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1 October 2013

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Dear Mr Andrus

Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

BDO welcomes the opportunity to comment on the OECD's Revised Discussion Draft on Transfer Pricing Aspects of Intangibles (the "Draft") and the efforts undertaken by Working Party No 6. We greatly appreciate the OECD's open and collaborative approach on this important subject.

We have incorporated into this letter, comments received from various team members of BDO's global transfer pricing network.

Given the substantial number of responses the OECD received after the 6 June 2012 Draft, we have endeavoured to keep our comments as brief as possible. We will be happy to expand our comments and suggestions at the public consultation in November.

1 **Movement of personnel within a MNE**

We are sceptical that there are many instances where the transfer of an assembled workforce from one country to another should, of itself, require an additional payment for time and expense savings (¶15). If the recipient country is paying for relocation costs and the time and effort it takes to convince individual employees to move to a new location, it is unlikely that there is much in the way of additional benefit left that would require a compensating payment to the original employer.

Whilst we acknowledge that the transfer or secondment of employees could result in the transfer of valuable know-how (¶15), that transfer could also lead to a change in the members of an MNE "performing and/or controlling" (¶75) functions related to the "development, enhancement, maintenance and protection" of intangibles (and hence, the allocation of returns attributable to the intangibles concerned). The dynamic nature with which such control is often exercised by MNEs should not be underestimated. For example, those relating to customer-facing intangibles versus those related to product-related intangibles, as control may be exercised by different actors within a MNE. The pricing of different intangibles in this context over time will therefore pose particular problems. Lack of greater clarity as to the appropriate treatment of such scenarios raises the possibility of conflicting analysis between tax authorities. An example illustrating these issues would be welcome.

2 **Overuse of "know-how" as a distinct intangible in the Draft**

We are concerned that the repeated use of "know-how" as an example of an intangible overstates its prevalence as an intangible requiring separate compensation. Under paragraph ¶17, we note that when a transfer of "know-how" is made from the transfer or secondment of an employee, an analysis should be undertaken to determine if a separate payment should be made for this transfer. In most instances, however, we would not expect that an additional payment would be required as know-how resides with the employee concerned, who would typically be free to leave employment, and the value of their knowledge is reflected in their individual compensation. If an unrelated company was to hire an individual directly from the open market, the hiring company would not typically have to pay their former employer for the know-how they have acquired as part of having been in their employment. We are of the view that know-how should only be considered separately if it can be owned, controlled and transferred.

3 **Aligning guidance with accepted tax and legal principles**

The broadening of the definition of intangibles for transfer pricing beyond established legal and tax principles may lead to increased uncertainty and expense for taxpayers. As such, we believe that a clear definition is critical to furthering this discussion. The Draft (¶40) lists an intangible as "something which is not a physical asset or financial asset..." The uncertainty over the definition of intangibles may lead to disparate views by tax authorities and taxpayers that could result in protracted disputes. We suggest that the final definition include a description of "what" the characteristics of an intangible are and not rely upon a term as vague as "something." Such a descriptive definition might start by describing an intangible as an asset that can be owned, controlled and transferred. As written, the Draft does not recognise that an intangible may have little or no intrinsic value of itself, unless in combination with other assets, services or attributes. We would suggest, for clarity, that the definition be further qualified by adding "whether alone or in combination with other intangibles or goods, services or other attributes," recognising that value from an intangible may not be realised unless its use or transfer were combined with other assets, services and attributes.[1]

The Draft addresses the treatment of intangibles in transfer pricing to the exclusion of other accepted tax concepts such as royalties under Article 12 of the OECD Model Tax Convention. While the Draft states (¶47) that the concept of intangibles for transfer pricing and the definition of royalties for purposes of Article 12 do not need to be aligned, the possibility that this may lead to increased double taxation and uncertainty should be addressed.

Synergies and the ability to provide high levels of service may, in addition to other attributes, be part of what comprises the value in a "brand." The Draft identifies (¶57) that "A brand may, in fact, represent a combination of intangibles including, amongst others, trademarks, tradenames..." but does not recognize that the concept of brand might also be supported by non-intangible attributes and functions. We suggest that the Working Party consider that the concept of "brand" may also reflect such non-intangible attributes and acknowledge that it would be appropriate to establish an arm's length return to these attributes by reference to comparability factors.

[1] We acknowledge that the Draft does recognize that some intangibles are more valuable in combination with other intangibles (¶111) and that "the interactions between various intangibles and services may enhance the value of both (¶118).

We appreciate that the Draft makes it clear that valuation for transfer pricing and tax purposes is different from valuation under accounting or business valuation purposes. With regard to the concept of ongoing concern or goodwill, it would helpful (¶62) to recognise that goodwill and ongoing concern value are used in the context of business transfers for accounting or business valuation purposes, whereas, for transfer pricing purposes, only the transfer of assets/attributes of that business may be tested.

4 **Ownership of Intangibles**

In general, we would like to see references to the role played by funding in the context of intangibles (as expressed and advocated in ¶74) to be used more explicitly and consistently throughout the report. We believe that funding can play a very important function in relation to the development of intangibles and the importance of that role should specifically be acknowledged. That is, in ¶73, the sentence "For example, where the legal owner makes no contributions that are anticipated to enhance the value of the intangibles, the legal owner will not ultimately be entitled to retain any portion of the return attributable to the intangible" overlooks the possibility that the legal owner might previously have funded the acquisition of the intangible at arm's length and might expect to continue enjoying the economic value of that intangible. In this context, the reference in ¶84 to a funder being entitled to a "risk-adjusted rate of anticipated return on its capital invested, but not more," does not reconcile with the fact that, if the funder is the purchaser of the intangible, it would expect to be entitled to all of the return from that intangible immediately after its purchase. The fact that the funder is entitled to a "risk-adjusted rate of anticipated return on its capital invested, but not more" also implies that the funder cannot benefit from unexpected, excess profits accruing to an investor. This ignores the fact that a "funder" acting at arm's length may be acting as a lender and also as an equity holder. An analogy may be made to the motives and form of funding provided by venture capitalists and private equity houses in funding their investments.

We believe that a more fundamental rethink of the role that funding plays in pricing intangibles is necessary, beginning with an analysis of whether funding would or would not have been advanced (seen from the perspective of lender and borrower), in what form, at what price and on what terms, and whether this is representative of what would have occurred at arm's length. Some guidance as to the circumstances under which such a transaction might be respected, re-priced or re-characterised under ¶1.64-1.69 and the consequential transfer pricing treatment of returns from that intangible would be useful.

The use of the wording in ¶77 "...on an arm's length basis for the intangible value anticipated to be created through such functions" could imply that the compensation to be paid by the legal owner of the intangibles to another enterprise "...performing ... outsourced functions" should reflect the anticipated value of the intangible, something that may not occur in a third party transaction. It is important to respect the fact that the principles of Chapters I through III apply equally in this instance in requiring that all members of the group receive "appropriate compensation for any functions they perform." The enterprise to which these services are outsourced might well expect or be entitled to no more than a routine return for its services. (See ¶90, where this clarification can also be made.)

With regard to ¶82, the meaning of "without more" might be further explained. While we assume that the phrase relates to the entity bearing the costs but not having other functionality, we would appreciate the clarification.

In addition to funding-related considerations in determining the returns to a contribution made by the legal owner of an intangible, we appreciate the Draft considers the connection between funding and risk-taking. We would note that, under ¶83, the risks assumed may also vary based on the nature of the funding and the funder. Under ¶89, it would be helpful to clarify that the legal owner need not "provide" the assets listed, but might equally procure the provision of these assets by a third party.

To evaluate whether associated enterprises that perform functions or assume risks related to the development, enhancement, maintenance and protection of intangibles have been compensated appropriately as discussed in ¶93, we believe that it is necessary to consider, in addition to "the level and nature of the activity undertaken," the nature of the associated enterprises themselves and their role in the value chain. We also believe that it is necessary to qualify the statement to the effect that the reference made to the level and nature of activity of comparable uncontrolled entities performing similar functions "...in similar circumstances to the transaction being tested."

5 **Rule of Thumb**

The Draft has an unfavorable view on rules of thumb (¶162), however, there is a body of academic research (Goldscheider, et al.) that is used to support this approach. Whilst we would never recommend using any rule of thumb as primary support, and although it is not supported by law, in practice it is used in a surprising number of transactions as guidance to ascertain validity or as a "sense check." We suspect that in reality, taxpayers and tax authorities will continue to use the rule of thumb as a sense check, although they may not disclose that this is the case. We suggest that the wording be amended to note the rule of thumb's usefulness as a sense check.

6 **Application of profit split methods**

The Draft as currently written appears to assume that there would be full disclosure of all facts pertaining to the circumstances of both licensor/transferor and licensee/transferee to each other. This may not occur between third parties at arm's length, so the assumption here may not be realistic. We believe that only those factors that may reasonably be expected to be disclosed between third parties in those circumstances (and therefore known to the counterparty) should be taken into account in determining an appropriate profit split that may be agreed to by the participating parties. The principles related to realistically available options (¶1.34 of the Guidelines) and the perspectives of both parties are relevant here and might be made explicit in ¶166. This is implicitly recognised in the Guidelines in ¶2.116 with "Under the transactional profit split method, the combined profits are to be split between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length."

7 **Selection of methods**

We appreciate that the Draft provides further clarification on the application of common transfer pricing methods, such as the CUP and profit split, often used in transactions involving intangible assets. The additional guidance is welcome and we are pleased to see the consideration of non-specified methods, such as those used in business valuations, given further support. Specifically, with regard to the discussion on valuation

methods based on the discounted cash flow (DCF), starting at ¶176, however, given the body of material available on this topic apart from this Draft, we wonder whether the OECD Transfer Pricing Guidelines in an appropriate place for this.

Whilst we acknowledge that it can be difficult to find a precise CUP for an intangible, we would appreciate some language in the Draft which is supportive of accepting imperfect CUPs when other methods are unlikely to provide a more accurate demonstration of what third parties would do when faced with a similar transaction.

8 **On the accuracy of financial projections**

We acknowledge that, in transfer pricing, the use of financial projections can be "a reliable tool ... for purposes of a transfer pricing analysis." Under ¶182, we would suggest changing this phrase to read, "...projections prepared for non-tax business planning purposes may be more reliable than projections prepared exclusively for tax purposes." With projections used for a merger or acquisition, the preparer of the financial projections may have created these for different reasons. For example, the preparer may have been asked to produce projections that yield the highest or lowest price for the seller. The preparer may also produce overly optimistic projections for the benefit of the shareholders of the company. Non-tax business planning projections may not produce the most realistic results, but may produce results that would skew results to a favourable outcome for the preparer. Projections should be reviewed to ensure they reflect the most realistic outcome and should be consistent with the projections that the taxpayer will use for other planning purposes.

9 **Regarding the examples**

In general, there are inconsistencies throughout and a number of circumstances where the principles outlined in the draft are contradicted by the suggested outcomes in the examples. We have not illustrated all instance where this occurs but, by way of example, we are not sure what principle is being illustrated in example 1 where it is clear that Company S has not actually paid for the intangible concerned.

In example 12 it is unclear as to why Company S should be entitled only to the income it derives from its exploitation of the intangibles (royalty free from Shuyona). What about income derived from the exploitation of the intangibles by other parties (including Shuyona itself)? The example would appear to imply that the intangible return, in that instance, should accrue to Shuyona. This is not supported by ¶80: "the entitlement of the legal owner [Shuyona] to retain any material portion of the return attributable to the intangibles after compensating other group members for their functions is highly doubtful."

We would like to thank the OECD again for this opportunity to comment and should be happy to expand on these points and contribute further to later stages of this review if required.

For clarification of any aspects of this response sent on behalf of the BDO transfer pricing network, please contact:

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1 October 2013

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Yours sincerely

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