (i) whether or not an intangible is transferred to a related party and (ii) when such a transfer is made. No allocation should be made until an intangible is transferred.

Embedded intangibles and package deals

The OECD Guidelines indicate that a transfer of intangibles is inter alia recognized in case of an outright sale of the intangible or a royalty under a licensing arrangement for rights in respect of the intangible property. It is also indicated that the compensation for the use of intangibles may not be readily visible when the compensation for the use of the intangible is included as part of the transfer price charged. The issue of these so-called embedded intangibles or package deals is whether a transfer of an intangible should be recognized and which of the parties to the transaction should be entitled to the income derived from the use of the intangible. Irrespective of whether a taxpayer charges one transfer price for the whole package or separately charges for the use of tangible and intangible assets, the OECD Guidelines currently only provide that the transaction should be concluded at arm's length.. More guidance in this respect would be useful.

Embedded intangibles usually arise with marketing intangibles such as trademarks, brand names logo's etc. No issue occurs if the party that acquires the tangible asset does not acquire rights to exploit the embedded intangible asset. In fact, distributors often perform marketing activities regardless of whether they possess the intangibles involved. It is conceivable that a distributor adds value to an intangible by making efforts to build up the reputation of a brand name in a territory where the branded product was unknown. In such event the question arises whether the distributor will have acquired rights over the intangible and, subsequently, whether royalties should be charged for the use of the brand name. However, it is noted that tax authorities may be reluctant to allow a separate royalty charge in addition to a package price in the event

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that a distributor obtains no rights to use or exploit a trademark other than to market and distribute a branded product in the first place.

As the classification of intangibles as embedded intangibles or separate charge is important for corporate tax purposes (i.e. qualification of part of the transfer as a royalty implies potential withholding tax issues), it would be useful if the OECD Guidelines could provide more specified guidance on this subject.

Inter-company assignment of employees

In today's knowledge economy, it is likely that the inter-company assignment of employees will gain increasing attention from tax authorities in the sense that a reassignment of an employee with certain know-how could be qualified as the transfer of an intangible.

The main question in this issue is first of all whether or not the knowledge of employees can be considered as an intangible. If so, the assignment of employees to a related company could be considered as the transfer of an intangible and, consequently, should be performed at an arm's length price. In our experience, there are quite some differing opinions in this regard. In some countries for example the know-how of an individual can never be qualified as an intangible under the reasoning that an individual cannot be sold, licensed or otherwise marketed. However, other countries take the opposite opinion. For example, the German tax authorities published a decree on the treatment of such assignments of employees. Although, the decree mainly deals with the allocation of costs, the decree also purports that an assessment should be made whether intangibles are transferred in case of an assignment of employees with know-how to related companies. Also, tax authorities in other countries have tried to argue (in some cases successfully) that a transfer of an intangible is made with the assignment of employees to a related company.

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In a situation where a company sets up a new manufacturing plant in another country - regardless of whether this is a low-tax jurisdiction - and a related company permanently or temporarily places a manufacturing employee as plant manager to train local employees to perform its own functions in the future, the question arises whether the know-how of this employee is an intangible owned by the company assigning the employee which should be compensated at arm's length. Given that the know-how of this assigned employee is very specific and crucial for the success of the new manufacturing plant, the fact that a royalty is charged may be reckoned as quite straight-forward. However, the new manufacturing plant could also have hired a local employee with this specific know-how in order to manage and train local employees which in it is nature would be an arm's length transaction. Therefore, one could argue that the arm's length principle does not require compensation in case of the transfer of employees.

Given the above considerations we feel it would be useful if the OECD Guidelines could provide guidance on this topic.

8. GUIDANCE ON BENCHMARKING

As discussed, the transfer pricing methods described in the OECD Guidelines are general in their application and not specifically written for intangibles. However, among the transfer pricing methods mentioned, the CUP, TNMM and profit split method are most commonly applied when determining the arm's length price of intangibles. Little guidance can currently be found in the OECD Guidelines on the selection of transfer pricing methods for intangibles. No guidance is provided on the benchmarking process after a transfer pricing method is selected.

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The CUP method is often applied for assessing the arm's length character of the transfer of intangibles through licensing agreements. First of all, it should be noted that the more unique the intangible is, the more difficult it will be to find a reliable CUP. If it is concluded that it should be possible to find a reliable CUP, the question arises which elements should be considered in choosing a reliable CUP. From the OECD Guidelines it follows that five factors should be taken into account when determining comparability:

- the characteristics of property or services;
- the functions performed;
- the contractual terms;
- the economic circumstances; and
- the business strategies.

Clearly, these comparability factors are of a general nature and not specifically tailored to the specific needs of intangibles. Due regard should be also given to technical elements (e.g. technical and economic life of the intangible, uniqueness, stage of development, economic benefits derived from the intangible) and juridical elements (e.g. exclusivity, legal protection, possibilities to sub-license). The main issue when assessing these aspects is to determine whether the intangibles involved are comparable and whether the circumstances underlying the transfer are comparable. More often than not such is not the case. Should it, however, not be possible to (more) reliably apply another transfer pricing method, it could be considered to apply the CUP nonetheless and make financial adjustments to adjust for the found differences. Practical guidance on determining comparability and considerations on making reliable adjustments to adjust for minor comparability would be very welcome.

TNMM is most often applied as a 'sanity check' to the results of a CUP analysis. For example, the TNMM is used to remunerate routine functions and the resulting residual profit is subsequently split using the profit split method.

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Profit split method can be used in the event that other transfer pricing methods are not usable due to the uniqueness of the intangible involved. Again, the routine functions are first rewarded on the basis of benchmarks performed, after which the residual profit represents the reward for the owner of the intangible. This method works out more or less the same as the TNMM. For both these methods, the problem with identifying comparable companies applies to a much lesser extent than that with performing a CUP analysis.

Nonetheless, as for comparability factors, some more specific guidance on the use of the TNMM and profit split for intangibles transactions between related parties would be pertinent as long as the application of these methods entails multiple debates between taxpayers and tax authorities. In particular criteria which might be favored to determine the profit sharing and how they could be ponderate should be explored.

9. ***DISTINCTION BETWEEN PLATFORM INTANGIBLES AND FUTURE ITERATIONS OF CURRENT EXISTING INTANGIBLES***

Generally speaking, a platform intangible is one that is anticipated to contribute to the development of future intangibles. When evaluating compensation for use of general intangibles, distinctions must be made between core platform intangibles that are further built upon and the future iterations of new intangibles that make use of the original platform intangibles.

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Platform intangibles are best illustrated in a software environment. The code that represents Version 1.0 of a brand new software program may be considered a platform intangible. Eventually Version 1.0 will be upgrade and further developed into Versions 1.1 and 1.2. Depending on the functionality that is added to each new version, there may or may not be new intangibles contributed to the product at each level of upgrade. Regardless, Version 1.0 was clearly used as the basis for developing Versions 1.1 and 1.2. At some point, future versions of the original software platform will be developed that have significant new intangibles of their own, but still have some semblance of the original core platform intangible from Version 1.0 embedded in them.

Core platform intangibles can have varying lives that are often significantly longer than product specific intangibles. Recognition and guidance of this principle would help to establish common methods and practices for identifying platform intangibles and quantifying their value.

Rights to use platform intangibles in the development of future intangibles must also be distinguished from rights to use product specific intangibles in the production and sale of those products. Platform intangibles inherently have a different value proposition, and are exploited in a significantly different manner, from make/sell intangible rights that simply provide a blueprint for reproducing a specific product.

10. ARRANGEMENTS MADE FOR THE TRANSFER OF INTANGIBLE PROPERTY AND DETERMINATION OF AN ARM'S LENGTH REMUNERATION

In practice, the way in which an intangible asset is transferred (or its use licensed) may have an impact on the arm's length price to compensate its holder, regardless of how the payment is implemented (upfront vs. payment periodic royalty).

The value of an intangible asset is not a static concept nor absolute, but rather depends, on one hand, on the benefits that the licensee expects to obtain from its use (which varies from one company to another), and on the other hand, on the manner in which it may be used, according to the arrangement done by the parties.

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To this extent, the OECD Guidelines provide for some general considerations (paragraphs 6.16 onwards) in connection with the traditional distinction between the outright sale of the intangible, the royalty under a licensing arrangement for rights in respect of the intangible property, or its inclusion in the price charged for the sale of goods.

Regarding these forms of transferring the use of intangible assets, it would be worth examining in detail certain problematic aspects that are generated in determining the price to be fixed in related party transactions, for example, the need to separate tangible and intangible property or the criteria to identify comparable assets when assessing arm's length remuneration for embedded intangibles, or how to value bundles of intangibles when their components have to be considered individually.

In addition to that, in recent times further types of arrangements to transfer or license the use of IP have been put in practice, such as the provision of high value services using intangible assets (software, for example) or the use of different types of intangible property in the generation of another new and distinct intangible (patent pools or cross-license agreements), thus being necessary to consider the main features that should be taken into account to determine an arm's length remuneration.

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Without prejudice to the comments included under paragraphs 6.20 onwards of the Guidelines, additional work should also be performed to provide clearer guidance on the relevance of some special issues inherent to intangible assets when performing a comparability analysis to apply the arm's length principle. Among other, these factors may be:

- Limitations or restrictions to the use of the intangibles[1].
- Difficulty in identifying adequate comparable transactions or assets to assess the arm's length nature of the intragroup remuneration, given the secret nature of this type of assets.
- Convenience and limits to include the remuneration of the intangible asset in the price earned for related products and services.
- Contribution or benefits provided by the user of the IP to its owner by means of improvements on it.

Another issue to be considered for further analysis within this project refers to the calculation of an arm's length remuneration when different intangible assets are licensed to run a business (for example, trademark and know how). The interaction of various assets may increase the individual value of its license, taking into account the higher benefits that may derive for the licensee from the joint use of them.

[1] Based, for example, on the geographic area in which they are exercised, on the expectations that an industrial intangible may be superseded taking into account the duration and degree of protection granted by the applicable industrial property law, or on the exclusive or non-exclusive character of the rights transferred.

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11. GENERAL GUIDELINES TO CONDUCT AUDITS RELATING TO INTANGIBLE PROPERTY

In recent times, tax administrations seem to be increasingly focused on conducting audits relating to the transfer or use of intangible property in MNEs.

Although the OECD Guidelines include some paragraphs providing general guidance for tax administrations to assess whether an arm's length value has been applied when there is a high uncertainty at the time the transaction is done, a more in-depth analysis should be made and further guidance be provided in connection with some issues which may be critical when auditing these types of transactions involving IP.

These issues should, in our opinion, comprise the following:

- Interdiction of using hindsight: when evaluating the price agreed in a transaction between related parties, consideration should be given to the facts and circumstances at that time, the information currently available for the parties to the determine an arm's length remuneration and what independent enterprises would have done under similar circumstances.

  Since tax audits are carried out a long period of time after the outset, tax administrations should not use information which was not reasonably available at that time to assess whether or not the price agreed on an arm's length basis.

- Price adjustment clause: the Guidelines provides for the use of this type of clauses in arrangements between unrelated parties when assessing the value of a related transaction as well as for the possibility that prospective renegotiations would have occurred in independent transactions when fundamental developments have taken place after the outset.

  A clearer view on the use of both instruments and the circumstances in which they might be applied would be desirable, taking into account the comments made in the preceding paragraph.

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We appreciate this opportunity to provide comments to the Committee of Fiscal Affairs and would be pleased to discuss this further and / or to participate in any further discussion on these matters. More information on how to contact me and about Taxand is provided as Appendix I. Taxand is wholly committed to supporting the OECD Committee of Fiscal Affairs and we look forward to contributing to further debate.

Yours sincerely,

Antoine Glaize

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Head of Taxand Global Transfer Pricing

This paper has been prepared by the Global Taxand Transfer Pricing Service Line group coordinated by :

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APPENDIX I

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