PRICEWATERHOUSECOOPERS

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Dear Mr Owens,

Transfer Pricing Aspects of Intangibles: Scope

PwC would welcome consideration by Working Party 6 ("WP6") of the transfer pricing issues arising in relation to intangibles. We have collected views and experience from our global transfer pricing network in order to respond to the OECD's invitation to comment on the potential scope of the review.

Our detailed comments are set out below. Overall, we note that there was strong support for such a review throughout our network for various reasons, the most common of which were that:

- intangibles have become considerably more important in business since Chapter VI was first published in 1995;
- the transfer pricing issues that arise have become more common and can be some of the most difficult to resolve; and
- the revised Chapters I-III now refer to valuable, unique contributions and valuable intangibles which are given a central role in determining the selection of the most appropriate method and comparability analysis.

We also note that Chapters VI and VIII are closely related since a high proportion of cost contribution arrangements are used for the development of intangibles. We would therefore welcome consideration of both Chapters in any forthcoming review by WP6.

Most significant issues in relation to the transfer pricing aspects of intangibles and shortfalls in existing OECD guidance

1. Characteristics of an "intangible"

The OECD Transfer Pricing Guidelines (the Guidelines) currently contain an outline categorisation of "intangible property" (trade and marketing intangibles) and an illustrative list of the assets involved. Since then we have observed a number of tax authorities take a much broader view of what intangibles might be or, in some cases, a narrower view based, for example, on local commercial law.

Widely differing approaches to the recognition of intangible assets increases the risk of economic double taxation and more detailed guidance from the OECD that might promote more consistency would be helpful. This view was also shared by our representatives in a number of countries that are not members of the OECD who reported that difficulties with characterisation can be quite pronounced in their territories, that the Guidelines are widely used as a reference by taxpayers and tax auditors and that consideration of these issues in Guidelines would be of significant practical help to both.

We recognise that there is a wide range of potential definitions and interpretations of the terms intellectual property, intangible property and, more generally, intangibles. However, as our representatives considered a number of the issues identified below the discussion kept returning to the question of whether something was or, more frequently, was not an intangible. An exact definition of all intangibles is likely to prove difficult and setting out the characteristics of intangibles may prove more worthwhile. In this regard, the use of case studies and illustrations of what is and (importantly) what is not an intangible would be welcomed.

We note that other international organisations have also had to consider a systematic basis for recognising and categorising intangibles. We note in particular the TRIPS Agreement and associated material maintained by the WTO which is relevant to transfer pricing as it is the relevant international legal framework. The question of whether an intangible is protected is surely relevant to its value if not its characterisation.

We would also note the detailed work in this area by the International Accounting Standards Board (IASB) which had to consider the question in order to provide rules on accounting for intangibles. Intangible assets are considered in detail in IAS 38 and are considered further in IFRS 3. The IASB is also currently working on valuation issues (see 7 below). As IFRS has been widely adopted, adoption by additional countries is continuing and there is a convergence project with US accounting standards, this is likely to represent a good common basis between countries for a discussion of the characteristics of an intangible in a manner that is likely to be recognised and understood by business.

2. Goodwill

A number of countries in our network reported that tax authorities sometimes try to take a very broad view of what might be an intangible and then use that either to attempt to enforce a transfer pricing adjustment or to try to force the use of the profit split method. We believe that it would be very useful if WP6 were to consider the following questions.

- How to separate factors which, whilst not tangible, are not “intangibles”? Perhaps in the sense that they are not assets, or not separable assets or cannot be owned or transferred – in which case, if they exist they may simply be a component of goodwill. Examples may include work force in place, network effects, location savings, “business opportunity” and “first mover advantage” or, for example, where commercial law protects a right that may not otherwise be considered an intangible e.g. in the EU an agent (but not a distributor) receives compensation if its agency contract is terminated
- When and in what circumstances it is relevant to consider goodwill? For example, it may be relevant when transferring a business but not when selling goods e.g. if the goodwill reflects the profits of the continuing business of selling those goods (i.e. profits on future sales which would be double counted if included in transfer prices) and is not an attribute of the goods themselves.

We consider that the sheer potential breadth of the term “intangibles” is such that there is real scope either for double taxation or inappropriate application of the Guidelines unless some further parameters are laid down in Chapter VI.

3. Relationship with tax treaties

Tax treaties also have explicit or implicit definitions of intangibles, often through the royalty article. Our experience is that these are sometimes applied to transfer pricing between the two countries concerned, partly because withholding taxes may also be relevant and the treaty language is then part of the broader case in point. The Guidelines put this issue to WP1 (Double Taxation), for example in Para 6.19, but recognise that some similar issues arise in transfer pricing to those considered by WP1 and are reflected, for example, in the commentary to the OECD Model Tax Convention. Two examples include:

- the question of whether some form of intangible may be associated or bundled with services; and
- whether a transaction which, for legal reasons, needs to be expressed as a licence is, in economic terms, more akin to a sale of goods or services e.g. when certain types of software products are sold.

Our network reported that these remain common problems in transfer pricing and in a number of countries they were considered to be very significant problems. One further issue reported is the difference between an Article 7 approach and that under Article 9 (see also points 4 and 5 below).

4. "Normal" profit and economic rent

One recurring issue in practice when dealing with intangibles is the question of a "normal" return and an economic rent i.e. returns in excess of the "normal" return which are also sometimes called "economic profit" or "super profit". We believe that there is a degree of confusion in relation to these concepts and their implications for transfer pricing. That confusion is not helped by a lack of precise terms for the concepts involved. Nevertheless, those concepts are inherent in several of the propositions set out in the current Guidelines – for example, a residual profit split or in the description of the value that may be found in trade marks and patents (Para 6.8). It also seems to be inherent in some of the new language in Chapters I-III regarding "valuable, unique contributions" (Para 2.59).

We consider that it would be helpful if WP6 considered the issue of economic rent and, in particular, consider whether it would be appropriate to set out some of the principles involved. One recurring issue is whether ownership of an intangible entitles a licensor to the full economic rent derived by a licensee.

5. Legal and economic ownership

The concept of economic ownership is found in the Guidelines – it is introduced in Para 6.3. The term beneficial interest is used in Chapter VIII.

Our network has found that economic ownership and beneficial ownership are difficult concepts in practice. In part because the term economic ownership has no legal meaning in most of the world and because the term beneficial ownership means something very specific in a few countries and not in others. Nevertheless, we do not find the concept of economic ownership contentious – what is difficult is evaluating its impact. It would be helpful for the OECD to consider economic ownership, indicators of economic ownership and the relative value of economic compared to legal ownership.

There are instances in which a MNE may, out of legal or commercial necessity, centralise intellectual property ownership, for example, because enforcement action in the courts can be difficult with multiple parties owning related intangibles. The owner in such a case may not necessarily be the original developer of the intangible or have borne the original costs or even use the intangible. A discussion of a practical approach to these sorts of problems would be of significant benefit e.g. whether the developer can retain the economic rights (i.e. value) while legal title is transferred. See also our comments on cost contribution agreements in 8 below where this principle is implicit.

It would also be helpful for the OECD to consider issues where one party develops intangibles on behalf of another party, e.g. contract research and development and contract marketing, where the costs are borne by one party but remunerated by the party that therefore bears the risks associated with the development of the intangible.

6. Marketing intangibles

The issue of marketing intangibles may fit into a number of the points raised above but since the GlaxoSmithKline case in the USA up to and including the most recent case in India regarding Maruti Suzuki, the issue has become an area of significant contention. It would be helpful for WP6 to consider the issues and provide greater guidance on the question of marketing intangibles. For example, is a high level of marketing expenditure alone sufficient for a distributor that does not own the trademark to obtain some interest in the trademark or other marketing intangibles? Or would the OECD expect other factors referred to in Chapter VI to be relevant such as the behaviour of the parties e.g. whether the trademark owner had significant influence over marketing expenditure, how it is spent and what it is spent on? Furthermore would such marketing expenditure create an interest in the marketing intangibles where it is reimbursed indirectly e.g. through the use of the TNMM to set transfer prices?

7. Valuation of intangibles

Some countries also reported questions on principles that should be applied in considering value and the difficulty of obtaining recognition of these because no mention is made in the Guidelines. For example, if an intangible has cheap substitutes or can be copied and is not protected then it is not highly valuable. Such questions are likely to increase in importance given the revisions to Chapters I-III of the Guidelines and the broader the approach to intangibles.

It is generally agreed that there are three principal valuation approaches – the market approach; the income approach; and the cost approach. The IASB and FASB are currently coordinating their approach to valuations. They plan to conclude their work by the first half of 2011 and much is already in the public domain. This work and the current Exposure Draft on valuation may provide a helpful framework for the OECD’s review. For example, the distinction between a valuation basis (“value in exchange” or “value in use”) and a valuation method. The Guidelines currently point towards “value in use” (Para 6.15) i.e. not necessarily the highest and best use but the use to which the related party actually has for the intangible. This contrast with some other valuation rules may be worth further consideration.

It would be helpful for WP6 to consider the valuation of intangibles so as to set out the OECD’s view on the circumstances in which different valuation methods may and may not be appropriate. For example, when considering the options available to the parties to a transaction (in accordance with 1.35 of the revised Guidelines), surely the cost of developing an alternative would operate as a ceiling which the transfer price should not exceed?

Our network has reported significant difficulties in this area ranging from straightforward disputes over valuations (which may be inevitable although a clearer framework would be useful) to wholesale rejection by tax authorities of potential CUPs for royalty rates which, it seems, is often done as an article of faith rather than through application of the principles now in Chapter III. We would welcome confirmation that the choice of methods in the new Chapters I-III applies to all transactions including intangibles and that the CUP method should continue to be treated as the favoured method (other things being equal) or whether secondary methods are necessary where CUPs are present and used.

8. Cost contribution agreements

At the time the original OECD Guidelines were drafted, cost contribution agreements (CCAs) were less widely used than today. The Guidelines in Para. 8.1 recognise the need for further study of many of the more complex issues. Since then the use of CCAs has significantly increased, particularly relating the development of intangible property, and further guidance would be welcomed. For example, we would welcome confirmation from the OECD that the arm's length principle should apply to CCAs.

There are a number of difficult areas relating to the establishment and maintenance of CCAs that could helpfully be considered. Some involve existing concepts in the Guidelines (e.g. the principle of mutuality or buy-in and buy-out payments) where differing national approaches now result in a serious risk of double taxation and further detail based on the experience of member countries would be welcome. Some address issues that have arisen since 1997 such as what costs should be included and whether special valuation rules should apply to buy-in and buy-out payments. Finally, our network has experienced difficulties as to whether certain transactions are eligible for CCAs (a number of countries reported that their tax authorities are profoundly reluctant to accept CCAs for services). Consideration of these issues would therefore be helpful.

Format of the final output of the OECD work

We have identified above a number of significant issues encountered in relation to the transfer pricing of intangibles and have set out those areas where consideration of the OECD would be beneficial.

Overall, we gratefully acknowledge the work done by the OECD in relation to the re-write of Chapters I-III and the additional Chapter IX on business restructuring. We think it would be helpful if the output of the OECD work around the transfer pricing aspects of intangibles resulted in updated Chapters VI and VIII of the OECD Guidelines.

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