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Organisation for Economic Cooperation and Development
Centre for Tax Policy and Administration
Attn. Mr. Joseph L. Andrus
2, Rue André Pascal
75775 Paris, France

Re: Comments on OECD Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions

Dear Mr. Andrus,

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft published June 6, 2012, and referenced above. The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we commend OECD Working Party No. 6 for providing the opportunity for business input on this important project.

The Discussion Draft includes a proposed revision of Chapter VI of the OECD Transfer Pricing Guidelines as well as a proposed revision of the Annex to Chapter VI providing examples illustrating the application of these provisions. These aspects of the Transfer Pricing Guidelines address the transfer pricing aspects of intangible assets. Our comments on the Discussion Draft are based on several overarching principles, which we believe to be widely shared by business enterprises and other stakeholders. First, it is absolutely critical that any revisions to the Transfer Pricing Guidelines provide more clarity and certainty for businesses and governments with respect to the issues addressed. The goal of revisions to the Transfer Pricing Guidelines should be to further the consensus among governments and taxpayers as to the application of the arm's length standard, thereby minimizing the risks of double taxation, consistent with the tax treaties under which the Guidelines are relevant. Second, this project should not be used as a platform to reopen issues that were resolved in the recent guidance on business restructurings included in the Transfer Pricing Guidelines in 2010; rather, any further revisions to the Transfer Pricing Guidelines should incorporate and build upon the consensus reached in the business restructurings project.

The Discussion Draft is divided into five parts: (1) identifying intangibles; (2) identification of parties entitled to intangible related returns; (3) transactions involving the use or transfer of intangibles; (4)

determining arm's length conditions in cases involving intangibles; and (5) an annex with examples illustrating the principles of parts (2) – (4). We provide comments on each of parts (1) through (4), with comments on the examples provided in context.

Identifying Intangibles

The Discussion Draft provides guidance on what constitutes an "intangible" for transfer pricing purposes. The Discussion Draft rejects definitions from other contexts. Instead, the Discussion Draft in paragraph 5 provides a two-part definition of "intangible": "something" (1) "which is not a physical asset or a financial asset," and (2) "which is capable of being owned or controlled for use in commercial activities." A guiding principle to determine whether an asset constitutes an intangible asset for transfer pricing purposes is whether, in a transaction between independent parties, compensation would be provided for the asset. The Discussion Draft provides that accounting and legal descriptions of existing intangible assets should not control the determination of whether an intangible asset exists given the constantly changing modes of doing business and intellectual property laws. To provide clarity and an analytical framework, however, legal and accounting definitions of intangible assets should serve as the reference point for defining an intangible asset. The Discussion Draft emphasizes, however, that even if an item constitutes an intangible asset, it will not necessarily deserve separate compensation or give rise to a premium return under all circumstances. To illustrate this point, the Discussion Draft identifies non-unique know-how as an intangible that might not, under particular circumstances, warrant a premium return. The Discussion Draft then provides illustrations of items that would be considered intangible assets under this framework. It concludes that goodwill and ongoing concern value may be intangibles under some circumstances and discusses assembled workforce. The Discussion Draft concludes that items not owned or controlled by a single entity, such as group synergies or market-specific characteristics, are not intangibles.

The NFTC applauds the efforts in the Discussion Draft to define the scope of the term "intangible," to clarify that not all intangible assets generate premium returns, and to clarify that group synergies and market characteristics are not intangibles. In this regard, we recommend that the Discussion Draft further limit the scope of the term to items that are proprietary – that is, items that are legally protectable such that the associated enterprises party to a transfer can exclude others from using the assets. In the absence of such proprietary interest, an independent transferee would not pay to acquire the item. Indeed, as other commentators have recommended, it may be helpful to retain the terms "intangible assets" or "intangible property" in the current Chapter VI to prevent confusion or misinterpretation. We therefore recommend that paragraph 5 of the Discussion Draft be revised to state that the term "intangible" is to be defined as "an asset which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and which is capable of being transferred."

Our recommendation is guided by the primary purpose for which classifying an item as an "intangible" is relevant, namely to determine whether a compensable transaction has occurred between associated enterprises. The definition of "intangible" for transfer pricing purposes is important in the context of determining whether a valuable intangible asset has been transferred between associated enterprises, and therefore whether compensation is due. It is not significant in determining the compensation due among associated enterprises in ongoing transactions that may involve the use or exploitation of intangible assets and similar items because such items may be taken into account regardless of any label in a

transfer pricing analysis through a comparability analysis. This observation is consistent with recent revisions to the Transfer Pricing Guidelines; for example, the recent revisions to the guidance on the profit split methodology provides that residual profits or losses are allocated in accordance with unique and valuable contributions of any type, not only in accordance with contributions of intangible assets.

Our recommendation is best illustrated in the context of goodwill, ongoing concern value, and assembled workforce. The Discussion Draft concludes that goodwill and ongoing concern value are valuable intangibles that should be taken into account under appropriate circumstances, namely when some or all of the assets of an operating business are transferred. But goodwill and ongoing concern value do not constitute interests in property in their own right, and it is not possible for one enterprise to transfer goodwill or ongoing concern value to another independent of a transfer of the entire business to which they relate. There is no purpose to defining these items as "intangibles," and such a classification may create a misimpression that such items can be independently transferred or that such items automatically attach to collections of assets. In cases where some or all of the assets of an operating business are transferred, then all attributes of those assets and that business should be taken into account regardless of whether they are classified as intangibles or not. Example 13 of the Annex illustrates this point. In that example, the goodwill and ongoing concern value associated with a parent company's operations in country B should be taken into account in evaluating the transfer pricing for the transfer of all of the parent company's country B business operations to a new associated enterprise without regard to whether the goodwill or ongoing concern value are classified as intangibles.

Similarly, assembled workforce can be thought of as a particular subset of ongoing concern value. An assembled workforce is not an interest in property, and it is not possible for one enterprise to transfer such an attribute to another independent of a transfer of the entire business to which the workforce relates. There is no purpose to defining this item as an "intangible." The Discussion Draft is correct of course that the existence of a uniquely qualified or experienced workforce may affect the arm's length price for services and should be taken into account in a transfer pricing comparability analysis. But it is not necessary to classify assembled workforce as an "intangible" to achieve this result.

Regarding market specific characteristics and group synergies, the NFTC commends the language of the Discussion Draft. These characteristics cannot be owned, controlled, or transferred and therefore should not be regarded as intangible assets within the meaning of the Chapter VI and the Transfer Pricing Guidelines. These characteristics may, however, affect transfer prices and should be taken into account through the required comparability analysis.

Our recommendation is consistent with the objectives of providing more clarity and certainty for businesses and governments and with building on the work done with respect to business restructurings. The definition of "intangible" is most relevant in the context of determining whether there has been a transfer, and in that context, a definition that goes beyond proprietary interests has the potential to lead to uncertainty and disputes. This is consistent with the guidance on business restructurings, which emphasizes that compensation is due as a result of a business restructuring only where tangible or intangible assets, as distinguished from profit potential, are transferred.

Finally, while we generally agree with the Discussion Draft's conclusion that the definitions of royalties in Article 12 of the OECD Model Tax Convention should not be relevant for the definition of intangibles for transfer pricing purposes, we believe that the Commentary on Article 12, regarding

transfers of certain non-tangible items that generate business profits, should be relevant for the classification of intangible assets in the Discussion Draft. For example, consistent with the Commentary, user transactions in software and digital products should not be treated as transfers of intangibles for transfer pricing purposes, even though no physical property is involved in the transfer. *See* Organisation for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, Commentary on Article 12 ¶ ¶ 12-17.

<u>Identification of Parties Entitled to Intangible Related Returns</u>

The Discussion Draft next addresses how to determine which members of an MNE group are entitled to returns from the use of intangible assets. The Discussion Draft identifies the concept of intangible related returns and provides that such returns should follow the contributions made by associated enterprises to the value of the intangibles. Comments are requested as to whether this formulation successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns attributable to intangibles should be determined on the basis of relevant functions, assets, and risks. The Working Party No. 6 delegates expressed consensus that the transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain intangible related returns without more. In paragraph 41, the Discussion Draft illustrates these principles by treating legal registrations and contractual arrangements as a starting point for the analysis, but places considerably more weight on whether a person physically performs through its own employees the important functions related to the development, enhancement, maintenance, and protection of the intangibles. To merit intangible related returns, the functions performed by an entity "would generally include, among other things, the design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, and important decisions with respect to defence and protection of intangibles and ongoing quality control."

The NFTC is concerned that the approach suggested by the Discussion Draft could undermine the arm's length principle by failing to give due regard to actual transactions and arrangements undertaken, to legal and economic ownership rights, and to the bearing of economic risk with respect to the development of intangible assets. A fundamental tenet of the Transfer Pricing Guidelines is that the arm's length principle can be satisfied by determining the arm's length price for an arrangement as actually undertaken and structured, except in rare or unusual circumstances. Rare and unusual circumstances include cases in which the transaction undertaken is inconsistent with the underlying economic substance, as evidenced by the conduct of the parties. We recognize the need for this exception to address arrangements lacking in economic substance. However, legal and contractual arrangements between associated enterprises should, in general, be respected. The conduct of the parties may be consistent with a broad range of potential legal or contractual arrangements and therefore cannot determine the entitlement to intangible returns without considering the structure of the arrangement. The conduct of intangible development functions by an associated enterprise, for example, may be consistent with the provision of contract R&D services for the economic owner of the intangible asset for a cost-plus fee or with the performance of R&D functions by the owner on its own behalf. The best way to determine which arrangement is intended is by examining the relevant legal, financial, or contractual arrangements. The Discussion Draft should clarify that the transaction or

arrangement actually undertaken, as evidenced by legal rights under contract or otherwise, typically will drive the entitlement to intangible related returns.

In addition, the Discussion Draft appears to apply a different standard to determine an entitlement to an intangible related return than to other elements of a traditional functional analysis, unduly emphasizing certain functions over assets or risks. Under a functional analysis, the returns to an associated enterprise depend on the functions performed, assets used, and risks assumed by the parties. In the context of intangible assets, the assets themselves may be legally and economically owned by an associated enterprise. Indeed, the legal right to exclude others from exploiting intangible assets is what gives such assets their value. Similarly, because of the speculative nature of many intangible development activities, bearing the costs related to intangible development often constitutes a significant risk assumed by an associated enterprise. It is not clear why the Discussion Draft dismisses legal ownership and bearing of intangible development costs as insufficient to attract intangible related returns. The Discussion Draft essentially asserts that an associated enterprise is entitled to intangible related returns only if it physically performs, through its own employees, the "important" functions related to the development of the intangibles without regard to legal or contractual arrangements or who bears the costs of intangible development.

The standard proposed by the Discussion Draft is unwieldy, inconsistent with the manner in which many MNEs operate, and likely to lead to significant uncertainty and controversy. At the margins, determining whether an associated enterprise is engaged in enough of the important functions related to intangible development may be difficult and uncertain for both taxpayers and tax administrators. More fundamentally, MNEs increasingly conduct intangible development activities in regional centers in multiple jurisdictions, as well as in manufacturing sites or other facilities. Where multiple associated enterprises are engaged in activities involving the same or related intangible assets, identifying the enterprises that perform the functions identified by the Discussion Draft will be intensely challenging both for MNEs and tax administrators. Presumably, this circumstance would require an allocation of intangible related returns among the associated enterprises that perform such functions. Yet the draft provides no guidance on the methodology that parties should use to make such an allocation. The uncertainty created by the proposed standard will increase compliance and enforcement burdens and will also likely increase the number of controversies in this area.

A preferable standard would focus on who funds intangible development costs where the funder is intended to be the economic owner of the intangible assets. We believe that funding intangible property development efforts, coupled with a legal or contractual indication that the funder is intended to be the economic owner of the intangible assets vis-à-vis associated enterprises, should be regarded as a strong indication that the funder is entitled to an intangible related return. If necessary to address abusive cases, the funder could be required to oversee the activity, at least at a high level. This standard is more consistent with the arm's length principle because it gives effect to a range of economic arrangements that could be entered into among independent parties. It would also bring the guidance in conformity with Chapter VII of the Transfer Pricing Guidelines, which provides for the use of cost contribution arrangements to develop intangible assets. In a cost contribution arrangement for the development of intangible assets, each participant is entitled to exploit its interest in the intangible assets developed separately as an effective owner thereof, and therefore entitled to the returns from the assets, because it bears the costs and risks of such development. The same should be true outside of the cost contribution

context when only one person bears the costs and risks of funding intangible development. Further, NFTC's preferred standard would lead to far more certain and predictable results for taxpayers and tax administrators.

Finally, we note that the use of the "intangible related return" concept seems unnecessary as a general matter and even within the framework developed in the Discussion Draft. This concept is axiomatically defined as the residual return once returns to all other assets (including intangible assets other than those being considered), business functions, and risks are considered. It is not clear why it is necessary to take this step rather than to determine the returns to which one or both associated enterprises may be entitled based on their functions, assets, and risk in accordance with a traditional functional analysis. While there may be circumstances in which the isolation of intangible-related returns may be illuminating, in general, this step strikes us as unnecessary. Further, in many cases it would be difficult or impossible to determine the intangible related return for any particular intangible asset. Any framework that depended on the determination of such returns would be difficult to administer and would lead to considerable uncertainty.

Transactions Involving the Use or Transfer of Intangibles

The Discussion Draft recognizes two general categories of transactions involving intangible assets: (1) transactions involving the use of intangibles in connection with the sale of goods or services, and (2) transactions involving the transfer of intangibles. The Discussion Draft provides additional guidance and considerations for cases where intangible assets are transferred in combination with other intangible assets or in combination with other business transactions and contains several illustrative examples.

Example 15 is noteworthy. In that example, Birincil acquires all of the shares of an unrelated company, Company T, for 100. The purchase price allocation performed for accounting purposes attributes 20 of purchase price to tangible and identified intangible assets, and 80 to goodwill. Company T then transfers all of its intangible assets to Company S, a subsidiary of Birincil. Company S then enters into a contract R&D arrangement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of intangible assets on behalf of Company S on a cost plus basis. Company S has a large research staff, including management personnel, and assumes full management responsibility for the conduct of intangible development. The example states that the allocations of purchase price for accounting purposes are not relevant for transfer pricing purposes, and that the purchase price reflects the arm's length price for the business of Company T. It concludes that, under arm's length transfer pricing principles, Company T should be entitled to compensation from Company S for the value allocated to goodwill, either as part of the compensation for the transfer of intangible assets or as compensation for the long term contract R&D arrangement.

In general, we applaud the use of examples to illustrate general provisions and provide concrete guidance, and we understand that it is not possible to provide examples that account for every factual variation or nuance. However, the analysis in Example 15 seems too facile. The 100 of purchase price reflects the value of Company T to its purchaser, Birincil, and not the value to Company T of its own assets and other attributes. There may be reasons why, at arm's length, Company T would not be expected to extract returns commensurate with the purchase price from its transactions with Company S or the exploitation of its own current assets. For example, the purchase price may reflect expected synergies between Company T and Birincil assets and attributes, including Company S's research and

management staff and the capital with which it will fund ongoing intangible development. This example should be eliminated or at a minimum substantially redrafted to reflect alternative analyses.

Determining Arm's Length Conditions in Cases Involving Intangibles

The Discussion Draft provides substantial guidance on how to determine the arm's length price of transactions involving the use or transfer of intangible assets. The Discussion Draft outlines considerations for conducting a comparability analysis of intangible assets, sets out a list of comparability factors specific to intangible assets, and identifies certain intangible assets that would be difficult to benchmark (so-called "D.1.(vi) intangibles"). The Discussion Draft then provides more specific guidance on the determination of arm's length prices using the five OECD transfer pricing methods and other valuation techniques, in particular discounted cash flow methods.

The NFTC is concerned with some aspects of the Discussion Draft that could be read to disparage the applicability of the comparable uncontrolled price ("CUP") method. While the Discussion Draft acknowledges that the CUP method may be appropriate in certain cases, the overall thrust of the Discussion Draft is to discount the applicability of the CUP method by highlighting the difficulty of finding comparable intangible assets or making sufficient adjustments. Other commentators have noted that a substantial percentage of cases involving intangible assets have been resolved in various jurisdictions on the basis of the CUP method. While it is not perfect, particularly where internal CUPs are not available, the use of observed royalty rates or other prices may be more indicative of the true arm's length result than a profit split, and simpler to apply than a discounted cash flow analysis. We agree with the concerns expressed in the Discussion Draft regarding some of the weaknesses of the discounted cash flow method, in particular the reliance on financial projections and the uncertainty of the discount rate determination. We believe that the CUP method, where applicable, often provides the most reliable and predictable indication of the arm's length result.

The NFTC is also concerned with the increasing prominence of the realistically available options principle and the potential for this principle to undermine the arm's length principle. As noted above, the arm's length principle generally requires a determination of the arm's length price for an arrangement as actually undertaken and structured except in rare or unusual circumstances. The realistically available options principle should not be used to circumvent the ability of taxpayers to structure their arrangements. While in some cases a realistically available options analysis may be useful as a check on prices, it is not appropriate to use this analysis to support a conclusion that a transaction should be disregarded or reconstructed by tax administrators. Further, though the reasonably available options principle might be appropriate in the business restructurings context, which focuses on significant one-time transactions, the great majority of transactions involving the use or transfer of intangible assets do not involve the issues that appear to be addressed by the principle. Accordingly, the realistically available options principle should not be used as a substitute for the arm's length principle.

The NFTC is concerned, moreover, with some of the guidance relating to intangible assets whose valuation is highly uncertain and whether it is realistic to hold taxpayers to the suggested standards. Paragraph 177 and Example 21 suggest that in some circumstances some independent parties involved in a transfer of intangible assets whose valuation is highly uncertain might insist on a term requiring the renegotiation of terms or might insist on short-term arrangements. It is not clear how taxpayers or tax administrators are to implement this guidance. For the behavior of unrelated parties to have an impact

on the agreed terms (rather than the pricing of transactions), must there be unanimity in the observed behavior? Is it appropriate to limit the analysis of the behavior of unrelated parties to the industry involved, or is the behavior of independent parties with respect to any intangible asset whose profit potential is uncertain relevant?

Finally, we note that since the development of Chapter VI, there has been a proliferation of transfer pricing documentation and penalty regimes. Given these regimes, it is even more important that the Transfer Pricing Guidelines provide guidance that can be complied with up front as books of account are prepared and tax returns are filed. The realistically available options principle and the guidance related to intangible assets whose valuation is highly uncertain both make it more difficult for taxpayers to have confidence that their reporting position ultimately will be acceptable to tax administrators when examined.

Sincerely,

Catherine Schultz
Vice President for Tax Policy