Deloitte LLP
2 New Street Square
London
EC4A 3BZ
United Kingdom

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.co.uk

Direct: +44 (0)20 7303 2218
Direct fax: +44 (0) 20 7583 1198
jhenshall@deloitte.co.uk

Organisation for Economic Co-Operation and Development
Centre for Tax Policy and Administration
2 Rue Andre Pascal
750016 Paris
FRANCE

By email: TransferPricing@oecd.org

29 September 2013
Our ref: JH/AL/AB

Dear Sirs

OECD Revised Discussion Draft on Transfer Pricing Aspects of Intangibles

We welcome the opportunity from the OECD to comment on the Revised Discussion Draft on Transfer Pricing Aspects of Intangibles issued on 30 July 2013. In order to streamline paperwork for the OECD we have collated material and input from several Member Firms of Deloitte Touche Tohmatsu Ltd, and therefore at the end of this letter we have noted the contributors and countries who agree with the views set out below.

Considerable work has been done since the original release of the early draft for discussion purposes in June 2012 and following the OECD's Public Meeting in November 2012. This process, allowing for early comment and debate, has been of great benefit in establishing clearer guidance in relation to the transfer pricing of intangibles, and we look forward to OECD Working Party 6 continuing with this practice in relation to future projects.

It is also important to consider the Revised Discussion Draft against the broader backdrop of the OECD's Base Erosion and Profit Shifting ("BEPS") project (in particular, Action 8 that is concerned with ensuring that transfer pricing outcomes in respect of intangibles are in line with value creation). The Revised Discussion Draft goes much further towards helping taxpayers and tax authorities understand the key factors in determining the appropriate pricing of intangibles. In particular, the emphasis placed on application of the arm's length principle and the approach set out in Chapters I-III of the Transfer Pricing Guidelines is an essential tenet for transfer pricing to be applied on a reciprocal basis in cross-border situations.

Essential for guidance to be principled

It is important for businesses and tax authorities, and coherence of the international tax system, for there to be a principled approach to transfer pricing, including in relation to intangibles. The alternative, whereby a lack of clearly-stated principle leads to different tax authorities taking different approaches, will lead to an increased number of disputes, resulting in more mutual agreement procedure ("MAP") cases where MAP is available, or more double taxation. In addition, if a lack of principle leads different taxpayers to different approaches, this seems to us to be unhelpful in light of one of the aims of the BEPS project to provide a level playing field. In either scenario, the outcomes could be detrimental to the promotion of international trade and economic growth.

The Revised Discussion Draft sets out to be a principled expansion of the existing Transfer Pricing Guidelines, and we agree that this is the right approach. There are several important reasons why the OECD should insist on providing a principled expansion of existing guidelines. Chief amongst them are:

- There is no need to depart from the arm's length principle (such as in increased use of recharacterisation, discussed further below) because with careful analysis and clear guidance in Chapter VI of the Transfer Pricing Guidelines (for the application of the principles contained in Chapters I-III) the result will be appropriate in the context of concerns about Base Erosion and Profit Shifting and can be applied to all taxpayers in all countries equally; and
- The revised guidance will also apply to current treaties that have adopted Article 9, and maximises the potential for this revised guidance to be of benefit in application of any national legislation of countries that follow the OECD Transfer Pricing Guidelines.

Recharacterisation

In light of the above, one area of concern that remains would be any departure from the principles in paragraphs 1.64 et seq of Chapter I of the Transfer Pricing Guidelines in relation to recharacterisation.

There are two fundamental issues with recharacterisation (as the OECD has determined in relation to previous work and which arise for the most part from the lack of principle in relation to an expansion of recharacterisation). The first is that the question always arises: "Recharacterise to what?" The second is that it is unlikely that two tax authorities will share the same view that the transaction should be recharacterised (or what the nature of the recharacterisation should be), leading to potential for dispute and MAP. The issues of concern to tax authorities can be dealt with in a more principled and ordered manner by application of the revised guidance (in particular the sections on the return due to the legal owner) and, where more than one party has contributed to the creation of value in the intangible, by the appropriate use of the profit split methodology.

Clarity and simplicity

The Revised Discussion Draft provides useful and principled guidance on many areas in respect of transfer pricing aspects of intangibles. There remain some paragraphs that would benefit from wording amendments for clarification and just a small number of points that should be revised. In addition, because of the consultative way that the discussion draft has developed, it is important that a fresh look is taken at the structure of the Chapter before it is released for inclusion in the Transfer Pricing Guidelines. This is necessary to ensure that taxpayers and tax authorities are presented with clear statements of the process and principles to be followed.

That said, the ultimate out-turn from the application of final guidance – if it were to be changed in this way – would be the same as that from this draft. In other words, to the extent that revision is still required it is to ensure the route taken to an arm's length answer is commensurate with the arm's length standard and the behaviour of third parties, rather than the answer itself. In other cases the guidance could be simpler and clearer to achieve the same end. This second paper, save for section D3 "Arm's length pricing when valuation is highly uncertain at the time of the transaction" which is still to be considered by Working Party 6, is welcomed as another big step forward in the process.

In particular, the instruction to consider "cause" for payment separately from "valuation" of the payment is welcome. In practice, many transfer pricing disputes stem from a failure to consider "causality" for payment before embarking on an argument about "valuation" of the payment. However, it would have been preferable to have seen the Revised Discussion Draft written afresh; informed by the first paper and by subsequent commentary and debate, rather than an editing of the original Discussion Draft. There is an opportunity to introduce structure and process into the guidance that would enhance its value in practical use. We expand this point below.

There are areas where significant improvements in clarity, brevity and usefulness of the guidelines could be achieved by following the arm's length principle and by asking the question: what happens between unrelated parties? In many cases this is because the draft does not yet have appropriate accuracy in the language that it uses. For example:

- The Revised Discussion Draft struggles to avoid using the categorisation of "intangible property" and "intangible assets", which is the arm's length approach in commerce. However, the paper creates afresh these two categories; dealing with intangibles that are owned and can be used, licensed or sold (which are intangible property) and intangibles that can be used, but are not owned, and can be transferred only associated with another good, service or intangible (which are intangible assets). Using these clear and well-understood definitions follows the arm's length principle and would simplify drafting of the remaining guidance. It would also make the guidance much clearer for taxpayers and tax authorities to follow without losing anything of what the paper is trying to achieve.
- The Revised Discussion Draft deals with cases where the owner of intangible property, such as a patent, has little substance and the activities that lead to the creation, commercialisation and defence of the intangible property are performed by others in the group. The guidance can be misread as suggesting that the income (the royalty or license received as turnover) generated by the intangible should be recognised in the hands of those providing the intangible with value and not the intangible property owner. That is a non-arm's length answer, amounting to recharacterisation of the transaction. The Revised Discussion Draft could achieve the same result within the current Guidelines and the arm's length principle by recognising that in this example there are two transactions (intangible property license and services (including R&D services) provided) that both need to be considered to achieve the correct result. The intangible property owner is the party who has a legal monopoly through the patent and is the only party who can charge / receive a royalty. However, the correct pricing of the R&D and other activity would, in these circumstances, mean that the final profit realised by the intangible property owner is small, commensurate with their limited functions, assets and risks. The return for bare legal ownership will be commensurate with a risk-adjusted finance return, and, at arm's length, considerably less than the return for human activity awarded to other entities. At paragraph 144, which uses the illustration of having access to a software platform under a licence which shortens the development time of a new and different software platform, the Revised Discussion Draft could be misread as departing from the arm's length principle. The arm's length approach will lead to a different solution to that currently indicated, discussed further below.
- Undefined phrases, such as "intangible related return" (paragraph 65) remove clarity from the guidance and should be avoided. Simple, plain guidance based on arm's length behaviour is required.

Valuation

It is very positive that the paper endorses the use of any pricing method, including valuation techniques if traditional methods are unhelpful, that would be appropriate to the facts and circumstances of the particular transaction.

It would strengthen the guidance significantly to include a requirement to show why, in cases where an alternative method is used, the traditional methods are not applicable and also to show that the method chosen has value as "evidence". That approach supports the exclusion of valuation processes such as "rule of thumb" (paragraph 162). In addition, if a transfer pricing case comes to litigation the courts will take into account evidence of arm's length behaviour. It also provides a safeguard against the correct application of a recognised technique which provides an improbable valuation because the technique is not appropriate to the circumstances of the transaction. We expand on this point below.

The material included in relation to the application of the discounted cash-flow method is insufficient and inappropriate. Its inclusion might be taken to indicate an approval, or preference, of this tool disregarding the importance in the choice and prioritisation of methods (paragraphs 2.1 to 2.11 of the Guidelines, endorsed by paragraph 149 of the Revised Discussion Draft). It should be removed from the guidance because the alternative approach to avoid the issue raised in this paragraph is to include a similar level of guidance for all other potentially applicable methodologies.

Location savings and group synergies

The new paragraphs for Chapters I - III introduced to deal with location savings and group synergies are welcome. These are well-reasoned, principle-based and need little, if any, adaptation. The continued inclusion of examples in the Revised Discussion Draft is very helpful. However, some of the examples are repetitive and add little or no value and some deletions may be appropriate. In other cases, the lack of examples showing the point of adjustment / no adjustment decreases their usefulness and amendments should be made accordingly.

Timetable

The timetable for production of the final version of the new Chapter VI on special considerations for intangibles, for inclusion in the Transfer Pricing Guidelines, is extremely tight. Ideally, the process would include a redrafting based on comments and discussions, with time for a further consultation. The goal of final guidance by September 2014, as set out in Action 8 of the BEPS Action Plan, makes this a challenge. However, the guidance on intangibles will be used by taxpayers and tax authorities (including those in developing countries that follow OECD principles) for many years, and ensuring that it is complete, clear, useful and accurate will be extremely important in minimising disputes, use of tax authority resources, double taxation and cases requiring resolution under MAP. It is in the interests of both tax authorities and taxpayers that the OECD should strive for high quality guidance in this area, irrespective of timetables.

Our key comments on specific sections (by paragraph) of the Revised Discussion Draft are set out in the attached Appendix.

If you have any questions please do not hesitate to contact me (jhenshall@deloitte.co.uk), Alison Lobb (alobb@deloitte.co.uk) or any of the signatories to this letter.

Yours faithfully

John Henshall

Deloitte LLP

Deloitte.

The following independent member firms of the Deloitte Touche Tohmatsu Limited network have contributed to and concur with this submission:

Signed

On behalf of Deloitte Tax LLP
United States
By Todd Wolosoff, Partner

Signed

On behalf of Deloitte Tax LLP
United States
By Arindam Mitra, Principal

Signed

On behalf of Deloitte Tax Services Pty Ltd
Australia
By Cameron Smith, Partner

Signed

On behalf of Deloitte Belastingonsulenten
Belgium
By André Schaffers, Partner

Signed

On behalf of Deloitte LLP
Canada
By Dr Muris Dujsic

Signed

On behalf of Deloitte Belastingonsulenten
Denmark
By Asger Kelstrup, Partner

Signed

On behalf of Deloitte & Touche Ltd
Finland
By Outi Ukkola, Partner

Signed

On behalf of Taj – Société d'avocats
France
By Sylvain Chevrier, Partner

Deloitte.

Signed

Richard Schmidtke

On behalf of Deloitte & Touche GmbH
Wirtschaftsprufungsgesellschaft
Germany
By Dr Richard Schmidke

Signed

On behalf of Deloitte & Associados, SROC, S.A
Portugal
By Patricia Matos, Partner

Signed

Steve Towers

On behalf of Deloitte & Touche LLP
Singapore
By Steve Towers, Asia Pacific Leader –
International Tax

Signed

On behalf of Deloitte Asesores Tributarios, S.L.U.
Spain
By Ramón López de Haro, Partner

Signed

On behalf of Deloitte AG
Switzerland
By Hans Rudolf Habermacher, Partner

Deloitte.

Appendix

Proposed amendments to Chapter I-III of the Transfer pricing Guidelines

Section D.6 Location Savings and Other Market Features (Paragraphs 1-34)

Overview

The analysis of location savings and other local market features will be included in Chapter I of the Transfer Pricing Guidelines (and not Chapter VI concerning special considerations for intangibles). We agree that this is the correct approach.

It is a cornerstone of transfer pricing that features of local markets are important only to the question of comparability; and only then when the comparison is between entities in different geographic markets. The features of any geographic market cannot be treated as either an intangible property or an intangible asset and by dealing with these matters outside of Chapter VI there is less risk of confusion in application of the Transfer Pricing Guidelines by tax authorities and MNEs.

Transfer pricing concerns only the financial and commercial conditions that exist between associated enterprises in different jurisdictions, compared to the conditions that exist between independent entities in the same or similar circumstances. The circumstances include comparability of market (geographic and otherwise) but the notion of a separate “jurisdictional premium” for residents of that geographic market is not a matter covered by Article 9 or the arm’s length principle.

Detail (references are to paragraph numbers)

2	Paragraph 2 refers to the guidance provided in paragraphs 9.148 to 9.153 of Chapter IX of the Transfer Pricing Guidelines, which deals with business restructuring, and notes that the principles laid out in those paragraphs apply generally to all situations. The principles set out in paragraphs 9.148 to 9.153 are largely based on two examples, which are both set in the context of a business restructuring. In general, we agree with the concept of location savings set out in Chapter IX. However, more specific guidance is required on this issue in a non-restructuring context.
3	Paragraph 3 sets out four points for consideration in determining how location savings are to be shared between associated enterprises. We generally agree with the principles set out in paragraph 3, subject to the comments below regarding the practical implications of applying those principles.
4	Paragraph 4 correctly states that where reliable local market comparable data is available from which to ascertain the arm’s length nature of inter-company prices, it will be the best basis for determining arm’s length pricing between the parties such that adjustments for location savings will not be required. This is important and helpful guidance, consistent with the arm’s length principle and global market forces.
5	Paragraph 5 addresses the situation where no local market comparable data is available and states that where this is the case, determining the existence and allocation of location savings, and comparability adjustments required to take account of such savings, should be based on all the relevant facts and circumstances including the functional analysis. We agree with this concept. More specific guidance, in the form of examples, would be helpful in relation to how location savings are to be identified outside of a business restructuring context if local comparable data is not available. For example, could the data available from another market benefitting from location savings be used to show the typical split of location savings between contracting parties?
6	We generally agree with the principles set out in paragraph 6 with respect to local market features that may give rise to circumstances and issues that may require consideration as part

	of a comparability analysis. As a point of emphasis, we recommend that the last sentence of paragraph 6 be amended as follows: "….to account for such factors *only* where reliable adjustments…."
7	We strongly endorse the approach taken in Paragraph 7.
8	We agree with the principles set out in paragraph 8 (i.e. that the determination of appropriate comparability adjustments for local market features should consider all the relevant facts and circumstances)
9, 10	Local market features may affect the arm's length price of goods transferred, services provided or consideration paid in connection with a business restructuring or intangible transfer, as the guidance sets out.
11	Features of the local markets, which are not intangibles, should be distinguished from any contractual rights or government licences which may be considered intangible property, as the guidance sets out.
12,13	It would be clearer if "intangible property" were to be used in the 5th sentence of paragraph 12 instead of "intangibles".

Section D7 – Assembled Workforce (Paragraphs 14–17)

Overview

We are generally in agreement with the concepts described in section A.

Detail (references are to paragraph numbers)

14	Paragraph 14 provides a definition of the assembled workforce and the potential effect that it could have on the arm's length nature of intercompany transactions. Paragraph 14 also provides recommendations as to when the potential impact(s) of an assembled workforce should be taken into account in a transfer pricing comparability analysis. We agree with the definition proposed and with the approach according to which any benefit or detriment attributable to the assembled workforce should be taken into consideration provided that relevant comparability adjustments can be performed in a reliable manner. However, because the comparability analysis should be conducted in a consistent manner across taxpayers we recommend substituting "ordinarily" with "systematically" in the following sentence: "[…] Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. […]" which then would read "[…] Such factors should systematically be taken into account in a transfer pricing comparability analysis. […]"
15	Paragraph 15 presents certain underlying drivers of the value that could be attached to the assembled workforce whenever the assembled workforce is transferred in the context of a business restructuring. It is important to note that when it comes to assessing the value of the assembled workforce paragraph 15 focuses exclusively on the cost approach aspect – i.e. cost avoidance (e.g. time and expense savings) in case of benefits or additional costs (e.g. potential liabilities) in case of detriment – and only from the transferee point of view. Put differently paragraph 15 solely analyses the "value" of the assembled workforce from the perspective of the transferee. This one-sided approach is inconsistent with guidance on the application of the arm's length principle which requires an appreciation of the perspective of all parties to the controlled transaction i.e. both the transferee *and* the transferor. For example, it might be that a transferor could have some interest in terminating its costly assembled workforce, or an advantage of avoiding the costs of terminating its employment contracts. Paragraph 15 should be amended accordingly.
16	Paragraph 16 addresses the situation of transfers and secondments of *individual* employees –

Deloitte.

	as opposed to the assembled workforce which results from a combination of employees. We generally agree with the principle of this paragraph according to which taken on an individual basis the transfer of employees should ordinarily not trigger a specific compensation. Likewise, in the case of secondments we concur that the value attached to the secondment should normally be regarded as equal to the full employment costs (salary, bonus, pension, etc.) of the secondee.
17	Paragraph 17 provides guidance for the following situations: (i) the transfer of valuable know-how from one associated company to another and (ii) the access to an assembled workforce without any transfer of employees. More generally paragraph 17 draws the line between the attributes of what should be regarded as mere comparability factors (and then analysed in light of Chapter I) and what should be regarded as either an intangible property or an intangible asset (and then analysed under Chapter VI). The current wording is imprecise and is likely to lead to conflict between tax authorities, and between a tax authority and an MNE. Section A of Chapter VI recognises a distinction between intangibles that are "owned and controlled" (intellectual property) and those that are not "owned and controlled" (intangible assets). The capabilities of an employee of the seconder's (or indeed, a transferor's) workforce – including any know-how – that are not "owned and controlled" by their employer are available to a new employer without payment to the old employer. Therefore to create such a payment "right" only as between related parties is to depart from the arm's length principle. It is only "secret know-how", more usually, and correctly, termed a "business secret", that the old employer can prevent an employee from making use of for their new employer or for the entity receiving the secondee. Therefore a payment would be due from the receiving company to the sending company only when the intellectual property (not intangible assets, which have no property right) of the old employer will be used by the employee for the benefit of the new employer in such a manner that such use, between unrelated parties, could be prevented by way of action to protect the 'business secret'[1]. To aid clarity in the guidance, to ensure consistency with Chapter VI of the Transfer Pricing Guidelines, and to prevent a departure from the arm's length principle paragraph 17 should be amended to reflect this point. It would be helpful to include an example illustrating the point raised above.

Section *D8 – MNE Group Synergies (Paragraphs 18–33)*

Overview

In general, the group synergies section is well drafted. In particular, we appreciate the balanced structure of this section which enables an easy reading and understanding of the section.

Detail (references are to paragraph numbers)

18	Paragraph 18 provides a comprehensive definition of what group synergies could be. We generally agree with the illustrations contained in this paragraph and appreciate the numerous examples listed, which cover the entire spectrum of real-life cases, and illustrate that synergies could be either beneficial or detrimental.
19	Paragraph 19 directly refers to Chapter VII (paragraph 7.13) for distinguishing between group synergies deriving from "*incidental benefits*" as opposed to those resulting from "*deliberate*

[1] See, for example, the US decision of the Georgia Supreme Court in Coleman v Retina Consultants P. C. et al [2009] No. S09A1485. In the USA trade secrets are a form of Intellectual Property under the Uniform Trade Secrets Act. In the EU national law concerning business secrets was surveyed for the European Commission by Hogan Lovells International LLP (MARKT/2010/20/D) *Report on Trade Secrets for the European Commission.*

	concerted group actions". In this context, we agree that the criteria for defining the term "incidental" should solely rely on the absence of deliberate concerted actions within the group, irrespective of "*quantum of such benefits".* Put differently, the quantum of benefits is not the driver of its qualification. As importantly, we agree with the conclusion of paragraph 19, according to which "incidental benefits" should not trigger a specific compensation.
20	Paragraphs 20, 21, 22 and 23 discuss the situations where group synergies (being benefits or burdens) are not incidental benefits but do result from deliberate concerted group actions ("deliberate group actions"). In particular, we concur with paragraph 20, which indicates that, as a starting point, a thorough functional and comparability analysis needs to be conducted to assess whether or not group synergies could be characterised as resulting from deliberate group actions. Paragraph 20 also clarifies that only if the group synergies result from deliberate group actions should these synergies be a comparability adjustment.
21	Paragraph 21, through the example of centralised purchasing, illustrates situations that should be considered as deliberate group actions – and should subsequently deserve comparability adjustment to ensure that the associated synergies are allocated among group members in a manner consistent with the arm's length principle. More specifically, we concur with the suggestion in paragraph 21 which indicates that a deliberate group action necessarily results from an initiative from the group itself, in an effort to voluntarily modify existing commercial conditions with suppliers. Conversely, any action solely resulting from a unilateral decision of an unrelated supplier would by default be characterised as an incidental benefit, and therefore should then not deserve a specific comparability adjustment since it is the result of an unrelated party's decision (which by nature is consistent with the arm's length principle).
22	Once deliberate group actions have been characterised and clearly identified as factors to be adjusted for, paragraph 22 outlines the necessary criteria to be taken into account to conduct this comparability adjustment. We agree with the three criteria identified: (i) the nature of the synergy; (ii) the quantum of the benefit or detriment; and (iii) the reliable manner to allocate this benefit or detriment among members of the group.
23	Paragraph 23 provides guidance as to how the benefit from deliberate group actions should be shared among group members and indicates that the allocation should be made in proportion to the contribution to the creation of the synergy. More specifically, following from the centralised purchasing reference of paragraph 21, paragraph 23 provides guidance as to how volume discounts resulting from a deliberate group action should typically be shared among members. In this instance, paragraph 23 suggests that synergies resulting from volume discounts should be shared among members in proportion to their purchase volumes, after an appropriate remuneration for the purchasing coordination activities. The phrasing of this example departs from the guidance to understand, through functional analysis, the contribution made by each party to the benefit achieved. It assumes a passive role of the "co-ordinating party" and a fee for that activity with the residual being shared amongst the entities providing the volume. While we agree that this functional analysis will often be the case, there is a risk that this guidance is misinterpreted to mean that centralised purchasing activity is always to be rewarded in this manner. We suggest that the example is made clearer by describing the low-value added nature of the "co-ordinating party" (which is currently assumed) to explain why under the arm's length principle the suggested solution is appropriate. Ideally, the example would be followed by a second example where the "co-ordinating party" plays a significantly greater role in adding value to the centralised purchasing and is therefore provided with a set price advantage for the entities contributing volume but is itself entitled to the residual. If the above is not possible, it is preferable to remove the example from paragraph 23 and simply have the first sentence, which is correct.
24-33	Paragraphs 24 to 33 consist of five examples illustrating the above-mentioned principles related to group synergies. We generally agree with these examples but have two specific comments on how synergistic benefits should be shared among group members set out below.
28	Example 3 is a good illustration of the comment made with respect to paragraph 23. Specifically, the allocation of synergies suggested in example 3 implicitly relies on the underlying assumption that Company A acts as a "routine" purchasing centre, i.e., with simple functions and limited risks. However, this assumption is not clearly stated in the example.

	Accordingly, to avoid confusion and an allocation that would be inconsistent with the functional profile of the parties to the transaction, a discussion should be incorporated into this example of the functional profile of Company A and the effective contribution of Company A in the deliberate group action triggering the synergies. This will allow users of the guidance to unambiguously correlate the allocation with the respective contribution of the parties to the synergies.
29-33	As with Example 3, in Examples 4 and 5 the central purchasing centre is systematically depicted as a basic routine service provider, deserving a cost plus basis remuneration. Accordingly, the allocations suggested in these examples assume that the entirety of the synergies have to be passed onto the other group members. In an effort to offer a balanced view, and to be in line with business realities, another example should be added in which the conclusion of the functional analysis would be that the functional profile of the central purchasing centre goes beyond a mere routine service provider and that the central purchasing centre has strategic purchasing skills, processes and capabilities enabling the group to generate synergies. For example, this might be the case where the group's business model centres on the purchasing function as the driving force of value (such as in a wholesale scenario). The conclusion of this example would therefore be that, under those specific facts and circumstances, a portion of the synergies would then be allocated to the central purchasing centre.
34	Paragraph 34 provides guidance as to when methods not described in Chapter II could be applied. We generally agree with the all the conditions specified in order to justify the use of a method not described in the OECD Guidelines. However, we observe that paragraph 34 only focuses on the criteria allowing the taxpayer to use a method not recognised by the OECD Guidelines ("other method"), but does not opine on the necessary conditions to ensure the reliability of this other method. We recommend adding guidance to the effect that evidence should be provided to support that (i) the methodology applied is evidential (i.e. the "rule of thumb" is not considered to be evidential of royalty rates by the US courts[2], and the UK courts have rejected third-party data as a means to set a fair royalty rate if it is not evidenced that the data is comparable to the tested transaction.[3]

[2] *Uniloc USA, Inc et al v Microsoft Corporation* [2011] US Court of Appeals for the Federal Circuit applied the "rules of evidence" in *Daubert v Merrell Dow Pharmaceuticals Inc* 113 S.Ct 2786 (1993)

[3] See *General Tyre & Rubber Co. V Firestone Tyre & Rubber Co Ltd* [1976] R.P.C. 197 HL ''Before a "going rate" of royalty can be taken as the basis on which an infringer should be held liable, it must be shown that the circumstances in which the going rate was paid are the same, or at least comparable, with those in which the patentee and the infringer are assumed to strike their bargain.''

Deloitte.

Chapter VI: Special Considerations for Intangibles

Section A - Identifying Intangibles (Paragraphs 34-64)

Overview

We are generally in agreement with the concepts described in section A.

Detail (references are to paragraph numbers)

37	The newly-inserted penultimate sentence in paragraph 37 may put too much focus on a potential recharacterisation of related party transactions involving intangibles. If this sentence remains in paragraph 37, additional wording should be added to make it clear that when dealing with intangible property, other than in exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for the actual transactions (see paragraph 1.64 et seq of the Transfer Pricing Guidelines). Matters that might lead to consideration of recharacterisation of an actual transaction, such as a lack of substance in an intellectual property-holding company, are better addressed through the correct pricing of all of the transactions that are concerned with that structure. Correct pricing of the "services" provided to the intellectual property-holding company would result in profits being declared for tax purposes according to the location in which value is added whilst applying the arm's length principle and avoiding the controversial issue of recharacterisation. Further, compared with the wording of the first Discussion Draft, the Revised Discussion Draft now includes "across the entire supply chain" to the last sentence. In combination with the first part of the last sentence, the scope of the required comparability and functional analysis may be understood to go beyond what is required for the purpose of the arm's length principle. In particular, due to the transaction-based approach as set out in the Transfer Pricing Guidelines, it is sufficient to perform a comparability and functional analysis with respect to the transaction parties and their part of the supply chain related to the intangible property considered. This is also our reading of the third sentence of paragraph 37, which limits the analysis to "each relevant member of the MNE group". We do not see a requirement to extend the analysis to the "MNE's global business and the manner in which intangibles are used by the MNE to add or create value across the entire supply chain". In order to correctly evaluate an intercompany transaction involving intangibles, is it not the value creation of intangibles across the entire supply chain of an MNE that is relevant, but rather the transaction between the related parties in itself and the value creation of the specific intangible property as considered in the intercompany transaction at hand. We understand that these amendments may have come up in context with the current discussions in relation to the OECD initiative addressing BEPS, e.g. with respect to Action 13 of the BEPS Report.[4] However, the amendments do not add value in relation to the identification of intangibles and therefore should be rephrased.
38	The textual passage in paragraph 38 "(…) (ii) the legal ownership of intangibles and the contributions to their development, enhancement, maintenance and protection" is not in line with the arm's length principle. In particular, in transactions involving intangible property, third parties would usually consider who has the legal rights to the intangible property. However, for exploiting an existing intangible property they do not consider who contributed to its development in the past. The "contributions to their development, enhancement, maintenance and protection" may be relevant with respect to arm's length conditions between the legal owner of the intangible property and any supporting services the legal owner may have received, e.g. through a contract R&D service agreement. Therefore, with regard to (ii) it

[4] See *OECD* (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, available online: *http://dx.doi.org/10.1787/9789264192744-en*, as well as the current version of the OECD action plan in that regard: OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, available online: *http://dx.doi.org/10.1787/9789264202719-en.*

	should be made clear that in order to determine arm's length conditions, only the relevant legal ownership and the allocation of legal rights regarding the use of the intangible property with regard to the transaction should be assessed.
39	Paragraph 39, if taken literally, makes it sound as though a payment is made between related parties depending only on whether or not intangible property is transferred between third parties. Clearly, third parties may transfer intangible property, e.g. the exclusive distribution right for a region, without asking for compensation. Even without compensation this transfer of intangible property can be in the interest of both parties because it provides the right incentives to the parties, e.g. by avoiding delays with respect to required marketing investments in the region. The purpose of paragraph 39, and the definition of intangible property, should be to clarify under which circumstances Chapter VI of the Transfer Pricing Guidelines is applicable. Paragraph 39 should therefore be rephrased in order to make it clear that an appropriate definition for intangible property should be found in order to understand what Chapter VI deals with, rather than to determine potential payments between related parties.
40	The sentence "Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction" in paragraph 40 is correct, but it is not important for the definition of "intangibles". Therefore this sentence should either be moved to another part of Section A or deleted. Additionally, the last part of the first sentence "(…) and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances (…)" is misleading given that it implies that an intangible could only exist if independent parties paid for it, which does not reflect reality.
42	The second sentence of paragraph 42 contradicts the statement in paragraph 40. An intangible asset can only be owned or controlled if a legal, contractual or other form of protection exists. Therefore, the existence of such protection has to be a necessary condition for an item to be characterised as an intangible asset.
44	The first sentence in paragraph 44 represents a contradiction to the definition of intangibles in paragraph 40, which states that an intangible only exists if a third party would pay for its use or acquisition. Contrary to this, paragraph 44 states that remuneration for the use or transfer of an intangible is not a necessary condition for an intangible to exist. Additionally, a definition of the term "premium return" is missing.
45	Paragraph 45 could be improved with simple guidance to state that the actual accounting or tax treatment of costs related to the creation of potential intangibles does not determine conclusively that an intangible exists.
46	The last sentence of paragraph 46 contains another reference to "identified relevant intangibles in the MNEs global business". For transfer pricing purposes, only specific transaction-based information is relevant and not that of the MNE's global business or entire supply chain, which may be not related to the transaction considered. (However, this is not to say that a one-sided analysis focussing only on one party to the intangibles transaction is sufficient to assess the position).
49	Paragraph 49 sets out that the approach to determine arm's length prices in cases involving an intangible does not centre on the categorisation of intangibles. Examples of "soft" and "hard" intangibles are mentioned; however, there is no requirement to place an intangible into a category, and we suggest removing the terms "soft" and "hard" intangibles as they have no relevance to third party transactions.
51	Paragraph 51 introduces a term "unique and valuable" which might be understood to imply that comparable third party data generally cannot be observed for "unique" intangibles. The word "unique" has an every-day meaning which might be brought to mind, rather than the specialised definition (which is unclear) which this paragraph appears to intend. It must be stressed that the uniqueness of intangible property does not automatically preclude the existence of a comparable intangible. For instance, by legal definition, every patent is unique with regard to the technology it applies in order to achieve a certain outcome; otherwise no

	patent would have been granted. Similarly all copyright in computer code is unique. However, there may be alternative approaches to achieve the same result by using another method or technology or ways of writing new code to achieve the same programming effect. For transfer pricing purposes, these alternative methods that lead to the same result by using different paths might be treated as comparable. As a result, a patent can be "unique" and also comparable. Therefore the word "unique" is likely to be confusing in the context which the Transfer Pricing Guidelines, as drafted, use the term. In order to improve this paragraph, "comparability" should be redefined such that "comparable" intangibles are required to yield the same result, however that result is obtained, and the word "unique" should be avoided. For example, suppose that a company purchases simple computer games from unrelated parties which it makes available through its web-based business. Each game purchased contains a unique program – source and object code - written by the author and that program is protected by copyright. However, all of the purchased programs achieve a similar result (a simple computer game) and the copyright to each game program is purchased for US$5,000. Even though the software in each game program is unique it is comparable in function and value-add and so for any internally-generated software game programs, having precisely the same function and value-add to the business, these unrelated party transactions would be good comparable data upon which to set the intra-group price.
52	Paragraph 52 states that the illustrations provided in the discussion draft should be adapted to the specific legal and regulatory environment that prevails in each country. This should not always be the case and this sentence should be omitted. As set out in the intangibles definition in paragraphs 40 and 49, the commercial law in each country will define what is patentable. For example, a business process can be subject to a patent in the US whilst the same business process may not be patentable in Europe. However, once it has been found that that there is, or is not, an intangible property (the patent), the transfer pricing analysis applies accordingly. As the Revised Discussion Draft defines intangibles by reference to what would happen between unrelated parties, there is no need to be more specific in identifying country differences; in fact, to do so might confuse rather than clarify the guidance. Additionally, the last sentence of paragraph 52 should not refer to the MNE's global business; only transaction-based information should be relevant.
53	Paragraph 53 discusses price and cost effects that could be reached through the use of patents. In this context, potential volume effects should be added. Moreover, it should be highlighted that price, cost and volume effects are an outcome of the use of intangible property in general and not only due to patents as a specific kind of intangible property. In order to ensure consistency, the respective wording should be moved to section A.1.
54	The contents of paragraph 54 are correct as long as they refer to secret know-how. In order to clarify this, the word "secret" should be added to "know-how" in the relevant passage.
57	In order to be precise, "sometimes" (sentence 1) should be exchanged for "should not be" and "In other contexts" should be deleted in paragraph 57.
59	Further explanation is necessary to clarify what is meant by "implied" in paragraph 59, as intangible property can only exist if it is owned or controlled.
61	Goodwill and on-going concern value should not be intangible property in the meaning of section A.1. The goodwill is only transferable in combination with other services, goods or intangible property. Therefore, goodwill should be valued as part of the transferred assets or service performed rather than being evaluated independently as intangible property. We consider this is one of the most necessary changes required to Section A. In addition, it should be noted that part of goodwill regularly relates to the assembled workforce. According to the guidance in section D., assembled workforce is not an intangible property in the meaning of section A.1. If goodwill is regarded as separate intangible property, this contradicts the classification of assembled workforce as not being intangible property. The guidance in this paragraph should be redrafted in order to reach greater consistency.
62	In general, sentences 3 and 4 of paragraph 62 are correct. However, as set out above, goodwill should not be considered intangible property for transfer pricing purposes. Rather, goodwill should be treated the same way as group synergies and market specific

	characteristics; i.e., as a comparability factor regarding the “profit potential” in the course of the arm’s length analysis of assets and services to ensure that the transfer price for the assets or services reflect the related goodwill.

Deloitte.

Section B - Ownership of Intangibles and Transactions Involving the Development, Enhancement, Maintenance and Protection of Intangibles (Paragraphs 65-103)

Overview

Section B describes a framework by which to allocate, between related parties, the so-called “return attributable to an intangible”. There are two objections to the way this framework is set out. Firstly, it does not give pre-eminence to the arm's length principle. Secondly, as described, it can amount to a recharacterisation of the actual transactions undertaken. A key driver of the problem is the use of the term “return attributable to the intangible” which should be removed from the guidance to minimise the risk of confusion. Both of these points are elaborated below. The starting point for analysing transactions involving intangibles should mirror the framework that was developed in Chapter IX of the Transfer Pricing Guidelines for the allocation of risks. To recap, Chapter IX establishes a two-step process for assessing whether the allocation of risk between associated enterprises is arm's length: (i)Is there reliable evidence of a similar allocation in comparable uncontrolled transactions, and, if not, (ii) is the allocation one that might be expected to have been agreed between independent parties in comparable circumstances? Relevant (but not conclusive) factors to consider in determining whether the allocation is one that would have been agreed between arm's length parties are the ability to control, and the financial ability to bear, the risk.

Before considering how to apply a similar framework to transactions involving intangibles it is important to consider how words used to express concepts will be interpreted by MNEs and tax authorities seeking to use the guidance in practice. The phrase “return attributable to the intangible” is vague and not defined. There is a considerable risk that this phrase will be interpreted as justifying, or even requiring, a transaction to be recharacterised so that the income (royalty, license, etc.) generated by an intangible property is considered to have been paid to a party who has no property right. That is a departure from the arm’s length principle and this recharacterisation is not required. By applying the arm’s length principle it is clear that the income from use of the intangible by someone other than the entity having that property right must flow to the party having the property right, commonly known as the licensor. However, where the licensor is not the party, or not the only party, contributing to the value of the intangible property there is a further transaction to consider; the arm’s length fee to be paid by the licensor to the party adding value to the intellectual property. The taxable profit declared by each of the licensee, the licensor and the enterprise providing (some or all) value to the intangible will be correct *net* of consideration of the arm’s length pricing of *both* related party transactions. This will result in achieving the objective of “fair” taxation of profit, without recharacterisation and within the arm’s length principle.

In applying a similar framework to transactions involving intangibles, the out-sourcing of activity concerned in the creation, protection or exploitation of intangible property to an associated enterprise should be considered to be arm's length behaviour if there is reliable evidence of a similar allocation of activity in comparable uncontrolled transactions. In that case consideration of the arm’s length nature of the price paid for out-sourced activity is still required. When lacking such evidence, the arm's length nature of the price paid by the licensor to the associated enterprise(s) providing this service is affected by the increased value being added, but it does not support or require the “recharacterisation” of the income (license or royalty) to be treated as if it had been paid other than to the licensor. Consideration of the additional value being added should begin by hypothesising the allocation that would be expected to have been agreed between independent parties in comparable circumstances. This assessment may rely on the relevant-but-not-determinative factors described in Section B, as well as on the "commercial reality" of the transaction, including evidence of arm's length behaviour in a commercial setting or commercial legal dispute. This approach is founded upon the primacy of a comparative (as opposed to an econometric) analysis in applying the arm’s length principle (see paragraph 1.6 of the Transfer Pricing Guidelines), but it is also supported by judicial precedents in commercial cases between unrelated parties. That exercise would then inform the functional analysis of the transaction between the licensor and the associated enterprise(s) adding value to the intangible property and thereby ensuring that an arm’s length price is paid for the service. Net of both the license income and the service payment calculated in this way both the licensor and the associated enterprise providing value to the intangible will report net taxable profit that is considered "fair" in the context of the OECD's work on BEPS[5] and in comparison to the aims and objectives of Chapter IX of the Guidelines.

Section B should explicitly state that actual evidence of a similar allocation in comparable uncontrolled transactions is the best indication that the allocation of activity in the controlled transaction should not give rise to unusual factors that must be taken into account in assessing the arm's length nature of the price paid by the owner of intellectual property rights and an associated enterprise(s) providing out-sourced services. It should also state explicitly that where the division of activity between the owner of intellectual property rights and an associated enterprise cannot be evidenced by reference to unrelated parties this is a matter to be taken into account in considering the arm's length nature of the fee paid by the owner of the intellectual property right to the associated enterprise providing the service.

The framework in Section B too easily favours an economic substance over legal form approach and, as a result, may in certain circumstances move toward recharacterisation outside the limited scope provided in paragraph 1.64 et seq of the Transfer Pricing Guidelines. In addition, in departing from the arm's length principle, this analytical framework is very likely to cause increased controversy and it therefore creates a potential risk of double taxation and/or an increased number of cases requiring resolution through MAP. As discussed above, there is a more appropriate transfer pricing answer to situations in which the legal owner performs limited functions in respect of the creation of value in an intangible, which is the appropriate use of transfer pricing methods to value the services provided by other parties; or perhaps the profit split methodology. This provides a principled approach, reflecting the arm's length standard, which takes the actual transactions as a starting point but ensures that transfer pricing outcomes are reflective of value creation.

Detail (references are to paragraph numbers)

65	Paragraph 65 is subject to the two points described above.
66	Paragraph 66 is supportive of paragraph 65 and is thus subject to the same two objections.
70	The first two sentences of paragraph 70 are correct, although the third sentence is not correct: "There may be some intangibles [in the sense of intangibles that are owned and might be used, licensed or sold] that are not protected by law or contract." As defined in paragraph 40 (and contrary to paragraph 42) an item of "intellectual property" is a monopolistic right created by law and therefore subject to legal protection. Without legal protection the "asset" is within the definition given in paragraph 43; it is to be taken into account in any comparability analysis for another transaction (use, license or sale) to which it is attached.
71	The second sentence of Paragraph 71 proceeds on a false premise – i.e. that there are some intangibles for which there is no legal owner. Please see the comments on paragraph 70 above.
73, 74	Paragraph 73 is subject to the two objections described in the "Overview" above. The paragraph is drafted based on a concept of "return attributable to the intangible" which, as explained is both incorrect and confusing. The paragraph should be redrafted following the lines explained in the introduction to this section. The same comments apply to paragraph 74.
76	Paragraph 76 is subject to the first objection described in the "Overview" above. Apart from that point, we generally agree with the paragraph if it were to be redrafted to remove the concept of "returns attributable to the intangible". Instead, the paragraph should recognise that there are two transactions to be considered, and that the matters raised in paragraph 76 refer to the functional analysis applicable to the transaction between the owner of intellectual property rights and the associated enterprise providing services which go beyond those that would be found between unrelated parties.
77	Paragraph 77 states that, "if [the legal owner] neither controls nor performs the function, the

[5] See *OECD* (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, available online: *http://dx.doi.org/10.1787/9789264192744-en*, as well as the current version of the OECD action plan in that regard: OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing, available online: *http://dx.doi.org/10.1787/9789264202719-en*.

Deloitte.

	legal owner likely would not be entitled to any on-going benefit attributable to the outsourced functions". This is a sweeping statement that should be deleted. It is subject to a number of criticisms: (i) an unsupported general statement, using the word "likely", will create the risk of misinterpretation; (ii) there is no reference to seeking evidence of allocations in comparable uncontrolled transactions; (iii) it ignores the legal owner's assets and risks; and (iv) as explained in the introduction to this section the relevant consideration in these circumstances is the arm's length remuneration to be paid to the associated enterprise providing these services, a point which is currently absent from this guidance.
78	Paragraph 78 uses the adjective "anticipated" in referring to the return related to the intangibles. The issue of basing allocations on anticipated returns, as opposed to actual returns, is not directly addressed in Section B; however, we agree that it should be.
80	We generally agree with the comments in paragraph 80. However, the fourth sentence ("Where the legal owner outsources most or all of such important functions to other group members, the entitlement of the legal owner to retain any material portion of the return attributable to the intangibles after compensating other group members for their functions is highly doubtful") is unhelpful in that it is not immediately apparent that the position here is viewed net of more than one transaction. In addition, in particular cases there might be other matters outside of those listed that contribute significantly to the value of an intangible, or to the exploitation of that value. Therefore, in its current form, this statement could lead to mispricing of transactions between the owner of the intellectual property right and the associated enterprise providing services and therefore to a breach of the arm's length principle, to double taxation, and to additional claims for MAP assistance.
81	We agree with the first sentence of paragraph 81. The second sentence is a sweeping statement, which would be improved by a reminder that a one-sided transfer pricing method, with the tested party being the party performing the important functions, can be used if there is evidence of pricing in comparable uncontrolled transactions.
86, 90, 93	Paragraphs 86, 90 and 93 are subject to the second objection described in "Overview" above: they do not focus on the actual transactions. They also use the concept of "return attributable to the intangible" which is unhelpful, as outlined in the introduction, and they fail to recognise that there will be more than one transaction in the circumstances outlined and that it is the transaction between the owner of the intellectual property right and the associated enterprise providing services that should be considered.
95	Paragraph 95 is subject to the first objection described in "Overview" above: it should indicate that the first step is to identify whether there is evidence of comparable uncontrolled transactions.
96	Two of the sentences in paragraph 96 should be referenced to third party comparable data. The first sentence ("When the distributor actually bears the cost.....") should indicate that the first step is to see if there is evidence of what happens in comparable independent situations. The seventh sentence ("An independent distributor in such a case...") is another unsupported general statement: it should be qualified by a requirement to see whether there is evidence of what happens in comparable independent situations.

Section C - Transactions Involving the Use or Transfer of Intangibles (Paragraphs 104-124)

Overview

The concepts described in Section C (and the examples used to illustrate the concepts) are generally correct. These concepts would be more easily explained, and the guidance made more practical and valuable, if the categorisations of intangibles identified in Section A – intellectual property (valuable intangibles that are owned and controlled and which can be used, sold or licensed), and intangible assets (valuable intangibles that are not owned which can be used, but not sold or licensed) were named as such, using these commercial terms, so that the terms could then be used in this section. We agree with the solutions presented in examples 19 and 20; however, examples 16 and 18 are likely to create more confusion than clarity in their current form. There are some instances where the draft guidance departs from the arm's length principle.

Detail (references are to paragraph numbers)

107, 108	Section C1 deals only with intangible property, not intangible assets, and this should be made clear in the opening of this section.
109	The closing sentence of paragraph 107 and all of paragraph 108 deal with restrictions and limitations in the rights transferred, noting the importance of these as aspects of the valuation exercise. We agree with the comment in paragraph 107 that specificity is required in identifying these aspects of intangible property transactions. Paragraph 108 opens by noting that contractual restrictions can be of significant importance in valuing intangible rights transferred. This should be followed by a warning that such restrictions do not have any effect on valuation if they have in fact no impact (no restriction) on the rights transferred. This ties in to the guidance in paragraph 109 that a tax authority (and we suggest that also an MNE) should not follow the contractual position if in practice the contract is not (or in truth could not) be followed. For example; the decision of the Court of the Grand Chamber (C-406/10) *SAS Institute v World Programming Ltd* considered the inclusion in a license to an unrelated party of certain restrictions on the use of software. These restrictions were claimed to prohibit the use of that software to aid a competitor to mimic its functionality and thereby improve their product and /or reduce their time to market for a new product. The court found that such restriction was not compatible with European Community law and therefore that these contract provisions were of no consequence. The complainant had no rights in law to prevent such use of their software and could not create those rights through contract. Paragraph 108 presents a seemingly balanced view that, as between unrelated parties, sometimes the rights to any further development of the actual intangible fall to the transferor / licensor or in other cases to the transferee / licensee. We are not aware of such restrictions / limitations being made by a transferor of intellectual property on a transferee in the case of unrelated parties and, to that extent only, we consider this statement to depart from the arm's length principle. The position stated in paragraph 108 is correct with respect to licensor / licensee agreements and the reference to transferor / transferee should be removed from this guidance. Without this change it is possible that this statement may be misinterpreted as being a permission to recharacterise the actual transaction. The guidance should include a statement to affirm that, as both circumstances (limitation of rights and no limitation of rights) are seen between unrelated parties, either arrangement is likely to be acceptable unless there is clear evidence to the contrary.
113	Paragraph 113 deals with situations in which several intangibles are intertwined and it is not possible "....*as a substantive matter.... to transfer one without the other(s).*" This statement introduces a new concept of "substantive matter" which is unhelpful. The clarity of the guidance would benefit from the application only of the arm's length principle in these matters so that one consistent standard is applied by MNEs and tax authorities. The text should therefore be adapted to refer to "...in uncontrolled transactions..." This change would reduce the possibility of an MNE

	or tax authority departing from the arm's length standard. We agree that in setting the required licence fee for the use of a trademark one should consider both the trademark and the associated reputational value, or the "goodwill". There is an opportunity here for the guidance to explain that in the context of transfer pricing the term "goodwill" means "the emotional connection of consumers to the goods or service"[6].
114, 117	Whilst it may, in some situations, be both possible and appropriate to separate transactions into several components, paragraph 117 would benefit from the inclusion of a note of caution that splitting a single transaction into several component parts and pricing each of them independently would not be appropriate if, as between unrelated parties, that bundle is priced as a single transaction. It would also be appropriate to caution that inappropriate splitting of a bundled transaction is likely to lead to a higher overall transaction price than that which would be agreed between unrelated parties in a similar bundled transaction. This paragraph should be consistent with and cross-refer to paragraph 3.9 *et seq* of the Transfer Pricing Guidelines that deal with pricing transactions separately or in aggregate. The example of "goodwill" given in paragraph 114 is unhelpful in its current form as it does not reflect accurately the commercial position and, therefore, the arm's length position. Goodwill in a business can be transferred to another party either by sale of the business or, in the case of registered trademarks only, on sale of the trademark. Goodwill is therefore an intangible asset as it is not capable of being sold separately from another asset and it is a matter of importance for the valuation of that other property that is transferred.
118	Paragraph 118 deals with separation of bundled intellectual property using the example of a franchise. The use of the phrase "…a so-called franchise..." might be misunderstood to disrespect, for transfer pricing purposes, a commonly used and successful business model. Where a franchise is the business transaction then, through comparable data or through profit split, it is the transaction that needs to be understood and priced. Only in rare circumstances would it be appropriate to recharacterise a transaction from a franchise into something that it is not; a series of separate licenses and services. However, paragraph 118 still suggests that: *"If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparable data cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both."* Firstly, it is the combination of the services and intangibles in a franchise that makes the transaction sufficiently unique that it cannot be valued as anything other than what it actually is; it is a franchise. Secondly, the separation of a franchise into constituent parts is not a valid approach to pricing the arm's length fee for a franchise as, contrary to the suggestion in paragraph 117; this will lead to an over-valuing of the transaction charge. The constituent elements of a franchise might include several different services combined with intellectual property (patents, copyright, design rights, trademarks and others) that, under a completely different and hypothetical transaction, *might* have been made available under different agreements, different terms, and at different prices, together with intangible assets (know-how, a proven business model, sector experience, and others) that must, if disaggregated, be attached (as a matter to be considered in valuation) to one of the foregoing services or intangible properties. A franchise is a commonly used, third-party business model and it is significantly different to an intellectual property licence (or series of intellectual property licences) alongside separately contracted services. The franchise business model carries a lower business risk profile for the franchisee, compared to a licensee. It is highly likely that the constituent parts of a franchise are not capable of being accurately valued by reference to third party licences for intellectual property because of that lack of comparability. In our experience the exercise of breaking down a franchise fee to identify all of the elements made available is difficult, if not impossible. It is likely that the exercise will end (i) without

[6] Lord McNaughton in the UK case : *CIR v Muller & Co's Margarine Ltd* [1901] AC 217

	producing evidence that all intangibles made available have been identified and (ii) resulting in individual valuations of those intangibles that have been identified which sum to a price significantly in excess of the arm’s length price of an appropriate franchise fee. Unbundling the business model into various components does not create a proper basis for the comparability analysis.

Section D – Supplemental Guidance for Determining Arm's Length Conditions in Cases Involving Intangibles (Paragraphs 125 – 223)

Overview

Associating OECD methodologies to traditional intangible property valuation approaches would be helpful and would mitigate possible confusion.

Traditional intangible property valuation techniques implicitly incorporate the "options realistically available" concept:

- The "cost approach," which can be associated with the transactional net margin and profit split methods, considers intangible property valuation from a seller's perspective (historical cost) or a buyer's perspective (replacement costs);
- The "income approach," which can also be associated with the transactional net margin and profit split methods from a buyer's perspective; and
- The "market approach", that is akin to the OECD's comparable uncontrolled price method and considers the transaction value from a neutral perspective.

Detail (references are to paragraph numbers)

129	The cross-reference of guidance applicable to intangibles within Chapter VI of the Transfer Pricing Guidelines to the guidance in Chapter IX for business restructuring is potentially confusing and, in some cases, it may be inappropriate as it might lead to pricing that is not arm's length. An example of this is the reference to place of execution of activity for discerning where risk is controlled (Chapter IX) with the place where royalty income should be paid for use of intangible property (Chapter VI). The place of performance of activity leading to the creation, defence or exploitation of an intangible does not affect the party to whom the royalty income should be paid, as the royalty is paid always to the party who has a legal right to prevent use of the intangible. The place of performance of those activities is important instead in considering the value paid for performance of those activities. To the extent that the concepts contained in paragraphs 9.59 to 9.64 have relevance to the transfer pricing of intangibles, they also have relevance to the transfer pricing of any product or service. To that extent these concepts should not be in Chapter IX of the Guidelines but in Chapter III.
139	It is correct to say that the useful economic life of intangible property asset may be different from the legal protection afforded to that intangible property - it can be shorter. At the end of the period of legal protection the intangible property ceases to have any "property right". Therefore the useful life of intangible property cannot extend beyond the period of legal protection. It would reduce potential confusion if paragraph 139 were to be re-worded to make clear that the economic life of intellectual property could be shorter than the period of legal protection, but not longer.
144	This paragraph might be misinterpreted as meaning that either a licensee cannot use licensed intellectual property to create new, and different, intellectual property if the license does not permit this, and that such permission would require additional payment. The example given relates to the use of a license to existing software as a means to shorten the development of new software. This statement is not the position that exists between unrelated parties and the example given runs counter to the decision in *SAS Institute v World Programing Ltd* [2 May 2012] C-406/10. A software developer has copyright over the source and object code of a program. They have no right to prevent the function of the program being observed and new code written to match or exceed that function. Not only is there no such right belonging to the software developer; they also cannot create such a right in the contract (software license) under which the software is made available.
145	Paragraph 145 also implicitly refers to an income approach ("anticipated future benefit"). This would be more appropriately included in section D.2. As examples of references on

	valuation approaches we suggest: • *"Fundamentals of Intellectual Property Valuation", Anson, American Bar Association, 2005* • *"Valuation of Intellectual Property and Intangible Assets", Smith & Parr, John Wiley & Sons, 2000*
160	In paragraph 160, the cost approach is unduly stigmatised as, from investors' and replacement perspectives; there are several circumstances where it may prove appropriate (although this is not always be the case). There should be no "general discouragement" of any valuation methodology; simply an instruction to prove that the method is appropriately evidential of the arm's length price and that it has been correctly applied.
163	The way the available methodologies are discussed and illustrated in paragraph 163 may bias the reader toward one or the other approach (i.e. comparable uncontrolled price or profit split), whilst it is the facts and circumstances unique to the taxpayer in question that should give that direction. Again, a stricter, traditional organisation of the approaches – market, income, and cost – together with a balanced description and association with the OECD methodologies may help create more clarity. In particular, the Discounted Cash Flow ("DCF") method is only a tool. The lengthy discussion on DCF goes too far in terms of selecting this tool over all others (and in addition does not go far enough to consider all of the practical issues that taxpayers and tax authorities should take into account in implementation). It would be preferable to remove this detail altogether in order to give a balanced and appropriate guide. In our experience tax authorities may have difficulties in accepting terminal value recharge on the paying end. As examples of reference material on DCF we suggest: • *"Financial Valuation", Hitchner, Wiley Finance, 2003* • *"Investment Valuation: tools and techniques for determining the value of any asset", Damodaran, John Wiley & Sons, 2002.* That said, it would be helpful to discuss how the DCF as a tool can be associated with the various approaches – i.e. market, income, cost.
171	Stating that a "tool" can be used as an OECD "method", as paragraph 171 does, undoubtedly add an element of confusion. We refer to our response to the June 2012 version of the OECD Discussion draft for an alignment between OECD "methods", corporate finance "approaches", and "tools". The presentation of comparable uncontrolled price (a), profit split (b) and DCF (c) (and further (d)) may create some confusion in that (a) and (b) are methods and (c) is a "tool".
197, 198	The discussion over form of payment is helpful as it illustrates the possibilities available to taxpayers and may avoid lengthy discussion on this subject with tax authorities.

Deloitte.

Annex

Examples to Illustrate the Guidance on Special Considerations for Intangibles (Paragraphs 224-330)

Overview

In general, examples increase the value and consistent application of the guidance. In particular, examples add practical value where they describe circumstances where there is no adjustment, and then make a small change to the facts and circumstances such that there is an adjustment, which allows taxpayers and tax authorities to see clearly where the line is drawn. It would be beneficial for the users of the guidance if the basic facts relevant to each example are listed with every example, instead of a referencing back to earlier examples.

The examples should not be based on the premise of a tax audit based on a tax authority uncovering additional facts or disagreeing with taxpayer judgement. This introduces a layer of anti-avoidance that is not relevant to guidance intended to benefit both tax administrations and multinational enterprises. The examples would fit better with the approach of the Transfer Pricing Guidelines if they were to be focused on the facts and the outcome. It is less easy to extrapolate from the examples based on the tax authorities having uncovered facts, which lead to a specific conclusion and apply to a specific set of circumstances.

In general, revisions should be made to the examples associated with Chapter VI to reflect the following:

- The pricing of transactions between associated enterprises is considered arm's length insofar as there is reliable evidence of similar pricing in comparable uncontrolled transactions;
- Actual evidence of similar commercial transactions between independent parties is the best indication that the pricing of transactions between associated enterprises satisfies the arm's length principle;
- Where the actual transaction is one that would have been undertaken between unrelated parties, as evidenced above, but there is no evidence of the arm's-length price of that transaction from comparable uncontrolled transactions, the task is to price the transaction that actually occurred. Examples showing the use of traditional and other methodologies would be appropriate.
- Where the actual transaction is one that would not have occurred between unrelated parties, as evidenced above, but the actual transaction can be priced the task is to price and not to recharacterise the transaction, save in the exceptional circumstances described in paragraphs 1.64 – 1.69 of the Transfer Pricing Guidelines. This is consistent with paragraph 1.11 of the Transfer Pricing Guidelines and with our comments relating to the main text of the guidance.
- Where the functional analysis of the transaction indicates that elements of, or control over, functions involved in the creation, protection, exploitation or development of intangibles are undertaken, wholly or in part, by an entity other than the owner of the intangible the examples should recognise that the arm's length pricing will be correct only if all of the transactions relating to the transaction are taken into account. The Transfer Pricing Guidelines take a transactional approach. At arm's length, party A would consider separately the license charged to party B for use of their intangibles from any payment they must make to party C for services rendered. Functional analysis will be essential to the outcome, and all important determining factors should be included for consideration. For example, consider enterprise D that acquires the legal rights associated with patents after grant of the patents; enterprise D had nothing to do with the creation or development of the intangibles. However, having paid an arm's length price to acquire legal ownership of the patent they are entitled to earn all of the reward which the patents generate. The factors of capital, maintenance and protection are important in that example but the factors of creation and development are unimportant.
- The control standard is determined based on the general proposition that the level of control required is that which an independent party would be expected to have in comparable circumstances; and
- Risk must be supported by capital (financial wherewithal). If risk is properly supported by capital, that capital should receive an adequate return.

Deloitte.

Detail

Example 1

In Example 1 the group parent (Premiere) is performing on-going research and development functions to support its business. Resulting patentable inventions are assigned to a subsidiary (Company S) that is responsible for the group's global patent administration. Company S makes a nominal payment (i.e., below arm's length value) each time an invention is assigned to comply with applicable contract law. Concurrently, Company S grants to Premiere an exclusive, royalty-free patent license for the full life of the patent. It is established that Company S does not have any technical research and development personnel, nor does it bear any research and development related expenses.

The example concludes that Premiere and not Company S is entitled to the income from the patents on the basis that Company S did not control the risk related to intangible development nor did it bear the related expenses. It also states that Company S should be entitled to an arm's length remuneration for its patent administration services and underlying costs, but nothing else.

As written, Example 1 can be misunderstood as favouring a subjective "economic ownership" concept over legal form. It can also be misunderstood as requiring that Premier should receive the patent income, not Company S. The analysis could be clarified by adding a statement that the only party entitled to the patent income in the example is the legal owner, Company S. However, the functional analysis of transactions relating to the intangible show that a second transaction must be considered; whether Company S paid an arm's-length fee to acquire legal ownership of the patent and the right to retain all future income generated by the patent; as opposed to the bare ownership, evidenced by the compensation paid to Premiere and the granting of an exclusive and royalty-free license back to Premiere. The examples in the Revised Discussion Draft are inconsistent, as a statement on the importance of considering the legal ownership rights being the starting point for the transfer pricing analysis was added to Examples 12 and 13 in paragraphs 269 and 274, but not here.

Reference to the control of the research and development functions relating to the development and enhancement of inventions is also confusing. Patents are by definition relatively "static" intangibles in that they typically mostly require maintenance (e.g., patent prosecution activities) and protection activities at the maturity point envisaged in the example. As mentioned above, the relevant functions relating to intangibles depends on the particular facts of a case (paragraph 39), which also need to take into consideration the nature of the intangible at stake (i.e., a relatively static-type of intangible vs. a more dynamic-type of intangible). As a result, those references (in the example) to the control (or rather absence thereof at the level of Company S) of development and enhancement functions serve as a confirmation of the legal form of the transaction as structured by the parties; that of a bare ownership transfer of the rights in the patentable inventions.

The OECD has modified the prior version of this example by indicating that Company S made a nominal payment to Premiere for intangible rights. If Company S did not pay an arm's length amount for the rights to the intangible then appropriate adjustments should be made. However, this issue is not related to who is entitled to receive patent income post the intangible sale, but rather whether an arm's length price had been paid for the acquisition of legal title and whether there is therefore a second transaction that should be priced between Company S and Premier. The appropriateness and timing of such a control analysis to divert the intangible related returns from an entity, which while not having controlled the research and development functions, has paid an arm's length price following the research and development stage for the full ownership right in the developed intangible, would be inconsistent with the arm's length standard.

Once the transaction as structured by the parties has been considered, (for pricing purposes) the example should be clarified to illustrate that the actual recipient of the income would only be denied the patent income (not the overall profit from the intangible) only if, as between unrelated parties, the licensee would not have to pay a fee. In view of identifying comparable arm's length situations, one needs to consider the wealth of information that exists in the telecommunication, pharmaceutical and other high-tech industries regarding so called 'patent wars' and the various arrangements in place between patent creators (whether or not currently legal owners), patent prosecutors (i.e., patent administrators), and non-practicing entities (that hold a registration of a patent but who may or may not be legal owners of that patent).

The outcome of Example 1 is not unreasonable, but the approach taken to reach the given solution does not accord with the arm's length principle. This example should re-emphasise the fact that the identification of the party entitled to the patent income needs to be aligned with the legal form of the transaction as structured by the parties (unless, exceptionally, a recharacterisation is appropriate under the principles of paragraphs 1.61 et seq of the Transfer Pricing Guidelines) and based on the arm's length principle rather than some form of hypothetical reasoning. Valuable services should be rewarded at arm's length.

Example 2

Example 2, a continuation of Example 1, addresses a situation in which Company S sub-licenses the patents it acquired from Premier in exchange for arm's length royalties from associated and independent parties. The Revised Discussion Draft concludes that Company S should not be entitled to retain income from its licensing over and above the arm's length compensation for its patent registration since it only performs patent registration functions. However, consistent with our comments on Example 1, the Revised Discussion Draft is again favouring a subjective "economic ownership" concept over legal form and failing to address the additional transaction associated with the example. As with Example 1, the analysis could be clarified by adding a statement that the starting point is the legal form of the transaction structured by the parties (and a concurrent analysis of the behaviour of the parties).

The Revised Discussion Draft suggests that "the appropriate outcome can be reached by assuring that the amount paid by Company S in exchange for the assignment of patent rights appropriately reflects the respective functions performed, assets used and risks assumed by Premiere and by S". This guidance appears to be drafted from a branch and a parent company context as the assets "owned" as opposed to the assets "used" is a more relevant consideration in the intangible context. As written, this amounts to recharacterisation of the transaction to a non-arm's length position. The appropriate test is to consider whether the amount paid to acquire the intangible property is arm's-length in nature, given the likely income stream that could be foreseen at the time of sale of the intangible to Company S. If that was an arm's-length price then any appreciation of value in the patent during the period it is owned by company S belongs to company S. If the price paid by company S to acquire the patent is significantly below the arm's length price, then there might be a secondary transaction to consider, between company S and Premier, as with Example 1.

Again, there is inconsistency, as a statement to the importance of considering the legal ownership rights being the starting point for the transfer pricing analysis was added to Examples 12 and 13 in paragraphs 269 and 274, but not here.

Example 3

Example 3, a continuation of Examples 1 and 2, addresses a situation in which Company S sells the patents to an independent enterprise at a price reflecting the appreciation in the value of the patents during the period that Company S was a legal owner. The example goes onto to suggest that under these circumstances and the same as in Example 2, Company S should be compensated only for the functions it performs, but should otherwise share in income from the intangible.

Consistent with our comments from Examples 1 and 2, this example is favouring a subjective "economic ownership" concept over legal form. It does not reflect the arm's length position and the changes to this example are similar to the matters outlined in relation to Examples 1 and 2 above.

Moreover, consideration must also be given to domestic laws and jurisprudence with respect to economic ownership vs. legal ownership. For example, in Shell Canada Ltd. V. R [1999] 3 S.C.R., the court indicated that *"Courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form. There are, however, caveats to this rule. First, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterisation is only permissible if the label attached by the taxpayer to a particular transaction does not properly reflect its actual legal effect. Second, it is well established that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to the taxpayer's transaction. Where the provision at issue is clear and unambiguous, its terms must be simply applied."* The court has indicated that absent that the legal relationships between two related parties are a sham, the legal structure must be respected and recharacterisation of the transaction must be avoided. Moreover, the court also indicated that where the terms of the Act are unambiguous, it must simply apply the unambiguous provision of the Act to the taxpayer's case. This jurisprudence points to the importance of considering legal ownership.

The Revised Discussion Draft must rely on the arm's length principle in these examples.

Example 4

Example 4 addresses a situation where there is a mismatch between the legal form of a transaction as structured by the parties and the ensuing functional characterisation of the parties on the one hand, and the transfer pricing outcome of the transaction (but not the substance of transaction), on the other hand. In general, we agree that it would be appropriate to reallocate the recall and product liability related costs from Company S to Primero.

Despite the comments above, it is somewhat confusing that Example 4 seems to make a direct link between recall and product liability costs and the entity entitled to the patent income. One would expect that the proper analysis to conduct would be to assess the nature of the risks involved, and then follow the Chapter IX framework to identify the entity bearing such risks. That being said, the ownership of the intangible asset being closely linked to the materialisation of the relevant risks would be an important consideration as part of this analysis.

Example 6

In the second bullet point of paragraph 243 it is stated that Primair and Company S adopt a lower price for watches than in Example 5. In Example 5, paragraph 240, however, it is stated that the price paid for watches is arm's length as it has been tested against identified comparable transactions. It does however, seems to be the case that Example 5 is applying a resale price method or a transactional net margin method, but this is not clear. For the sake of clarity in Example 6 it is recommended to reconsider the wording of Example 5 in respect of the price for watches.

In the last part of the second bullet point of paragraph 243 it is stated that "This results in Company S earning a greater total profit… because of its higher level of risk and more extensive functions". While we agree this would be the long term expectation for Company S it is difficult to predict the impact of the increased risk.

In Example 6, the Revised Discussion Draft suggests that because Company S is now involved in strategic marketing functions and incurs marketing expenses it earns a return that is consistent with the return earned by comparable marketers/distributors. Unless the comparable arm's length distributors used for benchmarking purposes are at a similar stage of the distributor life cycle as Company S, comparability adjustments may be necessary given the expectation that Company S may still be in a start-up mode. In this situation losses may be consistent with an arm's length result.

The Revised Discussion Draft suggests in this example that because Company S incurs marketing expenses and is involved in strategic aspects of marketing a product in its jurisdiction it made a contribution to the intangible value provided by its functions, risks and costs. This may not be correct in the case of routine distributors, which also incur marketing expenses and provide strategic input about the market in which they distribute products but have no expectations on establishing any co-ownership in the pertinent intangible assets or having entitlement to receive income from the intangible property.

Example 7

It is a difficult to differentiate between a "lower level of control" in Example 5 (paragraph 243 first bullet point) and "far more extensive" in Example 6 (paragraph 247). It could be considered if Example 5 is independently relevant or if it is covered by the normal application of the arm's length principle. Therefore this example begins without clarity over what has been found in the functional analysis.

In paragraph 248 it is stated that the marketing expense incurred in years 1-5 far exceeds that incurred by the identified comparable independent marketers and distributors. While we agree that this is a relevant point to analyse, it does raise a question as to the general quality of comparable data, as it is commonly known that comparable data is often significantly smaller than the tested party of an MNE. Comparing absolute values may therefore easily lead to a wrong conclusion of an intangible being created.

Further, paragraph 248 looks at marketing expenses incurred in isolation from the license fee that is paid. It would be more appropriate to look at the “total burden” placed on the licensee (license fee plus marketing costs) and to compare that with third-party data. If the “total burden” of the license is equivalent then the connected party transaction might indeed be correctly priced.

In relation to the conclusion in paragraphs 250 and 251 it is recommended that the wording in Example 5 (paragraph 240) that the price paid for watches is arm’s length as it has been tested against identified comparable transactions is reconsidered. If the price from Example 5 is truly arm’s length, then there are no grounds for an adjustment in Example 7 regardless of the fact that Company S has incurred marketing costs exceeding that of potentially comparable marketers and distributors, since it has also carried the risk of developing the intangible. In this case, such a risk has resulted in a lower overall profit for Company S.

A general caution with respect to Examples 6 and 7 is to be wary of only viewing risk as something that increases profit. Although risk is expected to increase the profit over a period if that risk is managed well, it may just as well lead to a loss in any year or to an overall loss if the risk is not managed successfully.

Example 8

The intention of Example 8 is unclear. The way the example is written, i.e. that an adjustment is in place because marketing spend is higher than the expected return, is objectively correct. We do not consider, however, that the example adds any value to the guidance.

The conclusion of Example 8 is based on the assumptions presented in paragraph 253. This example involves a related party distributor entering into a short-term distribution contract that does not allow it to recoup its investment associated with performing marketing activities and incurring marketing costs in the early stages of a product launch in its home country. The Revised Discussion Draft states that “under the circumstances, Company S is entitled to compensation for its risk contribution to the value of the R trademark and trade name during the term of its arrangement with Primair.”

It is difficult to decipher what “risk contribution” in relation to a trademark and trade name means from a commercial standpoint. Company S is entitled to additional compensation but this is a matter of comparability for the pricing analysis. In addition, one would also expect an analysis as to whether or not comparable arm’s length arrangements would also be on a royalty-free basis, and if that is not the case, then compensation to Company S may already be indirectly provided.

Example 9

We agree with Example 9. We would, however, recommend that the last sentence in paragraph 258 is changed to read as “Accordingly, a transfer pricing adjustment is imposed reversing the royalty payment made by Company S”. We also suggest that the example is re-worded to explain that the company considered these matters and made the resulting transfer pricing adjustment to its tax return, rather than considering this matter as discovered on tax audit. This would remove the ‘anti-avoidance’ element from the guidance.

Similar guidance was provided in Canada v. GlaxoSmithKline Inc. [2012] SCC 52. In this case, the judged ruled that an arm’s length distributor would be willing to pay more for tangible goods purchases if it meant it could distribute a product that generated a premium in the marketplace relative to competing products.

Example 10

With respect to Example 10, particularly for the points on marketing spend and the adjustment for years 1 - 3, please see our comments on Example 7.

We agree with the conclusion in paragraph 262 that an adjustment should be made to the paid royalty and not in the purchase price for the watches. This already follows from the fact that Company S is buying watches from an independent third party.

However, the way the example is constructed, it is difficult to assess if the fact that Company S has an apparently significant marketing spend would lead to the conclusion that the royalty should be reduced. Under the assumption that years 1 – 3 are already dealt with, separately from year 4 and going forward, would it not be the case, based on the facts, i.e. Company S not being under material instructions of Primair, as referenced in paragraph 243, that for year 4 and going forward, under the new agreement, Company S has all functions, risks and assets, (especially the license to use trademark R) making it able and capable of determining its own market strategy? If this is the case, it is not correct from a functional analysis perspective, to assess that the royalty has been too high as a consequence of the marketing spend of Company S being too high. Rather, the more appropriate transaction to analyse would be the royalty rate for the assessed value of the trademark, while the effective use of this trademark is not of equal relevance. If this were not the case, there would be very little difference between a distributor with full risk and a distributor with reduced risk.

In Example 10 additional remuneration is due to Company S on the basis that the pricing analysis ought to account for the intense marketing activities. For the avoidance of doubt, it is reasonable to directly compensate Company S for excess marketing expenditure (and associated risk) that it has incurred over and above what is indicated by comparable independent enterprises, and in commercial arrangements this compensation would usually be outlined *ex ante* in a contract taking into account the parties' expected risk-adjusted return on capital.

Moreover, the comparability analysis should also take into consideration whether Company S may have pursued a market penetration strategy, which may in the short term result in a lower margin (or even loss) and progressively (potentially) in a much larger profitability in absolute cash terms.

We suggest that the example be re-worded to explain that the company considered these matters and made the resulting transfer pricing adjustment to its tax return, rather than considering this matter as one discovered on tax audit. This would remove the 'anti-avoidance' element from the guidance.

Example 11

With respect to Example 11, we agree with the conclusion in paragraph 265 but not the method set out in the example.

Directionally, the opening statement in Paragraph 265 of Example 11 is useful because it validates the importance of legal ownership. However, the example could be clarified as the current facts do not explicitly support that Shuyona is the legal owner -instead, there is an unsupported assumption which reduces the value of this example. Recognising that legal ownership of patents and similar intangibles is governed by a unique body of law in each jurisdiction, and it would be appropriate to include a reference in the example such that the R&D contract between Shuyona and Company S attributes legal ownership to Shuyona under applicable law. Assuming that Shuyona is the legal owner; we agree that it is entitled to the income from the applicable intangibles. (The reference to "…compensation reflecting anticipated contribution to intangible value…" in the latter half of paragraph 265 is confusing and should be removed.) In such a case we also agree that Company S is considered to be a service provider with no ownership of the developed intangibles.

Company S is entitled to compensation for its functions performed, assets used and risks assumed based only on the year in which the R&D service was provided. Appreciation in the intangible value is to be attributed solely to the legal owner, in this case, Shuyona.

Example 12

With respect to Example 12, apart from the fact that Shuyona and Company S would need to enter into a license agreement in order for Company S legally to be able to use the rights registered by Shuyona and the point raised in relation to Example 11 about the correct test of 'legal ownership', we agree with the point that the example is making.

In the way the example is currently constructed, it could be debated whether there is a successive or single transfer (sale) of intangibles from Company S to Shuyona, which is not acknowledged by the parties. Regardless, according to the functional profile of Company S it is correct that Company S should also be able to enjoy the proceeds from the developed intangibles since it is difficult to disregard the legal form. The pricing of the intangibles would most likely be different from Example 11, as the functional profile of Company S is different. In such a case Company S would need to pay a royalty to Shuyona for the use of its rights.

We agree with the opening statement of Paragraph 269 subject to our previous comment on Example 11 relating to the importance of the transfer pricing analysis beginning with recognising the party that is the legal owner of the intangibles.

Example 13

We appreciate that the situation described in Example 13 is difficult, but the example does not provide guidance to resolve the situation. We therefore recommend that the purpose of Example 13 is reconsidered and additional guidance provided. Such guidance could be as simple as considering whether it is possible to outsource the functions, which Shuyona is undertaking but which should have been with Company T. Having a third party perform important and decisive decisions is commonly seen in the financial sector, where e.g. a broker will trade on behalf of its client without prior consents for the individual transactions, but within a limit.

As with examples 11 and 12, we agree with the opening statement of Paragraph 274 relating to the importance of the transfer pricing analysis beginning with recognising the party that is the legal owner of the intangibles.

Shuyona, Company S and Company T would be entitled to compensation that is consistent with what arm's length parties would earn for undertaking similar R&D and manufacturing functions. It is right that Company T should also be compensated for funding the on-going R&D. However, we also recommend that it is made clear that Company T is also bearing the investment risk associated with the R&D activities.

Finally, we also agree that it may be extremely difficult or even impossible to identify comparable arm's length transactions with such a structure and the use of profit split methods, valuation techniques, or other methods may be necessary to identify the appropriate level of compensation to Shuyona for its functions, assets and risks. This analysis should go beyond the “economical ownership” type analysis and must also consider the legal ownership of the intangibles and investment risk that relevant parties are undertaking. This analysis should be based on arm's length transactions.

Example 14

Our comments for Example 14 are similar to those for Example 13. We recommend that additional guidance is provided on how to resolve the situation if the example is maintained. We do not see the need for recharacterising the transaction, as the arm’s length principle adequately provides tools for solving the pricing or profit split between the parties.

As with examples 11-13, we agree with the opening statement of Paragraph 277 relating to the importance of the transfer pricing analysis beginning with recognising the party that is the legal owner of the intangibles.

Paragraph 276 describes how Company A transfers patents and related intangibles to Company S and that the payment made by Company S for these intangibles is arm's length. Company S has no technical personnel to perform the control functions over the R&D and contracts with Company A to carry on the research programme related to the transferred patents and related intangibles. Company S also agrees to fund all on-going research related to the product and assume the financial risk of potential failure.

Paragraph 277 goes onto to make reference to important functions highlighted in Paragraph 79. In this context it may be appropriate to again reiterate that the relevant functions relating to intangibles depend on the particular facts of a case, which also need to take into consideration the nature of the intangible asset (this is subject to a fact specific and thorough functional analysis). In Example 14, the facts given (transfer of patents) suggest that the medical compound is already invented and, therefore, that on-going

R&D relates to clinical trials and necessary approvals, which may reduce the apparent importance of the functions performed by Company A.

The split of the intangible return should be based on reference to what arm's length parties would agree to in commercial situations.

Company S is assumed to have paid an arm's length amount to Company A for the intangibles. If this valuation is based on future expected cash flows associated with these intangibles and the Revised Discussion Draft suggests that too much of the future cash flow (i.e., intangible profit) was allocated to Company S, then the original value that was paid by Company S to Company A was also too high.

Example 15

This example provides a scenario in which P licenses intellectual property to S for exploitation within a defined territory. S exploits the property both inside and outside the defined territory. Redefining applicable territory in the license agreement based on the conduct of the parties and requiring payment from S to P for the larger territory is only one solution. There could be other solutions that do not require imputed license terms but require S to compensate P for lost profits.

The solution given in paragraph 281 does not agree with the arm's length standard. Company S has met the terms of its license in that it has manufactured and sold products only in country B. The export of products to other territories was not an act of Company S, and, assuming all parties to be unrelated, Primarni would have no complaint against company S that would be actionable before a court in either Country A or Country B.

In commercial transactions this is known as a "grey" market or "parallel importing". Primarni is unlikely to have suffered any financial loss as a result of the export of products to other countries if the transaction between Primarni and Company S follows the arm's length principle; the patent royalty paid by Company S would include the value of sales made to all of its customers, including the sales to associated distribution entities. If the patent royalty is paid based on sales price by Company S, then as between unrelated parties, we would expect to see a different royalty rate applied to sales made as a distributor to customers (in this example, sales made in country B to unrelated parties) and to sales made as a manufacturer, or wholesaler, to other distributors (in this example, the sales made to associated parties who exported the goods to Asia and to Africa). The difference in the royalty rate would be expected to correct for the sales price difference between Company S and the related party distributor.

Another way to look into the transaction would be to compensate Primarni with a payment for refraining to exercise its rights in Asia and in Africa. As a result, disregarding or recharacterising the transaction as suggested in the solution in paragraph 281 would not be necessary and should be avoided in line with the recommendations of the Revised Discussion Draft.

The solution given in paragraph 281 should be revised in line with the comments above.

Example 16

This example should be removed in its entirety.

It is unclear from Example 16 what the facts are. From paragraph 284 it seems that Company S has developed an intangible, which seem to be legally owned by Ilcha, as stated in paragraph 282.

Goodwill should not be considered when Company S transfers tangible assets to Companies T and U, as it seems that Company S is trading under a license agreement with Ilcha, which may be terminated in accordance with the arm's length principle. The appropriate question to ask would be whether any compensation for contract termination would be required if the licensing transaction was conducted at arm's length. Paragraph 284 introduces a hypothetical acquisition transaction. This is unnecessary.

Also, as determined in paragraph 41, the accounting definition of an intangible is not necessarily similar to the transfer pricing definition of an intangible. Consequently the reference to accounting practice in Example 16 should be removed.

The example describes a situation where Company S has developed substantial business value in countries C and D for which an independent enterprise would be willing to pay on acquisition of Company S. As drafted, the example does not identify (under the principles of Section A, in particular paragraph 46) or make clear in any way what the intangibles are and who owns them. The example refers to “goodwill” that would only be recognised for accounting and business valuation purposes if the business were sold to an independent enterprise.

As set out in the closing sentence of paragraph 120, the ultimate objective is to identify the pricing and other conditions that would be established between independent enterprises in comparable transactions. When preparing a purchase price allocation following an acquisition, one has to consider the main drivers for the acquisition. If, for example, the buyer is acquiring a target with a brand but it intends to abandon the brand in favour of its own after the merger, the buyer is unlikely to assign a significant value for the target’s brand or maybe sees no value in it at all. Another buyer might think differently. Experience also shows that many business acquisitions are followed by visible and material accounting write downs, again subject to specific facts and circumstances.

The example also contradicts Example 18 (paragraph 292) where it is clearly stated that it is not relevant how the intangibles are defined and valued for the purposes of purchase price allocation. The Revised Discussion Draft (paragraph 62 of Section A) further states that accounting and business valuation measures of goodwill and going concern value do not, as a general rule, correspond to the arm’s length price of transferred goodwill or going concern in a transfer pricing analysis. We agree with the approach taken in Example 18 and paragraph 62 and not with the approach taken in this example.

In our view Example 16 is likely to create considerable uncertainty and lengthy disagreements, rather than helping tax authorities and MNEs to find solutions in the transfer pricing of reorganisations. For these reasons, Example 16 should be removed.

Example 17

Based on our understanding of facts in Example 17 the issue is the same or very similar to the issue in Example 13 and Example 14; please see our comments to Examples 13 and 14. This example could be deleted as it adds nothing over Examples 13 and 14. If it is to be retained, this example would be improved by reference to what would happen between unrelated parties.

It is not uncommon for distributors in third party situations to take a role in local advertising or carry at least a part of the cost of such advertising. In considering whether by action of the licensee or distributor that party becomes entitled to part of the reward earned by the marketing intangible (they never become ‘owner’ or ‘part-owner’ in the sense of legal title in the trademark) associated with the trademark, the test applied to unrelated parties is whether the total burden placed on the licensee or distributor (in this case, the activities performed, and the price of goods and cost and the activity of advertising) is, qualitatively or quantitatively, more than would be expected of a licensee or distributor. Only if this test is passed would the licensee or distributor become simultaneously entitled to some of the reward in relation to the marketing intangible.

The above test has been applied in several UK commercial cases. In the case of *Gromax Plasticulture Ltd* and *Don & Low Nonwovens Ltd* [1998] Ch. there is an example of this test being applied in seeking a solution to the question of whether a trademark owner or a distributor (unrelated parties) were entitled to the reward generated by goodwill in the trademark. This “bright line” test has been echoed in other tax cases, notably the Indian case of *Maruti Suzuki India Ltd v Additional Commissioner of Income Tax Transfer Pricing Officer New Delhi* W.P.(C) 6876/2008 (High Court of Delhi at New Delhi, 2010) and the US case of *DHL Corp.*, TC Memo 1998-461, RIA TC Memo.

It is clear from unrelated party commercial disputes that the party entitled to the financial benefit from an intangible is the party to whom a court would award that benefit. The primary rule is that this will be the party that holds title to, or registration of, the intangible and that rule will be set aside only if there are circumstances so exceptional that a bright line is crossed. If this bright line is indeed crossed, then the parties can become simultaneously entitled to some of the reward associated with the marketing intangible.

The decisions of courts in commercial disputes, such as *Growmax* referenced above, illustrate that even when the ‘bright line’ is crossed that does not allow a party other than the owner of the registered trademark to license the trademark to another party. Cases such as *Growmax* show that a royalty-free license to use the trademark in a business can arise, but nothing more. If there is to a license of the trademark to another party (related or unrelated to the Licensor) the license income must flow only to the Licensor as holder of the rights to prevent use of the trademark. However, in that case an additional transaction might arise in which marketing services (enhancing the trademark value) are supplied to the Licensor and correct pricing of this second transaction would leave the Licensor with an appropriate net profit.

Example 18

A purchase price allocation is not determinative of the value of tangible and intangible assets of a business for transfer pricing purposes (and may not even be indicative). This is adequately stated in paragraph 173, and Example 18 does not provide any additional guidance on this point. Additional facts are stated in Example 18, but it is unclear how these facts are related to the example.

This example deals with transfer of intellectual property after a business acquisition. The example cautions that intellectual properties transferred must be specifically identified and that definitions and valuations of intangibles contained in purchase price allocation are not determinative for transfer pricing purposes. It fails to recognise that value may be attributable to group synergies, and to other factors other than the tangible and intangible assets of the target company. The example goes on to claim that "value does not disappear, nor is it destroyed, as part of internal restructuring" but without accurate assignment of purchase price to all factors within and external to the target company that statement is likely to lead to over-valuation of intangibles transferred. While it is true at the instant of restructuring that value does not disappear and is not destroyed, there are many instances of value destruction even in the short term, post restructuring.

Supposing that part of the price paid by Birincil was driven by an incorrect assessment of the true value of company T, that part of the price paid for the shares in Company T was never an accurate representation of the value in the business of Company T and hence would not be reflected in either the value of intangibles transferred to Company S nor in the value of the business retained by Company T. The facts of the example state that Company T had only minimal sales. Equally, suppose that Birincil paid a premium to acquire the share capital of Company T because it saw strategic advantage for the group (removal of a potential future competitor, competitive advantage enjoyed because of a complete product range, or other factor). In those circumstances the full price paid by Birincil to acquire the shares of Company T would not be reflected in the value of the business of company T and therefore would not be reflected in the sum of the price paid by Company S for the transfer to it of intangibles plus the remaining value of the business of Company T. As drafted this example would incorrectly indicate to an MNE or a tax authority that there must always be parity between the sum total of the value of the business remaining in Company T and the value of intangibles transferred to Company S and thereby to allocate erroneously an additional value to the transfer of intangibles to Company S when there might be other factors to be taken into account.

Example 19

As the code developed in the Bank A engagement has features to justify the claim of copyright infringement if copied on an unauthorised basis by a third party, we agree with the solution provided in paragraph 295.

An additional example would be useful here. If the facts were changed slightly so that the code developed by Bank A was not actually copied (in whole or in part) but the functionality of that computer program was the inspiration for Company S and the functionality of the new code drew heavily on that knowledge. In these revised circumstances there is no potential case for copyright infringement (no source code or object code has been copied). Zhu has no legal rights to prevent a third-party from acting as Company S has acted, and a third-party would not pay Zhu. Accordingly no payment would be due from Company S to Zhu. This analysis is consistent with the decision of The Grand Chamber in *SAS Institute Inc. v World Programming Ltd* (2012) Case C-406/10.

Example 20

This example is similar to example 19, except here it is unclear from the facts whether the intellectual property is legally protectable and can be distinguished from the services of individuals. Providing such clarity would be useful.

Based on the limited facts in the example, we agree with the conclusion that two transactions should be recognised, being a service transaction and a transfer of rights to the software code. It may be worth considering adding that the use of the document management system, being an intangible asset, should be reflected in the pricing of the service provided to Company S by Prathamika.

Example 21

This example is similar to example 18. However, this example, cautions that synergy value should be identified in appropriate circumstances and to the extent the synergy value is not related to the specific geographic market in question, payment for intellectual property should appropriately reflect the existence of synergy value.

We agree that the purchase price allocation performed for accounting purposes is not determinative for transfer pricing purposes. As for the pricing of the license granted by Osnovni, which we assume becomes the owner of the intangibles previously belonging to Company T, when Company T is liquidated, we agree that it should be considered if the premium relates to the intangibles licensed to Company S by Osnovni.

The example does not comment on the funding costs and the risk assumed by Osnovni when acquiring the business of Company T in order to obtain access to the assets.

Example 22

This example deals with valuation of a bundle of intellectual property based on relief from royalty as well as discounted cash flow methods. The example seems to imply, but without any basis, that discounted cash flow method is more reliable than the relief from royalty approach in the context of the example. The example also seems to imply that valuation should be performed on a post-tax basis. Valuation pre- or post-tax should result in the same answer if appropriate discount rates are chosen. Clarification of this point would be helpful.

It could be considered whether the point being made would not be better made in the main text of Chapter VI, as opposed to in an example. This could be as a new paragraph after the existing paragraph 120. Suggested wording could be "When transferring all intangibles from a business, which will continue to operate with its remaining functions, risks and assets, it should be assessed whether a single valuation method does, or does not, not correctly price the transfer of the intangibles. This assessment could be made by considering whether the residual value of the entire business pre-transfer of the intangibles with the identified value of the intangibles reflects an arm's length value of the remaining functions, risks and assets after the transfer of the intangibles".

If this example remains in the guidance, we recommend that the word "dealings" is changed to the word "principle" in paragraph 305.

Example 23

This example is similar to example 22. It attempts to describe conditions under which an aggregate approach to valuation is appropriate. It would be appropriate to caution that intangibles must be identified with specificity and if aggregate valuation diverges significantly from valuation of separately identified intangibles, then further analysis to reconcile the difference is appropriate. Aggregate valuation approach is not more reliable by default.

Example 24

While we appreciate that Example 24 is simplified to make a point, there is no clear guidance as to what value to select as arm's length. Alternatively if the approach reflects that a range of values, e.g. between the minimum value for the transferor and the maximum value for the transferee, is the outcome, it would be helpful if such wording is included in the conclusion of the example or even better in the main text of Chapter VI.

There are several potential flaws in the application of economic principles even after accounting for simplistic assumptions. The example considers a situation where a business can maximise value through relocating certain functions to an alternative location. The increase in value can be attributed to cost savings as well as tax savings. The example considers transfer of intangibles and these savings complicate the valuation of transferred intangibles. The example points out that in these circumstances "options realistically available" to the parties must be considered. The example, as laid out, assumes that the discount rate for income associated with routine functions is the same as the discount rate associated with residual profit. This is unlikely to be the case in most realistic business scenarios. The example does not have any expenses associated with maintaining, protecting and developing the intangibles which is also unrealistic.

Example 25

This example attempts to explore conditions under which price renegotiation clauses should be part of agreements between related parties and concludes that given the facts it would not be appropriate to impute such a clause. The example in itself fails to shed much light on the question. The answer to this question must be grounded in facts, circumstances and evidence, both of the transaction under consideration and of arm's length behaviour. It should also be recognised that uncertainty creates risk for unrelated parties in a transaction. Many contractual forms between unrelated parties are written with the express intent of addressing such situations involving risk. Such conditions may not exist between related parties. Thus, as the Transfer Pricing Guidelines recognise, the contractual form between related parties in an MNE may be different from those between unrelated parties.

We agree with the conclusion in Example 25. The point in paragraph 324 that the use of hindsight is inappropriate is not only relevant in relation to intangibles, but to all transactions. This example should make clear that where unrelated parties would have concluded a deal based on the facts and circumstances known at that time it is not open to multinationals or tax administrations to use hindsight to return to the past and re-value the transaction. This is consistent with the decision of the UK Courts in the commercial case of *Force India Formulae One Team Limited v AerolabSRL* [2012] EWHC 616 (Ch).

Example 26

We agree with Example 26 on the facts given.

This example continues to explore the issue raised in the previous example and concludes that annual price adjustment clause would be appropriate. The factual background provides that it is not industry practice to enter into long-term agreements. In addition, there is no evidence that projections made by associated enterprises would have been considered adequate by independent enterprises. On the point of industry standard, please see our comments for example 25. The draft guidance correctly recognises that the contractual form between related parties in an MNE may differ from those between unrelated parties. On the point of adequacy of projections, it would be impossible for any taxpayer to prove this point. A taxpayer can only demonstrate that all available information was taken into account in creating the projections.

Example 27

Apart from the fact that Example 27 seems to be more relevant as an example of what could constitute a comparability analysis and is not particularly relevant for Chapter VI and the transfer pricing aspects of intangibles, we reiterate the point from paragraph 324 regarding hindsight. Especially when determining a license rate which a company is to pay for exploiting the intangibles, the rate is not affected simply because the economic environment did not develop according to the budget prepared at the time of determining the royalty rate. What is most important in such a situation is to assess if the conditions were at arm's length at the time the royalty rate was determined, taking into account the duration of the license period, the industry standards for renegotiating terms, etc. This is a question of facts and evidence.