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Comments on the OECD Intangibles Draft of June 6, 2012

Dear Mr. Andrus,

We are pleased for the opportunity to submit our comments on the Draft. It is a major enhancement in the analysis of all facets of transfer pricing principles related to intangible assets and its directions will prove very helpful guidance to managing tax controversies and double taxation issues. We will focus below on section B aspects where we believe that further consideration of the related impact and different perspectives should be given.

In particular, we refer to the paragraphs of Section B taking position on one of the most controversial issues, ie, the relevance of intangible funding vs management of functions and control of risks as drivers for the allocation of the intangible related return.

Example 1 under paragraphs 182-183 of the Draft illustrates the main concern, ie, the use of passive IP companies by MNEs as a profit shifting vehicle. Example 1 is an extreme case where the IP company claiming intangible related return has neither funded the intangible development nor paid an arm's length price for its purchase, nor managed and controlled the related key functions other than merely administering patent registrations with the competent authorities.

Between such an extreme scenario and the straightforward one described under paragraphs 37 with a complete alignment of functions, risks and costs related to the intangibles, a range of different cases may be identified in the ordinary course of business within MNEs and between independent parties.

Section B acknowledges that capital is a significant asset for the purposes of investment return allocation. However, it requires internal performance of so-called important functions to be respected as beneficial owner of the intangible related return. In particular, paragraph 40 introduces a distinction between important and other functions related to intangibles by advocating that only non-core functions may be outsourced without losing entitlement to intangible related return.

Paragraph 40 and the related paragraph 54 seem to stretch the fund manager example under paragraph 9.25 of the TP Guidelines on risk control by somehow emphasizing the relevance of asset development and management *per se* for the purposes of the intangible return allocation. The

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funding of the intangibles development and management is deemed immaterial to that end, as very clearly stated under paragraph 47 of the Draft. That is, it seems that the uniform view within WP6 is that capital is a secondary and ancillary asset for the purposes of intangible return allocation compared to internal performance of important functions. In other words, the risks related to the investment of capital in the intangible development are overshadowed compared to the carrying of the related important functions.

Indeed, Chapter IX on business restructurings identifies three key functions as the minimum threshold for allocation of return related to risks: decision to hire, decision of extent of authority and objectives, and decision of the amount of the investment. In our view, those three functions, as outlined by paragraph 9.25 in the so-called fund manager example, may equally apply to the area of intangibles. For example, a consumer product company may develop a new marketing campaign for the launch of a new product either entirely internally or by hiring an external advertising company, or through a combination thereof. Regardless of the internal or external performance of the related functions, purported to development of the intangible value in the market, the company will be entitled to the return achieved through the success of the marketing campaign by having taken the key decisions on the investment of capital to pursue the marketing campaign, and its way forward.

Similarly, we believe that, depending on the specific facts and circumstances, an IP company may be entitled to the intangible related return whether or not key function such as the development of the campaign for the launch of the new product is managed internally or externally, via third parties or intragroup, as long as an active decision-making control role is made by the IP company's personnel and/or board of directors on the proposals and recommendations made by group companies acting as service providers.

Intangible development may be capital intensive, eg, R&D in the pharma industry, or even in any new frontiers of the technology sector, eg, tablet development as a recent example. Once an intangible is developed, maybe its market success may fund its further development by itself internally but, before reaching such a level of internal funding, high external financial resources may be necessary and banks may not be willing or allowed to take significant risks in the pursuit of intangible development projects that may take years before generating adequate cash flow streams.

The open market is full of areas of investments whereby the return on the business activity is essentially allocated to investors taking a control decision role in the management of the business rather than a direct performance one. Private equity, real estate investments, securitization vehicles, hedge funds are all investment and industry sectors whereby active management of the business is commonly made in a service capacity without risk-taking. Even public companies, indeed, are based on the dichotomy risks vs active management as the ultimate risk of loss is taken by the shareholders rather than the group management, which only bears risks related to their own role and compensation.

Transfer pricing should mirror open market and third party transactions by focusing on the interaction of functions, assets and risks by taking into account the way they are specifically conducted in each case. Functions can either be carried out at full risk or limited risk. Similarly, any asset, including capital, may be used in a business activity with different level of risks.

As a result, while we understand and essentially agree with the conclusions in Example 1 as an extreme case study, we would hope that further variations of IP asset companies are illustrated by addressing scenarios whereby the IP company has taken development and on-going risk by investing its capital based on decisions taken by its management exercising active control on the people and companies performing functions externally, including the important ones. In particular, it may be helpful if WP6 may wish to identify how allocating the intangible related return in a scenario whereby capital for investment on intangibles and active control of functions is made by an IP company hosting the key decision-making people as directors while all other functions are outsourced to one or more operational companies located in the same jurisdiction, and/or third party external advisors.

If anti-abuse concerns about use of asset company vehicles as IP owners were inspiring the Draft, indeed, we believe that those legitimate concerns may be counteracted by each Country through mechanisms other than transfer pricing. The level of taxation in any given Country should not impact on the application of transfer pricing principles by focusing on functional analysis.

IP tax incentive mechanisms such as Patent/IP Box regimes (indeed increasingly implemented by various Countries) and/or specific anti-abuse measures available such as CFC regimes, deemed residence tests, blacklist rules requiring an active business test for deduction purposes, business purpose doctrine, etc., may be more efficient and better tailored to tackle abuses than applying transfer pricing rules to force profit allocation by weighting people functions more than assets/capital ownership and risks assumption than can be seen in dealings between independent parties.

Absent incentives such as Patent Box regimes, tackling profit allocation by attributing higher weight to functions rather than assets ownership and risk-taking profile may even trigger the relocation of people functions in the low-tax jurisdictions where capital and assets are legally owned also not to give competitive advantages to companies established from the outset in such tax-efficient jurisdictions. In the dynamics of the globalization and open market forces, a defensive approach by high-tax Countries may have the detrimental and paradoxical effect of further increasing the level of delocalization of operational functions.

As a result, based on the above, for the sake of clarity and as a possible basis for consideration, we take the opportunity to submit to WP6 attention a revised version of paragraphs 40, 47 e 54 of the Draft as follows:

40. *It is not essential that the party claiming entitlement to intangible related returns physically performs ~~all~~ of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, ~~some~~ of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, ~~in some cases~~, either independent enterprises or associated enterprises transacting on an arm's length basis to perform ~~certain~~ functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that ~~where functions are in alignment with claims to intangible related returns in contracts and registrations~~, the entity claiming entitlement to intangible related returns will **actively control** ~~physically perform~~, through its own ~~management~~ employees, the ~~important~~ functions related to the development,*

enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, the **control** ~~se functions~~ would generally include, among others, ~~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.~~

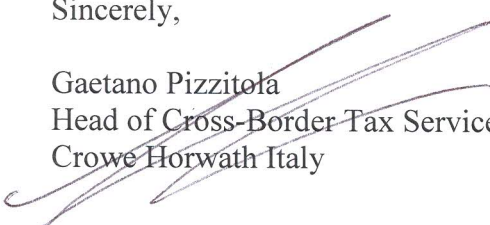
47. It is important to recognise, however, that bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns **if not aligned with the corresponding assumption of risks and active control of functions.**
54. In summary, for a member of an MNE group to be entitled to intangible related returns, it should in substance:
- **Either perform internally** ~~and control important the functions related to the development, enhancement, maintenance and protection of the intangibles~~ **and or actively control other related the functions performed by independent enterprises or associated enterprises that are compensated on an arm's length basis;**
 - Bear and control the risks and costs related to developing and enhancing the intangible; and,
 - Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

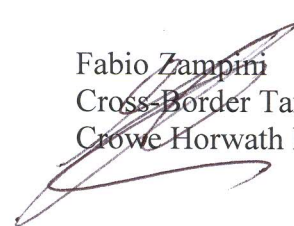
Where a party is allocated intangible related returns under contracts and registrations, but fails to perform **through its own employees** ~~and control important functions, fails to or actively control other related the functions performed by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and or controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.~~

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The Draft is a major enhancement and has stimulated, and will stimulate, further discussion and analysis on the most crucial transfer pricing topics by eventually reaching full or most consensus. Thank you again for the opportunity to participate in the discussion on the subject matter.

Sincerely,


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