AT ARM'S LENGTH

'Shadowlands': The OECD on Intangibles

by Jens Wittendorff

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On June 6 the OECD unveiled the status of its transfer pricing project on intangibles in the publication of a discussion draft of a revised Chapter VI of the OECD transfer pricing guidelines.[1] This project is important because intangibles are the core of value creation and determinative for the international allocation of tax revenues from multinational enterprises. The taxing right to intangible profits are assigned exclusively to the residence state of the intangible owner under the OECD model tax treaty unless an intangible forms part of the business assets of a permanent establishment in the source state.[2] Residence taxation means that a multinational may be able to influence where a substantial share of its profits are recorded and taxed. A multinational may thus be able to permanently reduce taxation under a territorial tax system or to defer taxation under a worldwide tax system.

More broadly, intangibles and other firm-specific advantages are not only the object of transfer pricing scrutiny, but one of the reasons for the existence of multinationals.[3] Hence, it may be economically optimal to exploit intangibles internally through associated enterprises rather than externally through independent enterprises because of market defects such as information asymmetry, uncertainty, and transaction costs. One of the pioneers of international taxation, Mitchell B. Carroll, realized the importance of intangibles in 1933:

> In the alchemy of a successful business, the intangible, immeasurable element of brainwork is a very important factor, if not the most vital factor.[4]

The arm's-length test of intangibles accentuates a number of general transfer pricing issues. First, comparable reference transactions rarely exist because intangibles are often unique. Second, the value of an intangible is normally its value in use, which is expected to last several years and which also depends on the resources and competencies of the individual enterprise. Third, these matters create informational asymmetry between taxpayers and the tax authorities. Hence, a proper arm's-length test requires detailed knowledge of

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[1]OECD, ''Discussion Draft Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions, 6 June to 14 September 2012,'' June 6, 2012. This project was launched in 2010; *see* OECD, ''Transfer Pricing and Intangibles: Scope of the OECD Project,'' 2011.

[2]Articles 7(1), 12(1), 13(2) and (5), and 21(1) and (2) of the OECD model. Article 12(2) of the U.N. model tax treaty assigns a taxing right to the source country regarding royalties. On the allocation of taxing rights to intangibles, see W. Schön, ''International Tax Coordination in a Second-Best World (Part II),'' 2 *World Tax J.* 1(2010), pp. 65 and 90.

[3]R.E. Caves, *Multinational Enterprises and Economic Analysis* (Cambridge: Cambridge University Press, 2007), pp. 3 and 190; and J.H. Dunning and S.M. Lundan, *Multinational Enterprises and the Global Economy* (Cheltenham, U.K., and Northampton, Mass.: Edward Elgar, 2nd ed. 2008), p. 99.

[4]Para. 676 of *Taxation of Foreign and National Enterprises — Vol. IV, Methods of Allocating Taxable Income* (Geneva: League of Nations, League of Nations Document No. C.425(b).M.217(b). 1933.II.A.).

the technological features of the intangible and its profit potential, the group's strategy and opportunities for exploiting the profit potential, and an understanding of complex financial, legal, and commercial matters. The uncertainty associated with an *ex ante* valuation of intangibles is a particular problem for the tax authorities. If the actual profits attributable to an intangible exceed the projected profits that influenced the valuation of the intangible transferred in a controlled transaction, the tax authorities may question whether the discrepancy was caused by unforeseen circumstances or by an abuse of the informational asymmetry.

The discussion draft has adopted an interim format to accommodate comments from business as the project progresses. The OECD cautions readers that the interim draft is not yet a consensus document and that it does not represent a complete draft of all the provisions ultimately expected to form part of the output of the project. It is likely that changes will also be made to Chapter VIII on cost contribution arrangements, and to chapters I and/or III on comparability analysis. A full discussion draft is expected to be published in 2013.

The interim draft addresses four main issues:

- identification of intangibles for transfer pricing purposes;
- identification of the parties that should be entitled to share in intangible returns (ownership);
- nature of the controlled transaction; and
- pricing of intangibles.

This article comments on each of the above issues and compares the discussion draft with existing OECD guidelines and U.S. transfer pricing regulations.

I. Identification of Intangibles

A. Definition

1. Autonomous vs. Domestic Law Interpretation

The first threshold issue is the definition of intangibles for transfer pricing purposes. The OECD guidelines provide exemplification of intangibles and leave it to domestic law to fill in the gap.[5]

The discussion draft starts by stating that article 9(1) of the OECD model, which provides the authoritative definition of the arm's-length principle, is concerned with ''conditions'' of controlled transactions, not with assigning particular labels to such transactions.[6]

This leaves readers with the impression that the OECD's position is that the status quo should be maintained and that article 9(1) does not deal with the characterization of controlled transactions. However, this would be a clear misconception of the OECD's current thinking. The discussion draft thus devotes considerable space to a new autonomous intangible definition.

Accordingly, a situation exists in which the OECD guidelines prescribe a domestic law interpretation and the discussion draft requires autonomous interpretation. To determine which of these mutually exclusive approaches is correct, one must consult article 9(1).

Object qualification is addressed in article 9(1) by the concept of ''commercial or financial relations.'' This term is undefined in the OECD model. A contextual interpretation must consider article 7(1), which article 9(1) supplements by determining the amount of business profits from controlled transactions that is covered by the taxing right of the two residence states.[7] There is thus an overlap of the profits from commercial and financial relations governed by article 9(1) and business profits governed by article 7(1). The term ''business profits'' must be interpreted under domestic law, according to the OECD commentary.[8] Because under article 7(1) business profits in an associated enterprise context are the result of ''commercial or financial relations'' referred to in article 9(1), article 3(2) and the context also require this concept to be interpreted on the basis of domestic law.[9] The existence, form, and content of a controlled transaction must thus be determined on the basis of domestic law before the application of the arm's-length principle of article 9(1).[10]

The OECD guidelines' approach is therefore correct because article 9(1) does not leave room for the autonomous interpretation of the discussion draft. This means that the OECD cannot disregard such peculiarities of domestic laws as the recognition for transfer pricing purposes of a ''business facility'' in the United Kingdom, a ''business opportunity'' in Germany, and the nonrecognition of goodwill for transfer pricing purposes in the United States. In terms of goodwill and going concern value, the discussion draft accepts that the diversity of domestic laws means that an autonomous definition cannot be applied.[11] For example, Danish tax laws apply a distinct legal definition of

[5]Para. 6.2 of the OECD guidelines.

[6]Para. 2 of the discussion draft.

[7]J. Wittendorff, *Transfer Pricing and the Arm's-Length Principle in International Tax Law* (Kluwer Law International, 2010), p. 178.

[8]Paras. 4 and 10.2 of the commentary on article 3 of the OECD model.

[9]Wittendorff, *supra* note 7, at 222; and J. Wittendorff, ''The Object of Art. 9(1) of the OECD Model Convention: Commercial or Financial Relations,'' 17 *Int'l Transfer Pricing J.* 3 (2010), p. 200.

[10]Brian J. Arnold, ''Fearful Symmetry: The Attribution of Profits 'in Each Contracting State,''' 61 *Bull. Int'l Tax'n* (2007), pp. 312, 321, and 334.

[11]Paras. 21 and 22 of the discussion draft.

Table 1. Scope of Article 9(1)

Stage	Topic	Issues	Application of Article 9(1)
1	Preliminary definition of controlled transaction	Does a taxable object exist?	No
		Who is the owner of the taxable object?	No
		Does a transaction covering the taxable object exist?	No
		Who are the parties to the transaction?	No
		When should the transaction be recognized for tax purposes?	No
2	Transfer pricing analysis	Is the pricing consistent with the arm's-length principle?	Yes
3	Taxation	Does authority to make a transfer pricing adjustment exist?	No
		Application of domestic substantive tax law to profits relating to a primary and corresponding adjustment	No
		Application of domestic and international tax law to secondary adjustment	No

goodwill, which differs from the residual value definition applied in financial accounting and in the domestic tax law of some countries.[12]

This raises the question about the use of the new definition. The overarching purpose of the arm's-length principle is to ensure that general tax laws operate according to their intended purpose without bias from controlled transactions. That is, the purpose of the arm's-length principle is to supplement general tax law on a domestic level and the genuine distributive articles on a tax treaty level.[13] This is achieved by authorizing adjustments in cases of mismatch between transfer prices and arm's-length prices. Taxation under domestic law is essentially made by reference to domestic legal concepts rather than cash flows and so forth.[14] Taxable objects created by the OECD under an autonomous definition do not establish, change, or restrict taxation under domestic law. Instead, the OECD creations must be ''translated'' into domestic law concepts in each of the contracting states in order to become operational; that is, a triple qualification must take place. The OECD is thus about to create a qualification system in the shadowlands with no link to the real world of domestic tax laws. The separation from domestic tax law concepts may mean that no legal basis exists for the taxation or amortization of items found to qualify as intangibles for transfer pricing purposes. This may give rise to double taxation as well as double nontaxation. This is primarily a domestic problem that may be resolved unilaterally by national parliaments.

A possible application of an autonomous definition for transfer pricing purposes would be to use it as a tool to evaluate whether a controlled transaction would be compensable between independent parties. However, the discussion draft rules out such an application by providing that the identification of an item as an intangible is separate and distinct from the determination of the value of the item.[15] This may very well be true for domestic tax law, but in an article 9(1) context the scope is precisely that of valuation.

Other general tax issues such as timing recognition,[16] ownership, and assignment of income principles[17] are likewise not addressed by tax treaties.

The result is that two of the four main issues addressed by the discussion draft (definition and ownership) are outside the scope of article 9(1).

The effects of the above conclusions for the scope of article 9(1) regarding the tax issues that arise in most transfer pricing cases are outlined in Table 1. Dispute resolution and non-income-tax matters such as customs are not addressed.

The scope of the arm's-length principle of article 9(1) is limited to stage 2 of a transfer pricing case. The issues under stages 1 and 3 normally fall under general domestic tax law.

The OECD does not interfere with domestic taxation under stage 3. By contrast, the OECD has for some years attempted to expand the scope of article 9(1) to cover preliminary issues of stage 1, causing the arm's-length principle to undergo a conceptual change from a narrow, price-based standard to a broader standard that incorporates economic substance principles.[18]

[12] *TfS* 2005.520; *TfS* 2005.308; *TfS* 2002.288; and *TfS* 1992.431.

[13] Wittendorff, *supra* note 7, at 177.

[14] J. Pedersen, *Skatteudnyttelse* (Copenhagen: GEC Gads Forlag, 1989), pp. 33 and 213.

[15] Para. 9 of the discussion draft.

[16] Para. 32.8 of the commentary on article 23A and B of the OECD model. *See* Steven P. Hannes, ''Transfer Pricing Discussion Group Comments on OECD's Business Restructurings Draft,'' *Tax Notes Int'l*, Mar. 16, 2009, p. 973, or *Doc 2009-4867*.

[17] Para. 22.1 of the commentary on article 1 of the OECD model. *See* J. Wheeler, ''The Missing Keystone of Income Tax Treaties,'' *World Tax J.* (June 2011), p. 247; and Wittendorff, *supra* note 7, at 151.

[18] J. Wittendorff, ''The Transactional Ghost of Article 9(1) of the OECD Model,'' 63 *Bull. Int'l Tax'n* 3 (2009), p. 107.

The inquiry is thus shifting from the price of a transaction to the transaction itself. This novel approach to transfer pricing must be rejected because none of the preliminary issues are within the scope of article 9(1).

If OECD guidelines on non-pricing issues should be powerful, it will be necessary for the OECD to change the wording of article 9(1) and for member countries to reflect such changes in domestic law and in tax treaties.[19] With the publication of the 2010 OECD model, this approach was adopted regarding article 7. However, whether it would be desirable with a change of the arm's-length principle of article 9(1) is questionable.

2. Transfer vs. Use of Intangibles

For transfer pricing purposes, intangibles are important in two distinct situations:

- transfer of intangibles; and
- use of intangibles.

In the first situation, the object of the inquiry is the intangible itself. In the second situation, the object is the goods, services, and so forth manufactured or sold on the basis of the use of intangibles.

The OECD guidelines apply distinct definitions of intangibles in the two situations. For the transfer of an intangible, an exemplification based on legal concepts is applied.[20] For the use of an intangible, an exemplification based on economic concepts is applied; for example, it is recognized that a ''marketing organization'' may constitute a unique intangible.[21] Items that are recognized as intangibles for economic purposes such as organizational capital may fully or partly overlap with legal concepts such as know-how. What is decisive for transfer pricing purposes is the contribution to profit of the item used rather than its qualification. In this context, the OECD is authorized to apply whatever definition of an intangible because it will solely serve as a tool for determining the arm's-length price of goods or services. (See Table 2.)

Table 2. Transfer vs. Use of an Intangible

Transaction	Object of Arm's-Length Test	OECD Authorized to Define Intangible?
Transfer	Intangible	No
Use	Goods or service	Yes

U.S. transfer pricing laws arguably are consistent with the OECD approach because the enumeration of an intangible in section 1.482-4(b) is only applicable to the transfer of intangibles, whereas a broader definition may apply to the use of intangibles.[22] For example, goodwill is not recognized as an intangible for the transfer of intangibles,[23] whereas this item is recognized in relation to the use of an intangible.[24]

The discussion draft clearly distinguishes between the transfer and use of an intangible. However, a new approach is adopted under which a uniform definition of an intangible is applied in both situations. (See Section I.A.3 of this article.) For this reason the new definition may be viewed as being rather broad in relation to the transfer of intangibles and rather narrow in relation to the use of intangibles. Regarding the use of intangibles, the definition is supplemented by the concept of ''unique and valuable contributions'' to a controlled transaction.[25] This concept will gain importance in relation to the use of intangibles if the unified definition is adopted. It is only a question of semantics whether such contributions are labeled ''intangibles'' or ''unique and valuable contributions.''

3. Three-Prong Test

The discussion draft introduces a general three-prong definition according to which an intangible is something that is:

- not a physical asset or a financial asset;
- capable of being owned or controlled; and

[19]J. Wittendorff, ''Consistency: Domestic vs. International Transfer Pricing Law,'' *Tax Notes Int'l*, June 18, 2012, p. 1127, *Doc 2012-10827*, or *2012 WTD 117-18*.

[20]Para. 6.2 of the OECD guidelines.

[21]Para. 2.32 of the OECD guidelines.

[22]Wittendorff, *supra* note 7, at 597.

[23]*Veritas Software Corp. v. Commissioner*, 133 T.C. 14 (2009), in which the Tax Court noted:

> We further note that the Administration, in 2009, proposed to change the law, expanding the section 482 definition of intangibles to include ''workforce in place,'' goodwill, and going-concern value. See Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals 32 (May 2009). For the years in issue, however, there was no explicit authorization of respondent's ''akin'' to a sale theory or its inclusion of workforce in place, goodwill, or going-concern value. [Footnotes in the original have been removed.]

The IRS contests the position of the Tax Court regarding goodwill being covered by section 1.482-4(b). *See* footnote 7 in ''Action on Decision in *Veritas Software Corp.*,'' AOD 2010-05, IRB 2010-49, as well as ''Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal Part Three: Provisions Related to The Taxation of Cross-Border Income and Investments, Joint Committee on Taxation,'' JSC-4-09 (Sept. 2009), p. 38. Goodwill may qualify as a non-routine contribution under the cost-sharing regulations; *see* section 1.482-7(g)(7)(v) (Example 1).

[24]*Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), in which the Tax Court stated: ''We note, however, that those witnesses did not give enough weight to goodwill and the value of the Lilly name.''

[25]Paras. 2.4, 2.25, 2.26, 2.32, 2.59, 2.61, 2.109, 2.121, 2.137, 3.19, and 3.39 of the OECD guidelines.

- for use in commercial activities.[26]

The discussion draft emphasizes that this definition is solely intended to be used for transfer pricing purposes and that it does not always coincide with definitions for accounting, legal, and general tax purposes.[27] The problems associated with using a definition that is disconnected from general domestic law is addressed above in Section I.A.1.

A purchase price allocation made for accounting purposes should not be controlling for transfer pricing purposes, because accounting law is not decisive for tax law in most countries and because purchase price allocations are made under the fair value standard. This reflects the position of the U.S. cost-sharing regulations.[28] The new definition also does not overlap with the definition of royalties under article 12 of the OECD model.[29]

4. 'Owned or Controlled'

The ''owned or controlled'' prong of the definition must mean that an intangible has to be excludable. The discussion draft does not address this requirement in any detail. However, the draft states that an intangible does not need to be protectable by law, contract, or otherwise.[30] An intangible can thus be an item over which a taxpayer solely exercises practical control. This position is consistent with the U.S. regulations.[31] If practical control is not present, an item should not be treated as an intangible because no value would usually be ascribed to the item in market transactions.

According to the discussion draft, a compensable intangible may thus encompass:

- intangibles protected under intellectual property law and registration systems;
- intangibles protected against unauthorized appropriation and so forth via unfair competition law or other laws, or by means of contracts including employment contracts; and
- intangibles whose use is not protectable under any applicable law but that are subject to practical control.[32]

It goes without saying that the value of intangibles covered by the last category will be affected by the lack of legal protection.

5. Specificity

The discussion draft requires that the identification of an intangible must be made with some ''specificity.''[33] Hence, a functional analysis should identify:

- the economically significant intangibles at issue;
- the manner in which they contribute to the creation of value in the transaction under review; and
- the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.

This test should safeguard taxpayers against ingenious tax inspectors claiming the transfer of vaguely specified or undifferentiated ''marketing intangibles'' and so forth. The specificity requirement reflects the position of, among others, U.K. tax authorities, which have been reluctant to recognize the existence and value of marketing intangibles.[34]

The excludability requirement means that the identification of an intangible cannot be made solely from an economic perspective. The discussion draft clarifies that identification and valuation are separate and distinct exercises.[35] Above-normal profits may thus be attributable to extraordinary good management of the resources of a company, which does not necessarily include valuable intangibles.[36] On the other hand, below-normal profits may be triggered by poor management of the resources of a company, which may include valuable intangibles. Hence, the approach under section 1(3) of the German Foreign Tax Act (Aussensteuergesetz) of relying on the application of an income-based method in order to identify intangibles is inconsistent with the discussion draft.[37]

6. Significance

The specificity requirement provides that the focus should be on economic significant intangibles. Not all intangibles deserve separate compensation in all circumstances, and not all intangibles give rise to premium returns in all circumstances.[38] This is in line with the approach underlying the OECD guidelines that call for the identification of the ''significant intangible assets.''[39]

[26]Para. 5 of the discussion draft.

[27]Paras. 5 and 6 of the discussion draft.

[28]Treas. reg. section 1.482-7(g)(2)(vii).

[29]Para. 12 of the discussion draft.

[30]Para. 7 of the discussion draft.

[31]Treas. reg. section 1.482-4(f)(3)(i).

[32]Paras. 31 and 32 of the discussion draft.

[33]Para. 11 of the discussion draft.

[34]International Manual 467160 (establishing an arm's-length price for valuable intangible property), p. 24.

[35]Para. 9 of the discussion draft.

[36]This assumes that management systems are not held to constitute an intangible. *See* Warner and McCawley, 887 T.M., *Transfer Pricing: The Code and the Regulations*, A-131.

[37]R. Schreiber, in: H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, I. Nationale Vorschriften, Funktionsverlagerungsverordnung (Cologne: Verlag Dr. Otto Schmidt, loose-leaf), m. nos. 4 and 60.

[38]Para. 9 of the discussion draft.

[39]Para. 9.80 of the OECD guidelines.

7. Commercially Transferable

According to the discussion draft, an intangible need not be separately transferable.[40] The statement is ambiguous but suggests that an intangible at least must be transferable in combination with other assets. The OECD should clarify this ambiguity. The probable reason why the discussion draft does not require an intangible to be separately transferable is to ensure that goodwill and going concern value are treated as intangibles for transfer pricing purposes.

U.S. transfer pricing laws require that an intangible be separable in the sense that it is capable of being sold, licensed, or exchanged in a market transaction.[41] This requirement was considered to be so obvious that it was omitted from the 1994 final regulations.[42] However, a 2008 technical advice memorandum suggests that the IRS may have adopted a new position that an intangible must simply be transferable in combination with other business assets.[43]

8. Intangibles vs. Services

The discussion draft does not require that an intangible has substantial value independently of the services of an individual. This is required under the U.S. regulations, however.[44] The OECD may have been influenced by the IRS, which is struggling with this requirement regarding the item ''assembled workforce.'' Hence, the Tax Court has held that an assembled workforce does not constitute an intangible within the meaning of section 1.482-4(b) because it is not enumerated in the regulations and does not have substantial value independent of the services of any individuals.[45] The IRS disagrees with the Tax Court's position.[46]

9. Categorization of Intangibles

The OECD guidelines use the concept of unique and valuable contribution,[47] which mirrors the U.S. concept of non-routine contributions.[48] The discussion draft argues that no distinction should be made between different types of intangibles such as routine versus non-routine intangibles, manufacturing versus marketing intangibles, and so forth. Nevertheless, a number of new concepts are introduced, such as insignificant intangibles, non-comparable intangibles, section D.1.(vi) intangibles,[49] and non-unique intangibles.[50] It would provide more clarity if the OECD would stick to a single concept throughout the guidelines, for example, the U.S. distinction between routine and non-routine contributions.

10. Summary

The definition of intangibles falls outside the scope of article 9(1) — that is, it is the prerogative of domestic law. The OECD thus oversteps its authority by providing an autonomous definition in the discussion draft.

It is questionable whether the OECD definition will be helpful in resolving definitional disputes at all. Regarding ''hard'' intangibles protected by registration, the definition does not add anything. Regarding ''soft'' intangibles, the only real guidance provided is that an item should be capable of being ''owned or controlled.'' This criterion is so elusive that it will hardly resolve any practical disputes concerning know-how, trade secrets, and so forth. Further, the discussion draft has renounced defining goodwill and going concern value.

The OECD should clarify that definitional issues in principle must be decided under domestic law and that the discussion of this matter is solely of a guiding nature. The OECD could be considered to focus the discussion on the issue when an intangible would be compensable in a market transaction. There is thus a thin line between the definition and valuation of an intangible.

Table 3 compares the definitions of an intangible for transfer pricing purposes in the discussion draft and U.S. tax law.

It follows from the table that the discussion draft applies a broader definition of an intangible compared with U.S. tax laws.

B. Application of Definition

1. General

The discussion draft concludes that the following items qualify as intangibles:

- patents;
- know-how and trade secrets;
- trademarks, trade names, and brands;
- goodwill and going concern value; and
- licenses and similar rights in intangibles.

This list of intangibles is uncontroversial except, perhaps, for goodwill and going concern value.

On the other hand, the following items do not constitute intangibles, according to the discussion draft:

- group synergies;
- market-specific characteristics; and

[40]Para. 7 of the discussion draft.

[41]*Merck & Co. v. United States*, 24 Cl. Ct. 73 (1991). *See* Wittendorff, *supra* note 7, at 598.

[42]Preamble, section 1.482-4, T.D. 8552 (IRB 1994-31).

[43]TAM 200907024 of Nov. 10, 2008, released Feb. 13, 2009.

[44]Treas. reg. section 1.482-4(b).

[45]*Veritas Software Corp. v. Commissioner*, 133 TC 14 (2009).

[46]AOD 2010-05 (IRB 2010-49).

[47]*See, e.g.*, para. 2.109 of the OECD guidelines.

[48]Treas. reg. section 1.482-6(c)(3)(i)(B)(1).

[49]Para. 89 of the discussion draft.

[50]Para. 113 of the discussion draft.

Table 3. Comparison of Intangible Definition in OECD Discussion Draft and U.S. Tax Law

Requirement	OECD Discussion Draft	U.S. Tax Law
Nonphysical asset	Yes	Yes
Capable of being owned or controlled	Yes	Yes
Substantial value independent of the services of individuals	No	Yes
Legal protection	No	No
Separately transferable	No	Yes
Specificity	Yes	Yes
Scope		
Transfer of intangibles	Yes	Yes
Use of intangibles	Yes	No

- assembled workforce.[51]

These items must be treated as comparability factors, according to the discussion draft.

2. Goodwill and Going Concern Value

Some commentators have argued that goodwill and going concern value should not qualify as an intangible for transfer pricing purposes. This issue has its roots in the domestic law of the United States and Germany, for example.

In the United States, goodwill and going concern value are not items enumerated as intangibles for transfer pricing purposes.[52] Nevertheless, the IRS argues that both items are compensable intangibles because they constitute ''similar items.''[53] The Tax Court has overturned this position.[54] On this basis it has been proposed that the definition of intangibles in IRC sections 367(d) and 482 be expanded to cover goodwill and going concern value.[55]

In Germany, goodwill is recognized as an intangible for transfer pricing purposes provided that a full or partial transfer of a business has occurred. Here, the issue is that a business restructuring normally must be valued on an aggregated basis.[56] This requirement raises questions regarding the identification of when goodwill should be included in the valuation.[57]

The OECD guidelines recognize going concern value as a compensable intangible.[58]

The discussion draft points out that the notions of goodwill and going concern value are ambiguous and that different definitions are applied in domestic laws. An attempt to adopt an autonomous meaning is not made. Cross-border disputes may easily arise regarding the definition of goodwill and the application of the definition. For example, it may be disputed whether a group service provider should be recognized as the owner of goodwill. In *Nestlé Finance France*, a French court held that the relocation of a routine cash pool function from a French company to an affiliated company in Switzerland triggered goodwill taxation.[59]

According to the discussion draft, goodwill and going concern value cannot be segregated or transferred separately from other business assets.[60] This means that an aggregated valuation including the value of the business as whole must *not* be made for a transfer of a single intangible.[61]

3. Group Synergies

Group synergies emerge as a result of group companies working together. According to the discussion draft, the value of group synergies cannot be attributed to a single entity in the group. This position is in line with case law of the United States and other countries.[62] The position of the discussion draft not to recognize group synergies as an intangible must be endorsed.[63] On the other hand, management systems and so forth developed in order to exploit group synergies may qualify as intangibles.

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[51]Paras. 23-25 of the discussion draft.

[52]Treas. reg. section 1.482-4(b). *See* Wittendorff, *supra* note 7, at 606.

[53]Joint Committee on Taxation, ''Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment,'' JSC-4-09, Sept. 2009, p. 38.

[54]*Veritas Software Corp. v. Commissioner*, 133 T.C. 14 (2009).

[55]Department of the Treasury, ''General Explanation of the Administration's FY 2013 Revenue Proposals,'' Feb. 2012, p. 90.

[56]Section 1(3), ninth sentence of the Foreign Tax Act.

[57]H. Wolter, ''Cross-Border Business Restructuring,'' *Cahiers de droit fiscal international*, vol. 96a (2011), pp. 349, 364.

[58]Para. 9.93 of the OECD guidelines.

[59]Tribunal Administratif de Paris, Ref. No. 0902095, May 11, 2011. *See* X.S. Jaime, ''French Administrative Court Supports Need for Exit Payment Following Cross-Border Transfer of Intragroup Routine Function,'' *Tax Mgmt Transfer Pricing Rep.* 20 (Apr. 5, 2012), p. 1237.

[60]Para. 21 of the discussion draft.

[61]*See* H-K. Kroppen and J. Carlos Silva, ''Cross-Border Business Restructuring,'' *Cahiers de droit fiscal international*, Vol. 96a (2011), pp. 17, 42.

[62]Wittendorff, *supra* note 7, at 601 and 619.

[63]Para. 23 of the discussion draft. *See* Wittendorff, *supra* note 7, at 602.

Synergies may also arise between multiple intangibles or other resources of a single taxpayer. For example, this may be relevant for:

- the use of multiple complementary intangibles;
- the transfer of multiple complementary intangibles; and
- the transfer of a single intangible to a buyer that owns a complementary intangible (illustrated by example 18).

In these situations synergies must be considered in the valuation of the intangibles. This may cause an enhancement of the value of a collection of intangibles or other resources vis-à-vis an asset-for-asset valuation, but it will not constitute a separate intangible. An aggregated valuation of interrelated intangibles must thus be made, according to the OECD guidelines,[64] the discussion draft,[65] and German tax law[66]; this is also the position of the IRS.[67]

4. Market Characteristics

A market characteristic is not treated as an intangible because it can neither be owned/controlled nor transferred by a taxpayer.[68] Relevant characteristics include location savings and market purchasing powers. This is a hot topic in the context of a new United Nations transfer pricing manual.[69]

5. Assembled Workforce

Assembled workforce may constitute an intangible under the OECD guidelines (marketing organization)[70] and the U.S. cost-sharing regulations (platform contribution) in relation to the use of intangibles.

Assembled workforce is an item that it was not possible for the member countries to reach a consensus position on.[71] Some members consider it to be an intangible whereas others do not. The inconsistent views clearly appear from the discussion draft.

On the one hand, it seems that an assembled workforce is not treated as an intangible (no explanation is provided).[72] It is unclear why assembled workforce cannot constitute an intangible like the broader concepts of goodwill and going concern value. The three items have in common that they are comparable market transactions and that they cannot be transferred separately. Also, they are taxable objects under the domestic law of some member countries (for example, IRC section 197 of the United States).

On the other hand, the discussion draft provides for two ''exceptions'':

- A favorable long-term contractual commitment to make available the services of a particular group of uniquely qualified employees may constitute an intangible in a particular circumstance because contractual rights and obligations may constitute intangibles.
- The transfer of an existing assembled workforce in connection with a business restructuring may benefit the transferee and affect the required compensation.

The first ''exception'' may be provided to safeguard the concept of a platform contribution under the U.S. cost-sharing regulations, which include assembled workforce.[73]

The second ''exception'' shows that the OECD is trying to have it both ways. That is, assembled workforce is and is not an intangible. This inconsistency basically reflects the disagreement among the member countries. It may also reflect the fact that the U.S. Tax Court has held that assembled workforce is not an intangible for transfer pricing purposes,[74] and that a law change has been proposed whereby this item will constitute an intangible under IRC sections 367(d) and 482.[75]

6. Summary

Table 4 summarizes and compares the application of the definition of an intangible in the OECD discussion draft and the U.S. regulations.

II. Ownership

A. Ownership vs. Joint Development

The second threshold issue in the discussion draft is phrased as the identification of the parties that should be entitled to share in intangible returns. This issue may be broken down into two distinct issues:

- tax ownership; and
- joint development.

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[64]Para. 9.94 of the OECD guidelines.

[65]Para. 115 of the discussion draft.

[66]Section 1(3) of the German Foreign Tax Act.

[67]TAM 200907024. The issue is at stake in *First Data Corp. v. Commissioner*, TC No. 7074-09, petition filed March 20, 2009. *See* L.F. de Moraes e Castro, ''Treatment of Business Synergy for Transfer Pricing Purposes: Critical Analysis of Sections 367(d), 482 and 936 of the Internal Revenue Code and Government Proposals,'' 3 *Int'l Transfer Pricing J.* 19 (2012), pp. 107, 118.

[68]Para. 25 of the discussion draft.

[69]Para. 3.2.4, Chapter 7, Practical Manual on Transfer Pricing for Developing Countries, October 2011 Working Draft.

[70]Para. 2.32 of the OECD guidelines.

[71]Quote of Joseph Andrus, ''Former OECD Transfer Pricing Head Quizzes Andrus on Discussion Draft's Approach to Defining Intangibles,'' 21 *Tax Mgmt Transfer Pricing Rep.* (June 14, 2012), p. 143.

[72]Para. 24 of the discussion draft.

[73]Treas. reg. section 1.482-7(c)(5) (Example 2).

[74]*Veritas Software Corp. v. Commissioner*, 133 T.C. 14 (2009).

[75]Department of the Treasury, *supra* note 55.

Table 4. Application of Intangible Definitions of OECD Discussion Draft and the U.S. Regulations

Item	OECD Discussion Draft	U.S. Regulations
Patents	Yes	Yes
Know-how and trade secrets	Yes	Yes
Trademarks, trade names, and brands	Yes	Yes
Licenses and similar rights in intangibles	Yes	Yes
Group synergies	No	No
Market-specific characteristics	No	No
Goodwill and going concern value	Yes	No
Assembled workforce	No / Yes	No

Tax ownership of intangibles is normally a decisive factor for income allocation between associated enterprises. For the transfer of an intangible, tax ownership is decisive for the attribution of the proceeds (sales price or royalties) between associated enterprises. For the use of an intangible, tax ownership affects the comparability analysis, the selection of the transfer pricing method, and the selection of the tested party. Tax ownership is also decisive for the attribution of expenditures incurred in connection with the development and enhancement of intangibles.

Joint development of intangibles is when an enterprise contributes to the value of an intangible owned by another taxpayer. This issue is often phrased as a question whether the enterprise is entitled to a share of the intangible return. This is a circular argument when the return from an intangible is calculated as the total return from the use of the intangible, minus a market return for other production factors employed. (See Section II.B of this article.) Also, the issue is presented as if governed by an attribution of income principle, which is not the case. In a transfer pricing context, the relevant question is whether the enterprise that contributes to an intangible owned by another taxpayer receives arm's-length compensation for its contributions. Hence, the entire return from the intangible should, in principle, be attributed to its tax owner.

The difficulties associated with the issue of joint development of intangibles is reflected in the different approaches applied under the U.S. regulations from 1968 (developer-assister rule)[76] to 1994 (excess expenditure test)[77] to 2009 (contributions to the value of intangible property owned by another).[78]

B. Intangible Profits

The discussion draft defines intangible profit relating to the use of an intangible as follows:[79]

Total return from business operations involving the use of the intangibles	-	Arm's-length compensation of other production factors used	=	Intangible profit

Intangible profit is thus defined as a residual return. A similar definition was relied on in *Roche Products Pty.*, in which the Administrative Appeals Tribunal of Australia held:

> Roche Basel owned the intellectual property associated with the drugs. It is the intellectual property which is really the product, not the pill or capsule by which is dispensed. . . . The profits from the exploitation of the intellectual property rights was something to which Roche Basel had a special claim even though the profit would be collected for Australian sales by the Australian subsidiary. The distinction between the two types of profits . . . are referred to as ''the profits of the patentee as such'' . . . and ''manufacturing and distributing profits.''[80]

A weakness of the definition lies in the fact that intangibles and other production factors are complementary. It may thus be difficult to reliably segregate intangible profits from profits of other production factors. All else being equal, this will mean that synergies are normally allocated to the owner of the intangibles.

Regarding the use of an intangible, the definition of intangible profits does not compete with any domestic law concepts because income tax is not a tax on notional rents or factor income.[81]

Regarding the transfer of an intangible, it is unclear whether this definition is applicable at all (''involving use of'').[82] This should be clarified. Assuming that the definition is applicable in this situation, it will often collide with the domestic law concept of taxable profits. For example, if a taxpayer disposes of an intangible, the capital gain under domestic law will basically be calculated as the difference between the taxpayer's sales price and the purchase price (subject to variations). An

[76]Treas. reg. section 1.482-2(d)(1)(ii)(b) (1968).

[77]Treas. reg. section 1.482-4(f)(3)(iii) (1994).

[78]Treas. reg. section 1.482-4(f)(4)(i).

[79]Para. 28 of the discussion draft.

[80]Para. 153 of *Roche Products Pty. Ltd. v. Commissioner*, Administrative Appeals Tribunal 639 (2008).

[81]W. Schön, ''International Tax Coordination for a Second-Best World (Part I),'' 1 *World Tax J.* 1 (Oct. 2009), pp. 67, 76.

[82]Para. 28 of the discussion draft.

application of the OECD definition of profits regarding the transfer of an intangible will cause further segregation from general tax law. Neither article 9(1) nor article 13 is concerned with the computation of taxable profits, which is left to the domestic law applicable.[83]

C. Three-Prong Approach

The OECD member countries have agreed that the allocation of intangible profits should reflect the functions performed, assets used, and risks assumed.[84] The discussion draft acknowledges that this approach can be expressed in different ways.

According to the discussion draft, the allocation of intangible profits should be governed by the following three-prong approach:

- *Ownership test*: The terms and conditions of legal arrangements, including registrations, license agreements, and other contracts.
- *Economic substance test*: Whether functions performed, risks assumed, assets employed, and costs incurred in developing, enhancing, maintaining, and protecting the intangible align with the result of the legal arrangement.
- *Arm's-length test*: Whether services provided in connection with developing, enhancing, maintaining, and protecting intangibles by group members that are not entitled to any share in intangible profits are on an arm's-length basis.[85]

This approach resembles the U.S. regulations introduced in 2009 under which the rules for determining the ownership of an intangible, in principle, are distinct from the rules for determining the allocation of intangible profits.[86]

The discussion draft means that under a license arrangement there will be two distinct intangibles, each with a single owner. This also reflects the U.S. approach in which a shift has been made away from a system with a single intangible with two owners to a system with two distinct intangibles, each with single owner.

The discussion draft states that multiple parties may be entitled to share the profits from a single intangible.[87] However, it is not specified how the allocation among multiple parties must be made. This was a hot topic in the United States during the drafting of the new services regulations, because the 2003 proposed regulations contained several examples that indicated that the residual profit-split method would often be the best method in cases that involved a contribution to the value of an intangible. However, this was not the intention, so the examples were modified.[88] OECD guidance on its position in this respect would be welcome.

D. Ownership Test

The discussion draft applies legal ownership as the basic allocation criterion for legally protected intangibles.[89] However, an allocation criterion is not provided for intangibles that are not legally protected. A relevant criterion could be practical control, which is applied in the U.S. regulations.[90]

For the use of intangibles, legal ownership or practical control must be decisive for the income allocation.[91] Hence, the concept of economic ownership is a creature of tax law that is unknown in market transactions in which independent parties must rely on legal ownership. The relevant question in a transfer pricing context thus is what bearing legal ownership has on market prices.

For the transfer of intangibles, ownership is a preliminary non-pricing issue that must be determined on the basis of domestic law. (See Section I.B of this article.) A full allocation of profits from the transfer of an intangible must normally be made to the legal owner. First, this conforms to the domestic laws of most countries in the absence of a tax avoidance scheme.[92] In countries such as Germany and Denmark, it is impossible for tax purposes to separate the income from an asset so that it is no longer attributable to the owner.[93] Second, full income allocation to the owner is consistent with the outcome of market transactions. Third, this is also consistent with article 12(1) of the OECD model tax treaty, which ascribes exclusive taxing rights to royalties to the residence state of the owner, and article 13(5), which ascribes exclusive taxing rights to capital gains to the residence state of the alienator. An allocation and the taxation of all or part of income in the form of royalties or a capital gain to a taxpayer other than the owner would thus infringe on articles 12(1) and 13(5) because a determination under article 9(1) of the parties entitled to intangible returns would not be decisive regarding these articles.

Application of legal ownership will normally not cause cross-border disputes regarding attribution of income from legally registered intangibles. However, disputes may arise regarding other types of intangibles.

[83]Para. 12 of the commentary on article 13 of the OECD model tax treaty; and Arnold, *supra* note 10, at 334.

[84]Preface to section B of the discussion draft.

[85]Para. 29 of the discussion draft.

[86]T.D. 9456 (IRB 2009-33). *See* Wittendorff, *supra* note 7, at 634.

[87]Para. 27 of the discussion draft.

[88]Preamble, "Explanation of Provisions," section 1.482-4T(f)(4), T.D. 9278 (IRB 2006-34).

[89]Para. 30 of the discussion draft.

[90]Treas. reg. section 1.482-4(f)(3)(i)(A).

[91]*See* Wittendorff, *supra* note 7, at 630.

[92]J. Wheeler, "Conflicts in the Attribution of Income to a Person," *Cahiers de droit fiscal international*, Vol. 92b (2007), pp. 17, 30.

[93]*Id.*

For example, under Danish tax law,[94] the value of a customer base developed by a distributor must normally be allocated to the supplier, whereas under German tax law,[95] the value must be allocated to the distributor.

E. Economic Substance Test

According to the discussion draft, a legal arrangement must be recognized only if it is in alignment with the conduct of the parties.[96] If there is a mismatch between the two factors, it may be appropriate to allocate all or part of the intangible profits in accordance with the economic substance of the arrangement.[97] This effect is illustrated by examples 10 and 11. Hence, the discussion draft could just as well have stated that the evaluation is based on economic ownership. It should be clarified whether this test applies to both the use and transfer of an intangible.

The new economic substance test must be satisfied if the legal owner should be entitled to retain the full intangible profit. According to the discussion draft, this evaluation is part of an ordinary arm's-length test and does not mean that the controlled transaction as actually structured is disregarded. The authority outlined in the OECD guidelines to disregard a controlled transaction in exceptional situations will thus operate independently of, and concurrently with, the new economic substance test.[98] This is consistent with the approach adopted by the OECD regarding business restructurings.[99]

The new economic substance test is based on an examination of the activities relating to the development, enhancement, maintenance, and protection of the intangible, including:

- the functions performed;
- the risks assumed; and
- the costs incurred.[100]

It is unclear why assets employed are not specified as a relevant factor. For example, if an intangible has been developed on the basis of a (platform) intangible owned by an enterprise that is not the owner of the subject intangible, it could be appropriate to allocate part of the intangible's profits to the owner of the platform intangible. This is a basic premise of the U.S. cost-sharing regulations.[101]

In terms of functions performed, a distinction is made between ''normal'' functions and ''super'' functions.

The legal owner should either perform the normal functions or arrange to have those functions performed under its control by other parties.[102] The concept of control should be interpreted in line with the hypothetical arm's-length test in paragraphs 9.23-9.28 of the OECD guidelines.[103] Hence, the legal owner must employ people who have the authority to, and effectively do, perform these control functions.[104] It is inconsistent with the business restructuring rules that the discussion draft does not recognize the outcome of an empirical arm's-length test in paragraph 9.19 of the guidelines.

The legal owner must perform the super functions through its own employees — that is, no outsourcing is allowed.[105] These super functions are described as follows:

> Depending on the facts and circumstances, these functions would generally include, among other things, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

In terms of risks assumed, the legal owner should bear and control the risks associated with the development, enhancement, maintenance, and protection of the intangible.[106] In this context reference is also made to the OECD guidelines on business restructurings (paragraphs 9.23-9.28).[107] Again, the question is why doesn't the OECD recognize an empirical arm's-length test of the risk allocation?

In terms of costs incurred, the legal owner should bear costs incurred to develop, enhance, maintain, and protect an intangible.[108] The owner could bear the costs by paying arm's-length compensation to an associated enterprise for functions performed by that enterprise under the control of the legal owner. This reflects the U.S. position that consideration for contributions may be embedded within the contractual terms for a controlled transaction.[109]

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[94] *TfS* 2008.369; *TfS* 2004.342; *TfS* 2002.563; and *TfS* 2001.231.

[95] Comments on section 3(1) of the Regulation on the Relocation of Functions (BGBl I 2008 1680).

[96] Para. 37 of the discussion draft.

[97] Paras. 54 and 55 of the discussion draft.

[98] Para. 53 of the discussion draft.

[99] Paras. 9.19-9.32 and 9.165 of the OECD guidelines.

[100] Para. 37 of the discussion draft.

[101] Treas. reg. section 1.482-7(b)(1)(ii) and (c)(1).

[102] Para. 38 of the discussion draft.

[103] Para. 41 of the discussion draft.

[104] Para. 9.24 of the OECD guidelines.

[105] Para. 40 of the discussion draft.

[106] Para. 42 of the discussion draft.

[107] *Id.*

[108] Para. 46 of the discussion draft.

[109] Treas. reg. section 1.482-4(f)(4)(i).

According to the discussion draft, the bearing of costs is subordinated to the performance of functions and control over risks.[110]

F. Arm's-Length Test

The arm's-length test outlined in the discussion draft of the compensation paid to associated enterprises that contribute to the value of an intangible is almost identical to paragraphs 6.36-6.38 of the OECD guidelines although paragraph 6.39 has been omitted.[111] Paragraph 51 of the discussion draft dealing with a distributor with a long-term contract of sole distribution rights should be updated to reflect that the discussion draft views contractual rights as intangibles in their own right.[112]

G. Summary

The discussion draft introduces a three-prong approach to evaluate the allocation of intangible profits among group members. A key issue with the discussion draft is the economic substance test that forms part of this approach. For a number of reasons, the OECD should consider abandoning this test whereby profits would be fully allocated to the owner of an intangible, subject to an arm's-length compensation being paid to associated enterprises for contributions to the value of the intangible.

First, it is circular to attribute an intangible return to a non-owner because intangible profits are defined as total return less arm's-length compensation for other production factors.

Second, the three-prong approach implies that a functional analysis must be made of associated enterprises making contributions to the value of an intangible in both step 2 (economic substance test) and step 3 (arm's-length test of contributions). It is hard to understand why the functional analysis of step 3 should not be sufficient. If this analysis establishes that an associated enterprise has made ''unique and valuable contributions,'' the profit-split method may qualify as the best method, causing this enterprise to be entitled to a relatively large share of the total profits (without characterizing it as an intangible return). This makes step 2 superfluous. Example 1 of the appendix would have the exact same outcome under a two-prong approach.

Third, regarding the transfer of an intangible, it would normally be contrary to domestic law and articles 12(1) and 13(5) of the OECD model tax treaty to make income allocation to a non-owner. The adoption of transfer pricing approaches that are inconsistent with general tax law should be prevented because transfer pricing forms part of the tax systems.

Fourth, it is questionable whether the economic substance test is capable of producing arm's-length results. The discussion draft is thus preoccupied with functions performed at the expense of risks assumed and cost incurred. This is contrary to economic theory in which the return required by investors is held to be correlated with the capital invested and risk assumed.[113] Functions performed are solely attributed a return equal to actual costs. This approach finds regulatory support in the rules on the transactional net margin method (TNMM) — that is, the OECD equivalent of the U.S. comparable profit method — which is assumed to be less dependent on functional comparability than the cost-plus method and the resale price method.[114] It is thus assumed that an additional function should be compensated for on a cost-only basis.

Fifth, article 9(1) does not authorize that legal arrangements, such as contractual risk allocations, are disregarded. The definition of the controlled transaction is thus a preliminary non-pricing issue that is the prerogative of domestic law. (See Section I.A.1 of this article.)

Sixth, the economic substance test is conceptually based on the authorized OECD approach (AOA) underlying the interpretation of article 7(2) of the OECD model tax treaty. The AOA has been developed because legally binding contracts cannot be concluded between a head office and its PE, which is contrary to the position between a parent company and its subsidiary. The tax policy reason for adopting the AOA in an article 9(1) context is obvious, since a factual, rather than contractual, income allocation between associated enterprises would prevent a contractual separation of the risks and assets from the functions. However, an analysis of the economic substance of controlled transactions is outside the scope of article 9(1).

Seventh, the complexity and uncertainty associated with income allocation on a factual rather than contractual basis will be massive. The economic substance test will thus work against one of the main aims of the OECD guidelines — to promote international trade and investments.[115]

Eighth, the economic substance test of the discussion draft is stricter than the U.S. counterpart, which normally recognizes the shifting of contractual risks, which are observed by the parties and which are more focused on quantitative factors, including costs (incremental marketing activities).[116] If an economic substance principle, as the one outlined in the discussion draft, was inherent in the arm's-length principle, the

[110]Para. 47 of the discussion draft.

[111]Paras. 48-52 of the discussion draft.

[112]Para. 27 of the discussion draft.

[113]U. Andresen, *Konzernverrechnungspreise für multinationale Unternehmen* (Wiesbaden, 1999), p. 207.

[114]Treas. reg. section 1.482-5(c)(2)(ii); and paras. 2.62, 2.106, and 2.107 of the OECD guidelines.

[115]Para. 7 of the preface to the OECD guidelines.

[116]Preamble, ''Explanation of Provisions,'' section 1.482-4(f)(4), T.D. 9278 (IRB 2006-34); and section 1.482-1(d)(3)(ii)(C), REG-146893-02, and REG-115037-00 (IRB 2003-44).

U.S. cost-sharing regulations would be superfluous in many cases because the inclusion of a ''cash box'' company as a participant could simply be disregarded.[117] Hence, the IRS must be of the opinion that cash box companies cannot normally be disregarded based on economic substance considerations.[118]

Ninth, the clear purpose of the economic substance test is to create a tax barrier for taxpayers to shift intangibles to low-tax jurisdictions. In essence the OECD has returned to the position expressed by some member countries in 1975 that an internal sale of an intangible should generally be disregarded for transfer pricing purposes:

> A more effective approach might be general agreement among member countries not to permit (or not to recognize) the transfer of patents between related companies in different countries. It is difficult to see what business purpose is in fact served by such transfers other than tax avoidance. Non-recognition would not mean that transfers of technology would be restricted. It would mean that only licenses to a related enterprise to exploit a patent in return for a royalty would be acceptable and that the complete rights to a patent in return for stock (or even cash) would not be recognized for tax purposes. Such a solution would go beyond the provisions of a tax convention, but it is not outside the competence of the Committee on Fiscal Affairs to consider.[119]

Again, the overall aim of the OECD guidelines is to promote rather than restrict cross-border trade and investments. Many controlled transactions involving intangibles are undertaken between associated enterprises of high-tax jurisdictions and without any tax avoidance objective.

Tenth, member countries have a variety of legislative options available if they wish to prevent tax base erosion ranging from far-reaching general antiavoidance rules to specific antiavoidance rules such as CFC rules. Hence, all tax planning does not need to be combated through the arm's-length principle.

III. The Controlled Transaction

The third threshold issue of the discussion draft relates to the identification and proper characterization of the controlled transaction.[120] Regarding the transfer of intangibles, the discussion draft touches upon several controversial issues.

First, the discussion draft addresses the issue of the right of the licensee to use an intangible for the purpose of further product development (platform rights) versus the right to use an intangible without further development (make-sell rights).[121] This echoes the U.S. discussion on platform contributions in a cost-sharing context.[122] According to the discussion draft, platform rights can affect the value of the license rights.

Second, according to the discussion draft, the nature of a controlled transaction must be analyzed in light of the conduct of the parties and economic substance.[123] For example, it is stated that contractual terms providing for nonexclusivity and limited duration need not be respected if such terms are not consistent with the conduct of the parties. This is also an import from the U.S. cost-sharing regulations, which provide a rebuttable presumption that platform contributions are made available exclusively.[124]

Third, for the transfer of multiple intangibles, the discussion draft states that the interaction between the intangibles may mean it will be most reliable to make an aggregated evaluation.[125] This would normally mean valuation under an income-based method rather than the comparable uncontrolled price method.

Fourth, the discussion draft holds that intangibles may be so intertwined that it is not possible, as a substantive matter, to transfer one intangible without transferring the other.[126] This is also one of the issues faced by the IRS in cost-sharing audits.[127]

Fifth, the discussion draft states that the provision of a service and the transfer of an intangible may be so closely intertwined that it is difficult to separate the

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[117]The IRS has described a typical cost-sharing arrangement as follows:

> The typical initial buy-in fact pattern involves an established U.S. group with significant self-developed intangibles. The U.S. group has a R&D capability consisting of fixed assets, an experienced workforce, and a record of successful products or technologies. The U.S. group and its CFC enter into a CSA to further develop the U.S. group's platform intangibles. . . . In such cases, the CFC's assets at the outset of cost sharing consist of only the cash required to pay the CSA buy-in and to fund its proportional share of the intangible development costs under the CSA.

See Chapter II.A of Coordinated Issue Paper, ''Section 482 CSA Buy-In Adjustments,'' LMSB-04-0907-62, Sept. 27, 2007.

[118]The ''active trade or business'' requirement of the 1995 regulations (Treas. reg. section 1.482-7(b)(c)(1)(i)) was repealed in 1986 (Preamble, ''Explanation of Provisions,'' in T.D. 8670 (IRB 1996-24)).

[119]Draft Report on Tax Avoidance Through the Improper Use and Abuse of Tax Conventions, May 21, 1975, CFA/WP1(75)3, p. 23.

[120]Para. 57 of the discussion draft.

[121]Para. 64 of the discussion draft. *See also* paras. 96, 100, and 101 of the discussion draft.

[122]Treas. reg. section 1.482-7(c)(1).

[123]Para. 65 of the discussion draft.

[124]Treas. reg. section 1.482-7(c)(2)(i).

[125]Paras. 67 and 115 of the discussion draft.

[126]Paras. 69 and 70 of the discussion draft.

[127]''Industry Director Directive No. 1 on Transfer of Intangibles Offshore/Section 482 Cost-Sharing Buy-In Payment,'' LMSB-04-0307-027, Apr. 5, 2007.

transactions for transfer pricing purposes.[128] In such a situation, it is held that an aggregated arm's-length test may provide the most reliable arm's-length result. This issue is illustrated by example 11. This also represents a U.S. import.[129]

IV. Arm's-Length Test

The lion's share of the discussion draft is devoted to the arm's-length test of the transfer or use of intangibles.

A. Arm's-Length Principle vs. Fair Market Value

The arm's-length principle and fair market value are distinct valuation standards that may cause results that differ significantly from each other.[130] Hence, the arm's-length principle requires subjective, entity-specific valuation, whereas fair market value requires objective, market-based valuation.

The OECD guidelines touch on fair market value in two instances. On the one hand, paragraph 6.27 contains a reference to fair market value that could be interpreted to mean that this standard is identical to the arm's-length principle. On the other hand, paragraph 6.15 states that valuation should not necessarily be based on the highest or most productive use. The guidelines thus do not subscribe to the highest and best use principle, which is inherent in fair market value. Hence, the OECD guidelines do not clearly distinguish the difference between the two standards. The Canadian Institute of Chartered Business Valuators in its comments has stressed that one of the key deficiencies of the guidelines is that they do not clearly define the governing standard.[131]

The discussion draft has remedied this issue by omitting paragraph 6.27. Unfortunately, the rejection of the highest and best use principle has also been omitted. However, the recognition of unique circumstances and the comparability requirement is emphasized. It is also stated that income-based methods must be applied in a manner that is consistent with the arm's-length principle, including the requirement for a dual-sided perspective and consideration of options realistically available for both parties.[132] This means that subjective, company-specific valuation — rather than objective, market-based valuation — must be made. The OECD would bring more clarity to the table if the issue of the arm's-length principle versus fair market value were addressed directly. The uncertainty among practitioners in this regard is evidenced by several comments submitted to the OECD in the course of the intangible project that do not distinguish between the two standards.

B. Realistic Alternatives

Regarding the comparability analysis, the discussion draft states that realistic alternatives of both parties must be considered.[133] This dual-sided approach reflects the position of the OECD guidelines[134] and German tax law.[135] This is illustrated by example 19. However, it is also stated that the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to a realistic alternative of the other party.[136] This reflects the one-sided approach of the U.S. regulations.[137] This raises the question of how a situation should be dealt with when the minimum price of the transferor exceeds the maximum price of the transferee determined on the basis of their realistic alternatives. In the marketplace, no transaction will usually be concluded in this situation. The discussion draft does not provide clear guidance regarding this complex situation except that it is stated that it may be considered whether the transaction may be disregarded or otherwise adjusted.[138]

C. Intangibles vs. Other Resources

According to the discussion draft, transactions structured in different ways may have similar economic consequences.[139] For example, the performance of a service using intangibles may have similar economic consequences to the transfer of an intangible. This issue is illustrated by example 16. This issue was solved in the 2009 U.S. services regulations by replacing the concept of a non-routine intangible with the concept of a non-routine contribution that may include services.

In the same vein, the discussion draft holds that residual profits should not always be allocated to the party entitled to intangible related returns.[140] Other factors that may contribute to value creation and be entitled to a share of residual profits include:

- risks assumed;
- specific market characteristics;
- location;

[128]Paras. 72 and 74 of the discussion draft.

[129]Treas. reg. section 1.482-7(g)(2)(iv).

[130]J. Wittendorff, ''The Arm's-Length Principle and Fair Value: Identical Twins or Just Close Relatives?'' *Tax Notes Int'l*, Apr. 18, 2011, p. 223, *Doc 2011-4517*, or *2011 WTD 74-12*.

[131]*See* http://www.oecd.org/document/5/0,3746,en_2649_33753_46030661_1_1_1_1,00.html.

[132]Para. 146 of the discussion draft.

[133]Paras. 80 and 81 of the discussion draft.

[134]Paras. 6.14, 7.29, 7.30, 7.33, 8.35, 9.63, 9.72, 9.81, 9.84, 9.91, 9.92, and 9.116 of the OECD guidelines.

[135]Federal Fiscal Court, May 17, 1995, IR 147/93 (BStBl II 1996 204, and section 1(3), sixth sentence of the German Foreign Tax Act).

[136]Para. 82 of the discussion draft.

[137]Treas. reg. sections 1.482-1(f)(2)(ii)(A), 1.482-3(e)(1), 1.482-4(d)(1), 1.482-7(g)(2)(iii)(A), 1.482-7(g)(4)(i)(A), and 1.482-9(h).

[138]Para. 83 of the discussion draft.

[139]Para. 107 of the discussion draft.

[140]Para. 108 of the discussion draft.

- business strategies; and
- group synergies.

This position bears the fingerprints of emerging economies. For example, an official of the Chinese tax authority has stated that relevant value drivers to consider include location savings, local infrastructure, market premium, low pollution abatement costs, and the value of foreign-developed technology versus the value of local research and development.[141] The traditional view of the OECD and the United States is that such items must be treated like any other comparability factors. The reason why these items are addressed in Chapter VI on intangibles is unclear.

D. Birth of the Income-Based Method

The United States has traditionally favored an empirical transfer pricing approach, but the lack of comparable transactions has recently caused a move toward a more hypothetical approach, for example, the introduction of the investor model of the cost-sharing regulations. U.S. tax law is thus approaching German tax law, which has traditionally relied on a hypothetical approach.[142] In practice both countries now favor income-based methods at the expense of the CUP method.

The OECD guidelines favor the CUP method[143] and only reluctantly acknowledge the application of income-based methods.[144] The discussion draft is about to break new ground in this respect.

First, the draft goes into considerable details discussing the comparability factors that should be considered especially regarding the CUP method.[145] Among other things, the discussion draft touches on the issue of platform contribution that will be used to develop next generation products and intangibles.[146] The intention clearly is to raise the bar for the application of the CUP method.

Second, the discussion draft endorses income-based methods, which are considered to be particularly useful when properly applied.[147] However, the draft cautions about relying on valuations made for accounting purposes because they may be biased in favor of conservative estimates, whereas valuations made for purchase price allocation purposes are rejected straight away.[148]

Income-based methods address the lack of empirical data and the value of an intangible being its value in use. The discussion draft does not discuss the fact that in transfer pricing a valuation is often confined to a single intangible. There is thus a need for a refinement of the income-based methods in order to reliably capture more narrowly defined income streams of individual intangibles, for example, by the application of profit-split approaches. Income-based methods do not address the issue of informational asymmetry. The key input figure is thus projected profits rather than actual profits. Income-based methods are not a panacea for transfer pricing of intangibles. The OECD should emphasize the best method rule.

The discussion draft addresses several key input factors for income-based methods.[149] It is held that intangibles must be valued before tax.[150] This mirrors the position of the U.S. cost-sharing regulations[151] and the opinion of the German tax authorities.[152] This is consistent with the general approach of transfer pricing — to measure prices and profits on pretax basis, because market prices are on a pretax basis.[153]

E. Profit-Split Method

The discussion draft confirms that the profit-split method is preferred by the OECD.[154] However, a specific taxpayer application of this method known as the declining-royalty approach is discouraged. For a transfer of partially developed intangibles, it is unlikely that the application of the profit-split method will yield a reliable arm's-length result.[155] This position is in line with the IRS's approach in a cost-sharing context.[156]

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[141] ''SAT Official Coming Assessments Will Focus on China's 'Unique Conditions,''' *Tax Mgmt. Transfer Pricing Rep.* (June 19, 2012).

[142] Wittendorff, *supra* note 7, at 774.

[143] Paras. 2.3 and 6.23 of the OECD guidelines.

[144] Paras. 2.123, 6.20, 6.25, and 9.94 of the OECD guidelines.

[145] Paras. 90-102 and 137 of the discussion draft.

[146] Paras. 96, 100, and 101 of the discussion draft.

[147] Paras. 109, 145, and 148 of the discussion draft.

[148] Para. 110 of the discussion draft.

[149] Paras. 154-170 of the discussion draft.

[150] Para. 169 of the discussion draft. However, example 15 of the annex seems to be inconsistent with the requirement for pretax value because the purchase price for all of the shares of a company seems to be equated with the arm's-length value of the business of the company. However, share prices are conceptually on a post-tax basis for which reason a gross-up for the tax effect should be made.

[151] Treas. reg. section 1.482-7(g)(4)(i)(G).

[152] Evaluation on post-tax basis is required under sections 1(4) and 3 of the Regulation on the Relocation of Functions (BGBl I 2008 1680). However, the tax authorities are requiring taxes to be considered in m. nos. 118 and 125 of the Circular on Business Restructurings, IV B 5-S 1341/08/10003, Oct. 13, 2010. *See* H-K. Kroppen in: H-K. Kroppen, *Handbuch Internationale Verrechnungspreise*, I. Nationale Vorschriften, Funktionsverlagerungsverordnung (Cologne: Verlag Dr. Otto Schmidt, loose-leaf), m. no. 138; and W. Wilhelm Fischer and M. Freudenberg, *Internationales Steuerrecht* (2012), p. 168.

[153] J. Wittendorff, ''Valuation of Intangibles Under Income-Based Methods — Part II,'' 6 *Int'l Transfer Pricing J.* 17 (2010), pp. 383, 394.

[154] Paras. 128, 136, and 140-144 of the discussion draft.

[155] Paras. 143 and 144 of the discussion draft.

[156] Treas. reg. section 1.482-7(c)(4)(ii) (Example 2). *See* Wittendorff, *supra* note 7, at 562 and 574.

F. What Happened to the TNMM?

It is striking that the discussion draft does not elaborate on the use of the transactional net margin method.

The CPM was thus developed with the specific aim of addressing the transfer of intangibles.[157] This method involves an arm's-length royalty that is determined as the difference between the pre-royalty profit margin of the transferee from using the intangible and a market return for the routine contributions made by the transferee.[158]

Moreover, the TNMM became a fully accepted method in 2010 when the stigma as a method of last resort was repealed.[159] Even Germany, the long-standing opponent of the TNMM, accepted it in 2005.[160] The OECD guidelines implicitly recognize the use of the TNMM for intangibles,[161] but no guidelines are provided. In particular, the OECD guidelines do not mention the U.S. approach of determining an arm's-length royalty as a residual amount.[162] This was arguably due to the reservations of several member countries in 1995 about the adoption of profit methods and periodic adjustments in the 1994 U.S. regulations.[163]

A 2008 OECD report examined three aspects of the use of the TNMM regarding royalties. First, the report revealed that there was no consensus among the member countries on the merits of the TNMM. The members could be divided into three categories:

- countries that accepted the use of the TNMM both to set and test a royalty;
- countries that accepted the use of the TNMM to set a royalty, but not to test the outcome of a royalty; and
- countries that did not accept the use of the TNMM either to set or to test a royalty.[164]

Second, the members were aligned regarding the use of the TNMM as a sanity check of the outcome of a primary method used to evaluate a royalty.[165] Third, the report contained the following statement regarding the comparability requirement:

> In addition, it should be noted that the functional analysis of a licensee may be different from the functional analysis of a non-licensed distributor or manufacturer because the licensee holds a contractual right over the intangible. Whether this difference materially affects the comparison depends on the value of the license right and on the extent to which the licensee actually exploits it, e.g. whether it has and actually exercises more autonomy in the development of products or of marketing campaigns than a non-licensed manufacturer or non-licensed distributor who would simply manufacture according to specifications or buy-and-sell products. Where appropriate, these differences need to be taken into account in the comparability analysis.[166]

The concern expressed in the 2008 report is carried over in the 2012 discussion draft, which holds that residual profits may not be allocable only to the licensor as reward for the intangible.[167] Other factors to consider include risks assumed, specific market characteristics, location, business strategies, and group synergies. Although the potential application of the TNMM is mentioned in the draft,[168] the clear impression is that this is a second-rate method.

The lukewarm attitude of the OECD toward the TNMM is maintained. The rejection of the CUP method without providing guidance for the application of the TNMM leaves taxpayers in no man's land. Hence, a very high share of controlled transactions involving contract manufacturing, distribution, and group service arrangements are priced and tested on the basis of the TNMM.

G. Commensurate With Income Standard

The discussion draft iterates the position of the OECD guidelines regarding situations when valuation is highly uncertain at the time of the transaction.[169] The purpose of these guidelines is unclear considering that valuation of non-routine intangibles normally is highly uncertain. It would be unwarranted to apply hindsight because the arm's-length principle must be applied *ex ante*.[170] Also, the arm's-length principle does not impose any requirement on taxpayers to adopt a payment form that conforms to market terms. Hence,

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[157]The origin of the CPM was the basic arm's-length return method outlined in the White Paper; *see* ''A Study of Intercompany Pricing under Section 482 of the Code,'' Department of the Treasury and Internal Revenue Service, Oct. 18, 1988, Notice 88-123, 1988-2 C.B. 485.

[158]Treas. reg. section 1.482-5.

[159]Paras. 1.45, 1.49, 3.50, and 7.31 of the 1995 OECD guidelines.

[160]Para. 3.4.10.3.b of 2005 transfer pricing circular, IV B 4-S 1341-1/05, Apr. 12, 2005.

[161]Para. 6.26 of the OECD guidelines.

[162]Para. 84 of ''Transactional Profit Methods: Discussion Draft for Public Comment,'' OECD, 2008.

[163]T. Miyatake, ''Transfer Pricing and Intangibles,'' *Cahiers de droit fiscal international*, vol. 92a (2007), p. 32, note 12.

[164]Paras. 84-85 of ''Transactional Profit Methods: Discussion Draft for Public Comment,'' OECD, 2008.

[165]*Id.* at paras. 86-88.

[166]*Id.* at para. 89.

[167]Para. 108 of the discussion draft.

[168]Paras. 85-88 of the discussion draft.

[169]Paras. 171-178 of the discussion draft.

[170]Paras. 2.130, 3.73, 5.20, 6.32, 8.20, 9.56, 9.57, and 9.88 of the OECD guidelines.

there is no room for a commensurate with income standard in an OECD context.

H. Group Synergy

The discussion draft treats group synergy, as well as market characteristics and assembled workforce, as comparability factors rather than intangibles. This position should be endorsed, and it accords with the OECD guidelines and the U.S. regulations.

The transfer pricing consequences of market characteristics and assembled workforce may be determined by reference to empirical market data.

By contrast, group synergies and other forms of economies of integration are not present in market transactions for which reason the identification, measuring, and allocation among group members poses a conceptual problem.

Economies of integration may lead to associated enterprises realizing higher total profits than otherwise comparable independent enterprises. The total group profits may be broken down into a market return, which is attributable to the production factors, and an organizational return, which is attributable to the form of organization.[171] The market return is similar for associated enterprises and independent enterprises. In contrast, the organizational return is distinctly different for associated enterprises. Hence, a discrepancy between the market price and the transfer price of a controlled transaction does not necessarily mean that there is income shifting contrary to the arm's-length principle.

In a narrow set of cases it may be possible to perform this exercise based on certain assumptions, for example, that independent parties would share common benefits in proportion to the contribution made to obtain those benefits. For example, in a number of court cases, it has been held that volume discounts should be allocated to the group members that demanded the goods, rather than to centralized purchasing entities.[172] This was also the position of the 2008 OECD discussion draft on business restructurings.[173] However, the 2010 OECD guidelines adopted a more flexible approach in which all or part of the cost savings may be allocated to a central purchasing company.[174] It would have been more appropriate to maintain the position that conceptually volume discounts must be allocated among the companies requiring the goods.

In most cases the application of one-sided methods means that economies of integration are often fully allocated to the group member that is not the tested party, that is, the owner of non-routine intangibles. This may cause overcompensation of the intangible's owner.

The discussion draft requires that group synergies be identified and reflected in the method selected.[175] However, the draft does not explain how this should be handled in practice.[176]

V. Conclusion

The OECD discussion draft on intangibles is an important document that will remedy a key shortcoming of the OECD guidelines when finally implemented. The absence of comparable transactions has thus caused the 1995 OECD guidelines not to be very useful in practice regarding intangibles.

The significance of the issue for the international allocation of tax revenues is seen in the fact that the discussion draft bears the fingerprints of several countries. The position of the United States as the international standard-setter in transfer pricing is clear from the draft. The positions of the recent U.S. services and cost-sharing regulations, as well as some of the IRS's litigation positions, are reflected in the discussion draft. The German tax authorities have protected their position that the arm's-length principle requires a dual-sided analysis. The Netherlands and other countries are responsible for spread of the authorized OECD approach from article 7(2) to article 9(1). Emerging economies such as China and India have brought market characteristics and group synergies to the table. Reconciling the patchwork of conflicting interests in this area surely requires great diplomatic skills and a clear understanding of the proper interpretation of article 9(1) and the arm's-length principle.

The discussion draft is too ambitious in three respects whereby article 9(1) is pushed beyond its borders.

First, the characterization of an item as an intangible is based on domestic law regarding the transfer of intangibles. Article 9(1) of the OECD model tax treaty, which forms the legal basis for the discussion draft, does not authorize an autonomous definition in this context. The OECD must live with the diversity of domestic law.

Second, the new OECD definition of profits regarding the transfer of intangibles will often conflict with domestic law. The calculation of taxable business profits is also outside of the scope of article 9(1).

[171]H-J. Kleineidam, in: Franz Klein et al. (eds.), *Festschrift für Hans Flick* (1997), p. 857.

[172]Wittendorff, *supra* note 7, at 338.

[173]Para. 172 of "Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment," OECD, 2008.

[174]Paras. 9.154, 9.156, 9.159, and 9.160 of the OECD guidelines.

[175]Para. 108 of the discussion draft.

[176]The issue was raised in Preamble, "Explanation of Provisions, 11. Controlled Services Transactions," T.D. 9278 (IRB 2006-34).

Third, the economic substance principle proposed for the allocation of intangible profits lacks authority in an article 9(1) context. The OECD should abandon this principle and accept that intangible profits are allocated to the owner under general tax law. This would be consistent with market transactions and ensure that article 9(1) is applied in a manner consistent with domestic tax law and the genuine distributive articles of the OECD model tax treaty. For example, the allocation and taxation of royalties or capital gains to a taxpayer other than the owner would infringe on articles 12(1) and 13(5). Parties making contributions to the value of an intangible owned by another taxpayer may be fully compensated under an ordinary arm's-length test.

By contrast, the discussion draft lacks ambitions regarding the TNMM/CPM. The comparability requirement is emphasized, which raises the bar for the application of the CUP method. This makes it more important than before that taxpayers are entitled to apply the TNMM regarding simple distribution, manufacturing, and group service arrangements. Even though the TNMM originally was developed to deal with the transfer of intangibles, the discussion draft does not elaborate on the application of this method. The focus is devoted to the CUP method, profit-split method, and income-based method. Considering that all multinationals are relying on the TNMM, it is necessary to bring this method to the table. ◆