

FACULTY OF BUSINESS LAW

European and International Tax Law
University of Lund

Zhanna Gres
zhanna.gres@gmail.com
+46764091235

VALUATION OF INTANGIBLE PROPERTY FOR TRANSFER PRICING PURPOSES

Master Thesis

Tutor: Lars-Gunnar Svensson
Examinator: Cécile Brokelind
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ABBREVIATIONS

AE	Associated Enterprise
CP	Cost Plus
CPM	Comparable Profits Method
CUP	Comparable Uncontrolled Price
CUT	Comparable Uncontrolled Transaction
CRA	Canadian Revenue Agency
IRC	Internal Revenue Code
IRS	Internal Revenue Service
GSK	GlaxoSmithKline
MNE	Multinational Enterprise
MTC	OECD Model Tax Convention
OECD	Organization for Economic Co-operation and Development
PWC	PricewaterhouseCoopers
R&D	Research and Development
TNMM	Transactional Net Margin Method
TPG	OECD Transfer Pricing Guidelines
U.S.	United States

Abstract

This master thesis aims to discuss and criticize various methods used for the valuation of intangible property for transfer pricing purposes. The paper makes observations at the most commonly used methodologies of the OECD Transfer Pricing Guidelines (TPG) and the United States' transfer pricing regulations. It is intended to demonstrate the use of these methods in relation to the intangible property. Analysis and criticism of the methodologies will be made by emphasizing some practical examples through court case law.

The OECD TPG recommends various methods to be used for transfer pricing of tangible and intangible properties, as well as provision of services. One should bear in mind that the OECD TPG is voluntary and may serve as basis or a starting point for many countries' transfer pricing regulations.¹ Many countries closely follow the OECD TPG, however, discrepancy could appear in the particular national transfer pricing legal framework. The OECD published several reports related to transfer pricing and the latest one was updated in 2010 where attention was given particularly to intangible property. The OECD has been stressing the issues regarding intangibles since there is a lack of guidance pertaining to identification and valuation of such assets for transfer pricing use.²

The Internal Revenue Service (IRS) is the U.S. tax collection and tax law enforcement agency. In the U.S. the Congress passes tax laws that taxpayers are obligated to comply with.³ The regulations are laid out in sections of the Internal Revenue Code (IRC). Section 482 of the IRC authorizes IRS to “*adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income.*”⁴ This section of the Code lays out adjustments that tax authorities can make for transfer pricing purposes. The U.S. has been often referred to have the most sophisticated and aggressive transfer pricing regulations.⁵ In 1968, more emphasis was put on various methods determining an appropriate transfer price and in 1986 the U.S. Congress modified Section 482 of the IRC paying more attention towards intangible property. In 1994 transfer pricing regulations were challenged in relation to the arm's length principle, explicitly related to the comparable transactions. Thus, the “best method rule” was introduced that allowed taxpayers to choose the method based on the data availability and comparability.⁶

¹ Borkowski, Susan, *Transfer Pricing of Intangible Property. Harmony and Discord Across Five Countries*, pg. 352

² OECD TPG document on Intellectual Property, pg. 2. The recent OECD TPG has a separate section discussing the issues concerned the intangibles (Special Considerations on Intangible Property).

³ Internal Revenue Service site, The IRS Mission, can be accessed www.irs.gov

⁴ Ibid.

⁵ Markham, Michelle, *The Transfer pricing of Intangibles*, pg. xv

⁶ Brauner, Yariv, *Value in the Eye of the Beholder: The Valuation of Intangibles or Transfer Pricing Purposes*, pg. 97

Valuing intangible property is not easy and often it is hard to measure the real value of assets that do not have any physical substance. The characteristics of intangibles are distinctive and in many cases it is hard for a company to identify the future outcome and return from these assets. The arm's length principle has been used in the determination of a transfer price. On the other hand, determining the arm's length price for intangible property could be problematic.

Since there is no uniform rule to establish the right transfer price for an international transaction for either tangible or intangible property, there is a potential to disagreement in regards to what amount of tax should be paid.⁷ The U.S. transfer pricing regulations, state explicitly what methods to be used for intangibles. It seems that both the OECD and the U.S. favor the comparable uncontrolled price method or as the U.S. calls it - the comparable uncontrolled transaction method. This method is based on the reliability of comparables and applicable by many countries in their transfer pricing regulations. As it is observed in the GlaxoSmithKline (GSK) Canada case the tax authorities favored this method over the resale price method.

The use of profit based methods has been more globally discussed in the transfer pricing world.⁸ The profit based methods are suggested to be applied when the comparable information is not available or could be used for non-routine⁹ intangibles, as it is demonstrated both by the OECD TPG and the U.S. regulations. Some well known transfer pricing disputes such as the GlaxoSmithKline (GSK) America case shows that the methodologies used including data interpretation and facts considered, led to different outcomes and significant amount of taxable income requested by the U.S. tax authorities to be paid by GSK America.

Due to the fact that in today's economy, intangible property is beneficial for both MNEs and governments creating possible valuable and unique asset as well as likelihood to produce a large amount of profits. Governments want to make sure that these profits are taxed fairly and the correct taxable income is recorded in particular jurisdiction.¹⁰ Since it could be challenging to determine an appropriate transfer price for intangibles, the potential for disagreements and abuse of rules is likely to occur.

⁷ PWC, *International Transfer Pricing 2011*, pg. 14

⁸ Jenkins, Michael, *Transfer Pricing Australia: the Roche Case*, pg.1

⁹ Tax Executive Institute, *Temporary and Proposed Section Section 482 Regulations – Intercompany transfer pricing* Nonroutine intangibles are not explicitly defined but in general the term means intangible property.

¹⁰ PWC, pg. 1

1. Introduction

In the diverse economy as we are in today, where the globalization and the increase of international trade are evident, inter-company pricing becomes a necessity for a large number of businesses.¹¹ Transfer pricing appears to be one of the most important international tax issues for both taxpayers and tax authorities, where it is often misunderstood with tax ‘abuse’ and applied in negative subtext. As the Organization for Economic Development and Cooperation *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD TPG) depicts that the concept of transfer pricing should not be confused with tax avoidance or fraud, even though transfer pricing may be applied for such purposes.¹²

New innovations and developments have been evolving extensively and are becoming one of the major profit contributors for the multinational enterprises (MNEs). Frequently the transactions involving intangibles are often raise serious uncertainties in the inter-company transfer pricing realm. How to put a price on the priceless?¹³ How does one value unique assets that cannot be compared to any other assets existing? MNEs are faced with these sorts of questions when intangible property is involved.

Complex features of intangible property, diverse definitions under various jurisdictions and the concept of ownership of such assets create confusion for all the parties involved. The main principle behind inter-company transactions is the arm’s length principle, which considers related party transactions as they were unrelated. However, in practice it is hard to establish the arm’s length price for intangibles. “Because of the unavailability of market value and inappropriateness of historical cost, most valuations of intangible assets are based on some form of economic valuation.”¹⁴ Valuation of intangibles is very complex, given that some intangibles are unique and cannot be compared to other non-physical assets. In practice, it is challenging to set a market price for intangibles since the value cannot be determined and the future outcome is uncertain. Thus, valuation of intangible property for transfer pricing taxation is even harder to determine.

The OECD and the U.S. have been one of the major players in the transfer pricing arena. The OECD has been developing international taxation principles for several decades¹⁵ and transfer

¹¹ PWC, pg.14

¹² OECD TPG (2010) , Para 1.2.

¹³ The Economist, *A price on the priceless*, June 10th, 1999. Even though, it was written almost twelve years ago, the question regarding intangibles and its valuations still remains to be answered.

¹⁴ Brockington, Raymond *Accounting for Intangible Assets*, pg. 171

¹⁵ OECD TPG, pg.18

pricing has not been left without a consideration. While the OECD is one of the key players in transfer pricing development, the recommendations of the OECD are not legally binding member countries to follow, rather helps governments to co-ordinate domestic and international policies.¹⁶ The U.S. has one of the oldest transfer pricing regimes¹⁷ and understanding of the U.S. transfer pricing rules is noteworthy for various reasons, particularly for the reason that the U.S. is a key market for a high number of MNEs¹⁸ and estimates of intra-company trade is fairly high.¹⁹

1.1. Purpose

The purpose of this master thesis is to critically examine various transfer pricing methods used for valuation of intangible property. Specific goal is to investigate the problems of the methods recommended by the OECD and the U.S. transfer pricing regulations. Observations of these methods could be made through existing case law in order to illustrate how MNEs and tax authorities deal with the issue related intangible property for transfer pricing purposes.

1.2. Method

Both comparative and legal method will be used in this paper in order to inspect the main issue addressed. Looking at the OECD TPG and the U.S. transfer pricing regulations will be used for researching differences and similarities in methodologies used. The legal method will be applied when examining domestic regulations used for transfer pricing of intangibles, in this instance the U.S. regulations. Further, reference will be made to academic journals and practitioners, as well as practical implication will be illustrated through the case law of several countries.

1.3. Outline

The first part of this thesis will give a general introduction to transfer pricing related to intangible property. The OECD and the U.S. perspectives will be discussed. Moreover, the general definition of intangible property will be presented to illustrate the complexity of the issue. The

¹⁶ OECD TPG, pg.2

¹⁷ KPMG, *Global Transfer Pricing Review*, pg.188

¹⁸ PWC, pg.777

¹⁹ The U.S. Department of Commerce, *U.S. good trade: Imports and exports by related parties*. The U.S. Department of Commerce (2010) estimates that intra-company trade is 48% of the U.S. exports and 40% of the U.S. imports

second part of the thesis will go more into discussion of various transfer pricing methods used for the intangible property. The discussion will be divided at looking at the traditional transactional methods and profit based methods, in particular how they are applied in relation to intangible property. Looking at some court cases from the U.S., Canada and Australia as part of practical illustration will be important for this part. The global formulary apportionment method will be briefly mentioned to illustrate an alternative approach. Finally, critical analysis of transfer pricing methods for intangible property will be given. Some remarks will be made in regards to the 'abusive' transfer pricing as it perceived in the international community. Further the final conclusion will be made.

1.4. Delimitations

This thesis will only focus on the discussion related to transfer pricing methods in relation to intangible property. Thus, methods used for valuation of tangible property and services will not be discussed. Even though, deeper understanding of various concepts, such as the arm's length principle, associated enterprise, etc might be crucial, yet, it falls outside the scope of this paper. As well as looking into definitions, ownership and transferability of intangible property can be a discussion of its own and will not be highly developed in this study. The author addresses this paper towards a reader familiar with such concepts and further reference can be made to the OECD TPG or other specific national legislations.

It is recognized that there are other transfer pricing methods that could be used for valuation purposes of intangible property. Nevertheless, emphasis will mainly be on the most common methods used in the U.S. and recommended by the OECD.

Finally, advanced pricing agreement and mutual assistance articles will not be covered in this paper. While the author realizes that it has been a widely discussed and important aspect of transfer pricing, yet it will not be examined.

2. Transfer Pricing and Intangible Property

2.1. Introduction

This chapter briefly introduces the general notion of transfer pricing in the international arena. The general definition of transfer pricing will be given. However, the focus will be mainly put on the intangible property in the context of transfer pricing. It would be necessary to give a brief overview of intangible property in order to fully analyze the issues related to such assets for transfer pricing purposes. The concept of intangible property will be illustrated from the OECD and the U.S. perspectives.

2.2. The Notion of Transfer Pricing

With the increase of international trade comes uncertainty of tax treatment between inter-company transactions²⁰ due to a high number of economic activities performed by MNEs through inter-company activities. As the OECD TPG state, “*transfer prices*” would be the prices at which an enterprise transfers goods and intangible property or offers services to associated enterprises.²¹ While companies are trying to increase their competitive advantage, transfer pricing frequently becomes a problem for both MNEs and tax authorities when inter-company prices do not reflect a market price,²² based on the notion of the arm’s length principle. The arm’s length principle implies that any inter-company transactions should be treated as transactions that occur between unrelated parties, all facts and circumstances remaining the same. Applying the arm’s length principle may be hard when it is concerning valuable assets, such as intangibles, since transactions involving intangibles have special characteristics and finding comparables may be thorny.²³ Thus, the tax treatment of intangible property requires special attention in the transfer pricing context.²⁴

²⁰ Markham, Michelle, pg. 1

²¹ OECD TPG, (*Preface*). Please note, “associated enterprises” is an enterprise that meets the criteria according to Article 9 of the OECD MTC, pg.19

²² Markham, Michelle, pg. 1

²³ OECD TPG, pg.196

²⁴ Markham, Michelle, pg.2

2.3. Intangible Property in the Transfer Pricing Context

Because of the nature of intangibles, it is very problematic to find a single approach that could be applied to all transactions related to intangible goods.²⁵ Major discussions have been done by countries such as the U.S. and the organizations like the OECD, in order to resolve the issue regarding valuation of intangibles for transfer pricing purposes. Later in this paper, various methods will be discussed in order to present the current situation of valuation of intangibles.

2.3.1. Definition of Intangible Property - Perspectives of the OECD and the United States

Understanding the distinctive characteristics of intangibles is vital for determining a transfer price of such assets, since there are many types of intangible property which may involve various transactions. There are also different classifications of intangible property that can be applied or defined differently under various laws and tax jurisdictions.

The OECD TPG discusses intangible property in Chapter VI (*Special Considerations for Intangible Property*). The TPG defines intangible property as “rights to use industrial assets such as patents, trademarks, trade names, designs or models.”²⁶ Also “literary and artistic property rights and intellectual property such as know-how and trade secrets” are included in the definition.²⁷ The OECD TPG categorizes intangible property as trade or marketing intangibles. Trade intangibles are the type of intangibles that are created by manufacturing activities or Research and Development (R&D).²⁸ Marketing intangibles help in commercial utilization of a product or service.²⁹ The value of both trade and marketing intangibles depends on many factors and the environment it is in.

In some jurisdictions, the definition of intangibles is defined for transfer pricing rules, such as in the U.S.³⁰ In the U.S., the IRS regulations define the intangible property in Section 482-4(b) of the IRC, “intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual-

²⁵ Brauner, Yariv, pg. 87

²⁶ OECD TPG, Para 6.2.

²⁷ Ibid.

²⁸ OECD TPG, Para 6.3.

²⁹ OECD TPG, Para 6.4.

³⁰ Markham, Michelle, pg.3

*“(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
(2) Copyrights and literary, musical, or artistic compositions;
(3) Trademarks, trade names, or brand names;
(4) Franchises, licenses, or contracts;
(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
(6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.”³¹*

The U.S. regulations refer to the intangible property as an asset that obtains its value from non physical attributes but from the intellectual content or other intangible property.³² Having different definitions of intangible property may create disagreements for valuation of such assets and the methods that should be applied when evaluating them.

2.3.2. Transfer and Ownership of Intangible Property

Taking into account of not having an accurate definition of the intangible property, other factors should be considered such as ownership and transferability of these sorts of assets.

The transfer of intangible property between related parties can occur through sale or license. When the sale of intangible property takes place, the party that purchased the asset would be the legal owner and entitled to royalties related to it.³³ Also, another common way to transfer intangible property is through licensing. Licensing is a way for a developer of intangible property to allow using certain asset, yet, the licensing agreement may vary, specifically in regards to royalty rates.³⁴ “Some intangibles are transferable, but only at a high cost or unpredictable chance of success. Such intangibles are again, tricky to valuate.”³⁵

Determining the ownership of intangibles is needed, given that the implication of the owner may vary under different tax jurisdictions. The ownership of an intangible can be established through legal or economic ownership.³⁶ Countries such as the U.S. put more weight on the legal

³¹ U.S. Treasury Regulations, Section 1.482- 4(b)

³² Ibid.

³³ PWC, pg. 85

³⁴ OECD TPG, Para 6.16. The OECD defines royalty as a recurrent payment and may differ based on the turnover of the licensee. Thus, determining this payment may be difficult. I will not go into discussing this issue more but it is important to consider.

³⁵ Brauner, Yariv, pg. 89

³⁶ OECD TPG, Para 6.3.

ownership, which can be established by law or through the contract.³⁷ If there is no legal ownership of intangible property, then the developer that carries out the largest amount of direct and indirect costs will be the owner of the intangible property.³⁸

3. Transfer Pricing Methods

3.1. Introduction

This part of the paper turns into a discussion related to the applicability of transfer pricing methods for intangible property. The goal is to provide a theoretical description of the common transfer pricing methods that are based on the arm's length principle offered by the OECD and the U.S. Two categories of methods, traditional transactional and transactional (profit based) methods will be introduced. The main goal is to investigate how these methods are applied to intangibles. More focus will be put in assessing these methods and how applicable they are in practice.

3.2. Background

There are a number of commonly recognized transfer pricing methods that are used to establish transfer price based on the arm's length principle. "The arm's length standard is the heart, spirit and the foundation of the current international transfer pricing regime."³⁹ The arm's length principle is "the international transfer pricing standard" used by MNEs and tax administrations to determine inter-company prices.⁴⁰

Reference to the arm's length principle could be made in Article 9 paragraph 1 of the OECD MTC,⁴¹ *"Where conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

³⁷ U.S. Treasury Regulations, Section 1.482- 4(3)(f)(ii)

³⁸ U.S. Treasury Regulations, Section 1.482- 4(3)(f)(ii)(B)

³⁹ Brauner, Yariv, pg. 96

⁴⁰ OECD TPG, Para. 1.1.

⁴¹ The OECD MTC, Article 9.1.

Countries, such as the U.S. define the arm's length principle in its transfer pricing provisions. Section 482-1(b) of the US transfer pricing regulations provide a detailed definition of this principle that “*determines the true taxable income of a controlled taxpayer*” as if it occurred between uncontrolled taxpayer under the same situation.⁴²

The idea behind the arm's length principle is that the price of transactions between related parties should be as it were the price on the same transactions between unrelated parties. The arm's length principle examines market conditions entailing both the inter-company and unrelated party transactions.⁴³ While the arm's length principle seems to be useful for MNEs when transferring goods or services, the concept may be tough to apply in transactions entailing intangibles.⁴⁴ When using the arm's length principle for the transfer pricing purposes a taxpayer is required to find a comparable market transaction between related parties and set a price as it was unrelated party transaction,⁴⁵ therefore, finding comparable transactions for intangible property is a challenge in this instance.

3.3. The OECD Approach

The OECD TPG recommends applying the method that is most appropriate in particular case, could be determined through functional analysis and comparables of the information.⁴⁶ Based on different facts and circumstances, as well as comparability factors, one method may be more appropriate over the other.

According to the OECD TPG, there are traditional transaction methods and transactional profits methods.⁴⁷ The traditional transactional methods include the comparable uncontrolled method (CUP), the resale price method (RPM), and the cost plus (CP) method applied when comparables are available. Among the transactional profits methods are the transactional net margin method (TNMM) and the profit split method (PSM). The OECD TPG recommends using these methods for tangible and intangible property, as well as provision of services. However, the OECD TPG does not specifically elect what methods to be used for intangible assets.⁴⁸ Rather it takes more of a flexible approach, where for difficult cases where one method is not conclusive various

⁴² U.S. Treasury Regulations, Section 482 Section 482-1(b)

⁴³ PWC, pg. 51

⁴⁴ Markham, Michelle, pg. 2

⁴⁵ Brauner, Yariv, pg. 96

⁴⁶ OECD TPG, Para 2.2.

⁴⁷ OECD TPG, Para 2.1, pg. 59. Discussion on the selection of the transfer pricing methods

⁴⁸ Markham, Michelle, pg.6

methods could be used.⁴⁹ Under the OECD TPG methods should be chosen based on the functional analysis and comparability analysis.⁵⁰ Inter-company prices should be established by analyzing the comparable factors between related and unrelated transactions. For that, the OECD TPG lays out five factors that may be useful when determining comparability:

- (1) *Characteristics of the property or services transferred;*⁵¹
- (2) *functional analysis*⁵² - i.e. the functions that each enterprise performs including risks undertaken;
- (3) *contractual terms;*⁵³
- (4) *economic circumstances*⁵⁴ - i.e. different geographic markets; and
- (5) *business strategies.*⁵⁵

These factors are important when looking at the circumstances and choosing the method in order to establish the arm's length price.

3.4. The United States - the 'Best Method Rule'

The U.S. regulations use the 'best method rule',⁵⁶ which under the facts and circumstance offers the most reliability.⁵⁷ As the regulations imply, there is no strict priority of methods and the taxpayers are free to try out different methods in order to determine the most reliable outcome.⁵⁸ The taxpayers are free to choose the methods that are most appropriate to a certain transaction.⁵⁹ Different methodologies could be examined by taxpayers in order to provide a reliable arm's length result.

⁴⁹ OECD TPG, Para 2.1.

⁵⁰ OECD TPG, Para 1.6. It states that the comparability analysis is "at the heart of application of the arm's length principle"

⁵¹ OECD TPG, D.1.2.1, pg. 44

⁵² OECD TPG, D.1.2.2, pg. 45

⁵³ OECD TPG, D.1.2.3., pg. 47

⁵⁴ OECD TPG, D.1.2.4., pg. 48

⁵⁵ OECD TPG, D.1.2.5., pg. 49

⁵⁶ U.S. Treasury Regulations, Section 482-1(c)

⁵⁷ Ibid.

⁵⁸ Ibid.

⁵⁹ Markham, Michelle, pg. 4

The U.S. regulations make specific reference in regards to methods used in connection with tangible and intangible properties, and services. In regards to the methods to be determined in connection with transfer of intangible property, the U.S. regulations suggest using the comparable uncontrolled transaction method (CUT), the comparable profits method (CPM), and the profit split method (PSM) and other methods are also permitted (as long as the ‘best method rule’ is applied).⁶⁰

The U.S. regulations state that “*the comparability of transactions and circumstances must be evaluated considering all the factors*”⁶¹ and when applying a specific method certain comparability factors may be more important than others, yet, analysis of all factors is required.

Similar to the OECD TPG, the U.S. also established five factors for the purpose of comparability analysis when using particular methods. These factors are outlined in the U.S. regulations:

- (1) *Functions;*
- (2) *contractual terms;*
- (3) *risks;*
- (4) *economic conditions; and*
- (5) *property or services.*⁶²

In addition to comparability analysis, functional analysis of a business is important to recognize what functions a party performs and what activities it is responsible for (such as R&D, sales, marketing, etc).⁶³ Based on that, it would be possible to look at comparable enterprises in order to evaluate transactions involved. It is important to bear in mind that functional analysis is not a way to look for comparables, it is rather a way to determine what type of comparables have to be looked upon.⁶⁴

Once the business is characterized through functional analysis, it may help to identify the pricing structure. However, the next step would be to look for comparables, which could be gathered through internal or external sources. In general internal comparables could be gathered within related parties, through management discussions. External comparables could be collected from independent enterprises. This information may be obtained from commercial databases, industry publications, employees, etc. However, access to this information may be very limited or sometimes unavailable.

⁶⁰ U.S. Treasury Regulations, Section 1.482-4(a)

⁶¹ U.S. Treasury Regulations, Section 482-1(d)(1)

⁶² *Ibid.*

⁶³ PWC, pg. 51

⁶⁴ PWC, pg.69

4. Presentation of Methods

4.1. Tradition Transactional Methods - Introduction

This chapter of the paper presents traditional transactional methods presented by the OECD TPG and the U.S. regulations. Special attention is given to how these methods are applicable to intangibles. Methods such as the CUP or the CUT (as it is called in the U.S.), the RPM and the CP methods will be examined in order to demonstrate how transfer price is set in comparable transactions between the AE. Traditional transactional methods use information reflected in comparable uncontrolled transactions and both the OECD and the U.S. seem to favor these methods, considering the most reliable way to determine the arm's length price.⁶⁵ While the OECD recognizes all these methods could be applicable to valuation of intangibles, the U.S. only accepts the CUT method to be used for valuation of intangible property for transfer pricing purposes. The applicability of any of the OECD transfer pricing methods depends on facts and circumstances of the situation, nevertheless, the CUP method is preferred by the OECD.

4.2. The Comparable Uncontrolled Price/Transaction Method

The comparable uncontrolled price (CUP) or CUT method takes in consideration the price set for products or services in controlled transaction to the price charged in comparable uncontrolled transactions. This method requires using similar transactions between unrelated parties and level of comparability used is very high.⁶⁶ For instance, factors such as terms of a transaction, volume of sales and timing of a transaction may be acceptable for adjustments when using the CUP method. Yet, the material product differences, quality of a product and/or geographic market differences may not be considered for adjustments and this method will not be useful in such circumstances.⁶⁷

4.2.1. The OECD - the CUP Method

The OECD TPG, states that the CUP method is the “*most direct method in determining the arm's length price*” and “*the most preferable over all other methods.*”⁶⁸ In particular, this method appears to be the most “reliable” when related parties sell the same or similar products as independent parties would. The OECD TPG depicts that it may be difficult to come across

⁶⁵ Markham, Michelle, pg. 7

⁶⁶ King, Elizabeth, pg. 22

⁶⁷ PWC, pg. 37

⁶⁸ OECD TPG, Para 2.13.

similar enough transactions and if there are some differences, adjustments may be appropriate.⁶⁹ The CUP is often reliable when an independent enterprise sells the same product as it is sold between an AE.⁷⁰ As the OECD points out the CUP method could be used for intangibles when the same owner transfers or licenses comparable intangible property under comparable conditions to an independent enterprise.⁷¹ Having appropriate information will be important for establishing the arm's length price when using the CUP method. This could often be problematic when determining the transfer price for unique or valuable intangibles, considering that comparables may not exist in such circumstances.

4.2.2. The United States - the CUT Method

While the U.S regulations uses the CUP method, yet, only allowed to be used for tangible property. On another hand the U.S. accepts a similar method called the comparable uncontrolled transaction method (CUT), which is specifically applicable towards intangibles. According to Section 482-(4)(c)(1) : *“In general. The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction.”*⁷² It is important to bear in mind terms and circumstances of the transfers, the stages of development, terms and duration of a license. The CUT method is used in cases where the comparison can be made to the same intangible under similar conditions, where slight differences between the transactions and has *“reasonably ascertainable effect on the amount charged”*⁷³ and adjustments could be made. In such circumstances this method will be *“the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible.”*⁷⁴ Like the CUP method it is preferred by the domestic U.S. provisions to be applied in order to come up with the reasonable arm's length outcome.

4.2.3. Analysis

As the OECD TPG state the CUP method could be used in establishing the arm's length price of the intangible property, yet this method is highly relied upon the use of comparables. In cases such as intangible property finding comparable could be an obstacle due to the unique characteristics of such assets.

⁶⁹ OECD TPG, Para 2.15.

⁷⁰ OECD TPG, Para 2.18.

⁷¹ OECD TPG, Para 6.23.

⁷² U.S. Treasury Regulations, Section 482-4(c)(1)

⁷³ U.S. Treasury Regulations, Section 482-2(2)(iii)

⁷⁴ U.S. Treasury Regulations, Section 482-3(4)(b)

When using the CUT method provided by the U.S. regulations, the application of the CUT would require for the controlled and uncontrolled transactions “*involve either the same intangible property or comparable intangible property.*”⁷⁵ However, in some industries where new innovation and developments occur, finding similar intangible comparison maybe be almost impossible. Thus, using the CUT may not be appropriate in those situations. This method is also highly receptive to the suitable data; its availability, reliability and completeness.⁷⁶ Using the CUP/CUT method would be best when compared transactions are very similar. Misunderstanding can occur and create uneven estimations of the price.

4.3. The Resale Price Method

The resale price method (RPM) is often used by distributors and resellers where same products sold in similar markets. This method is most commonly used by a distributor where gross margin on a product from an AE is compared with a gross margin from unrelated parties.⁷⁷ The method takes the price of a product purchased from an AE and then resold to a third party.⁷⁸ The gross margin is calculated through the percentage of net sales, taking into account operating expenses and risks assumed to determine the “resale price margin.”⁷⁹ This method is not used in the U.S. regulations for valuations of intangible property. On another hand, the OECD TPG recommends using this method in some instances involving intangibles.

4.3.1. The OECD - the RPM

The OECD TPG states that this method is “*probably most useful where it is applied to marketing operations.*”⁸⁰ As with the CUP method, product differences should be taken into account but broader differences will be more reflected in the functions performed.⁸¹ The OECD TPG says that for the purpose of this method, fewer adjustments would be needed to account for product

⁷⁵ U.S. Treasury Regulations, Section 482-4(2)(iii)

⁷⁶ Brauner, Yariv, pg. 129

⁷⁷ King, Elizabeth, pg. 19

⁷⁸ OECD TPG, Para 2.21.

⁷⁹ OECD TPG, Para 2.21.

⁸⁰ OECD TPG, Para 2.21.

⁸¹ OECD TPG, Para 2.25.

differences when using the RPM.⁸² The OECD TPG states that minor product differences have less effect on profit margins as it has on the price.⁸³

In relation to the intangible property, product similarity might be of a great importance, since the property transferred in controlled transaction should be compared to the property transferred in the uncontrolled transactions.⁸⁴ As a result, finding similar products in a specific industry would be vital. The OECD TPG points out that particular care should be given when a reseller considerably contributes to the creation or maintenance of intangibles (such as trademark or trade names) owned by an AE.⁸⁵ In such instances it is hard to value a final product,⁸⁶ since it is hard to determine the value created by it. When evaluating the intangible property the TPG also says that the RPM could be used in cases where an AE sub-licenses the intangibles to independent enterprises in order to examine the terms of controlled transactions.⁸⁷ This method considers more functions performed and the OECD TPG recognizes that there is also a problem of finding the comparables but more importantly when performing the functional analysis.

4.3.2. The United States – the RPM not used for intangibles

On another hand, the U.S. regulations apply this method only to valuation of tangible property, it states that this method “...*evaluates whether the amount charged in a controlled transaction is arm’s length by reference to the gross profit margin realized in comparable uncontrolled transaction. The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property...*”⁸⁸ Typically this method is applied to tangible property transactions where the reseller “*has not added substantial value to the tangible goods by physically altering the goods before resale.*”⁸⁹ The regulations also state that this method not typically used for intangible property in order “*to add substantial value to the tangible goods.*”⁹⁰ This is a difference from the OECD TPG where the RPM could be applied in certain situations related to intangibles.

⁸² OECD TPG, Para 2.23.

⁸³ Ibid.

⁸⁴ OECD TPG, Para 2.25, pg. 66

⁸⁵ OECD TPG, Para 2.29, pg. 67-68

⁸⁶ Ibid.

⁸⁷ OECD TPG, Para 6.24.

⁸⁸ U.S. Treasury Regulations, Section 482-3(c)(1)

⁸⁹ Ibid.

⁹⁰ Ibid.

4.3.3. Analysis

The RPM could be problematic to apply in practice for intangible property transactions. This method considers more functions performed rather than on products in general and in practice it could be hard to gather all necessary information related to functional analysis. Even though, the OECD claims that RPM could be applied in intangible property in cases such as sub-licensing intangible property to an independent party, the U.S. does not apply this method for intangibles. Analyzing the nature of functions performed and determining the final value of the product, when a reseller contributes to the creation of the product could be a long and not an easy process. In addition to that, collecting information related to the functional analysis and identifying comparables is a barrier. Evidently, the U.S. does not agree with the OECD TPG and decides not to use this method in the valuation of the intangibles.

4.3.4. Practical Example – The GlaxoSmithKline Canada

This GlaxoSmithKline Canada case is an illustration of the intricacy of both the CUP and RPM used in practice. GlaxoSmithKline Canada (GSK), a well established pharmaceutical multinational company with large number of subsidiaries all over the world. It performs various functions such as R&D, manufacturing, marketing, sales, etc. GSK is known for its drug Zantac, patented and trademarked. The dispute that occurred in Canada, where GSK was a subsidiary in Canada of the Glaxo Group Ltd. headquartered in the UK.

In brief, GSK Canada purchased an ingredient (ranitidine) for the production of its drug (Zantac) from 1990-1993. GSK purchased ranitidine from the Swiss company for \$1,512 to \$1,651 per kilogram, where generic Canadian manufacturers usually paid \$194 to \$304 per kilogram for ranitidine. The disagreement was between the Canadian Revenue Agency (CRA) and GSK Canada, where the argument was focused on the transfer price paid for ranitidine.⁹¹ GSK had two separate agreements for supplying and licensing the drug. The Supply Agreement allowed them to purchase a drug from a Swiss company. Under the License Agreement, GSK paid the royalty payment of 6% for net sales of all the products, including Zantac, to GSK parent in the UK. The Canadian Court concluded that both of these agreements had to be considered independently.

The CRA argued that the CUP method should have been applied and compared to the price paid for ranitidine by other generic drug manufacturers in Canada. However, GSK used the RMP arguing that ranitidine that they purchased from the Swiss company could not be compared to the ranitidine that other manufacturers in Canada purchased. By using the RPM, GSK showed a gross margin ranging from 45.8 to 82.4, thus the Court did not accept this argument due to the fact that comparables used were from different geographic market and GSK performed more functions than it was compared to. Therefore, the higher gross margin had to be used in the

⁹¹ GlaxoSmithKline Inc v. The Queen, Docket: 98-712, May 11,2008

valuation. The Court stated that the issue was whether the transfer price was “reasonable in the circumstances.” It was concluded that the CUP method was the “preferred method” and it would be appropriate using other Canadian generic manufactures for the purpose of the comparison used in the CUP method.

4.4. The Cost Plus Method

In practice the cost plus (CP) method is rarely used for intangible property. It is most often applied for contract manufactured type of products or services. The arm’s length price is determined by adding an appropriate markup to the cost of production.⁹² The reference is made to the costs acquired by the supplier in controlled transactions for a property transferred or services performed to an associated buyer.⁹³

4.4.1. The OECD – the CP method

The OECD says that this method perhaps is most applicable when it comes down to semi-finished sort of goods sold between an AE.⁹⁴ It takes in consideration, the costs that are incurred by the supplier in controlled transactions. The CP method determines the arm’s length price by using the markup cost of the production.⁹⁵ When evaluating comparable transactions, things to be considered such as capacity issues, volume and geographic market in order to determine the appropriate cost base. As it is with the RPM, similar comparability factors should be considered as wells as emphasis is put upon on the functions performed, and to make appropriate adjustments. Appropriate adjustments should be made in order to insure consistency because the markup has to be measured consistently between an AE and independent enterprise.⁹⁶ Internal comparables and external comparables would be suitable when establishing reference to the cost plus markup.⁹⁷ The challenge with this method is that it is often difficult to determine the relationship between the costs and profit markup.⁹⁸ In cases involving intangible property where small costs have been incurred by developing a valuable asset⁹⁹ and these costs may not

⁹² PWC, pg. 39

⁹³ OECD TPG, Para 2.39.

⁹⁴ Ibid.

⁹⁵ PWC, pg. 39

⁹⁶ OECD TPG, Para 2.46.

⁹⁷ OECD TPG, Para 2.40.

⁹⁸ Markham, Michelle, pg. 101

⁹⁹ OECD TPG, Para 2.43, pg.72

necessarily relate to the market prices. Important factor that should be taken into consideration is different accounting policies that are used for determination of the markup. There is no common cost accounting concept and MNEs may have different approaches to treat these costs.¹⁰⁰ Thus, adjustments will have to be made where accounting differs between controlled and uncontrolled transactions, to ensure consistency.¹⁰¹

The OECD provides an example where the CP method could be used for intangible property, where a company of the same MNE agrees to carry out the contract for a research in another company of the same group.¹⁰² All risks of the research are borne by the latter company that also owns the intangible and takes upon all the profit and losses from the research. The costs that the occurred during the research have to be compensated and additional cost may show how innovative the research is.¹⁰³ As the OECD TPG states this is a typical situation when the CP method is applicable for the intangible property.

4.4.2. The United States – the CP Method not used for intangibles

Unlike the OECD the U.S. does not apply this method for intangible property. The U.S. Section 482-(3)(d)(1) describes the cost plus method as “*the cost plus method evaluates whether the amount charged in a controlled transaction is arm’s length by reference to the gross profit markup realized in comparable uncontrolled transactions.*”¹⁰⁴ This method is typically used in manufacture, assembly, or other production of goods,¹⁰⁵ used for tangible goods.

4.4.3. Analysis

This method appears hard to apply in practice in relation to intangible property. Identifying cost related in the development of intangibles in many cases is tricky. The markups could vary from one product to another in manufacturing intangibles.¹⁰⁶ This method can generally be applied to contract R&D situations. However, it is tough to determine the appropriateness of comparable

¹⁰⁰ Markam, Michelle, pg. 101

¹⁰¹ OECD TPG, Para 2.46, pg. 73

¹⁰² OECD TPG, Para 2.55.

¹⁰³ Ibid

¹⁰⁴ U.S. Treasury Regulations, 482-(3)(d)(1)

¹⁰⁵ U.S. Treasury Regulations, Section 482-3(d)(1)

¹⁰⁶ PWC, pg. 39

uncontrolled transactions, especially when valuable and unique intangibles are developed.¹⁰⁷ The U.S. does not prefer the CP method and states that it is only applied to tangible goods.

5. Profit Based Methods

5.1. Introduction

The goal in this part is to present profit based methods and how they are applied in relation to the intangible property, illustrated through the OECD TPG and the U.S. regulations. The transactional net margin method (TNMM) or the comparable profit method (CPM) as it is called in the U.S. and the profit split method (PSM) will be introduced and demonstrated through practical examples. These profit based methods use the gross margins of comparable companies, rather than actual transactions as it is used in the traditional pricing methods.¹⁰⁸ The comparison is made in relation to the net profit indicators (e.g. profit margins).¹⁰⁹ The analysis of their relevance in regards to intangible property will be provided. Since MNEs face great challenges finding reliable information to find comparability of transactions related to valuable intangibles, more attention has been given towards profit based methods.¹¹⁰

5.1.1. The OECD - The Transactional Net Margin Method

The transactional net margin method (TNMM) takes the net profit method relative to an appropriate base¹¹¹ similarly to the CP method and the RPM, an appropriate base (e.g. costs, sales, assets) realized from controlled transactions.¹¹² In order to indicate the net profit, reference could be made to internal comparables or if not possible to obtain then external comparables may be used.¹¹³ Functional analysis is essential in order to find comparability and make necessary adjustments.¹¹⁴ The strength of this method is that the net profit indicators are perhaps less influenced by transactional differences as it is in the circumstances with price as used in the CUP

¹⁰⁷ Markham, Michelle, pg. 102

¹⁰⁸ Markham, Michelle, pg. 7

¹⁰⁹ OECD TPG, Para 1.35.

¹¹⁰ Ibid.

¹¹¹ OECD, TPG, Para. 2.58.

¹¹² OECD TPG, Para 2.58.

¹¹³ OECD TPG, Para 2.58.

¹¹⁴ Ibid.

method.¹¹⁵ This method is statistical and does not use a one set of comparable transactions in order to establish the arm's length prices.¹¹⁶ The information regarding the net profit could be more easily obtained through the financial statements of independent parties.¹¹⁷ However, the OECD states that the TNMM is most likely will not be reliable in the transactions that entail unique and valuable contributions, in those cases the profit split method would be more applicable.¹¹⁸

5.1.2. The United States - The comparable profits method

The U.S. has a very similar method as the TNMM, which is the comparable profit method (CPM) referred to in the U.S. Section 482-(5)(a) of the regulations, where it states, "*In general. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.*"¹¹⁹

The arm's length price is based on the comparable operating profit tested party would have on a related party transactions if the profit would be equal to an uncontrolled transaction¹²⁰, where ratios are used (*e.g.* ratio of operating profit to sales, rate of return on capital) to indicate profit, by using different factors in the ratio calculations. The profit level indicators are used in order to determine whether the operating profit represents the arm's length price.¹²¹ This method is suggested by the U.S. regulations to be used for the intangible property.

5.1.3. Analysis

The CPM and the TNMM would be applied in cases where other methods could not be used due to different functions (as for the RPM), product differences (as for the CUP) or costs cannot be identified to adjust the mark up (as for the CP method). Thus, looking at net profit level indicators would be more appropriate. The TNMM/CPM are closely similar with some minor

¹¹⁵ OECD TPG, Para 2.62.

¹¹⁶ Brauner, Yariv, pg. 130

¹¹⁷ PWC, pg. 44

¹¹⁸ OECD TPG, Para 2.59.

¹¹⁹ U.S. Treasury Regulations, Section 482-(5)(a)

¹²⁰ U.S. Treasury Regulations, Section 482-5(d)(4), operating profit is defined as gross profit less operating expenses, all income included from business activities, except interest and dividends

¹²¹ U.S. Treasury Regulations, Section 482- 5(b)

differences, both considering the profit level indicators and examining profits of an AE in controlled transactions.

5.1.4. Practical Example – the Roche Case Australia

Roche Products Pty. Ltd, Swiss company with subsidiary in Australia, was supplying and selling pharmaceutical and diagnostic products, where the prescription pharmaceutical business was supported by the R&D.¹²² (See *Figure 2.*) The case raised questions related how transfer pricing analysis should be performed and the use of the profit based methods in order to establish the arm's length price.¹²³

In the Roche case, the TNMM used by Roche was rejected. The issue brought to the Australian Administrative Appeals Tribunal was to determine the appropriate arm's length price by looking at each product divisions. This TNMM was criticized by the Tribunal, stating that this method usually relies on profit data from the comparable companies and benchmarked in relation to a third party. "*These produce statistical averages and not real or actual results.*"¹²⁴ Rather the CUP method was favored by Judge Downes. As it was stated in the final decision determining the arm's length price for sale of pharmaceutical products could be difficult. This is due to the fact that the comparables are hard to find and there is no substantially free market for such products.¹²⁵ However, the CUP method was still favored over the TNMM, criticizing whether the profit based methods could provide the arm's length results.¹²⁶

5.2. Profit Split Method

The profit split method (PSM) is used where information regarding comparables may not be sufficient to use.¹²⁷ This method is commonly used for transactions which are hard to identify and finding closely related comparables is difficult, in cases like intangibles. The PSM is applicable in circumstances where two or more parties of a controlled group own intangible

¹²² Roche Products Pty Limited and Commissioner of Taxation [2008] AATA 639, Para 3.

¹²³ Jenkins, Michael, *Transfer Pricing in Australia: The Roche Case*, pg.1

¹²⁴ Roche Products Pty Limited and Commissioner of Taxation [2008] AATA 639, Para 115.3.

¹²⁵ Roche Products Pty Limited and Commissioner of Taxation [2008] AATA 639, Para 7.

¹²⁶ Jenkins, Michael, pg. 3

¹²⁷ OECD TPG, Para 2.109.

property.¹²⁸ In order to calculate the arm's length price it would be important to know how the profits would be split between unrelated parties stressing all the facts and circumstances as if it were in AE transactions.¹²⁹ The major advantage of this method is that it puts more weight on allocating actual profits earned rather than determining what the correct price should be.¹³⁰

5.2.1. The OECD – the PSM

The OECD TPG allows the range of profit split methods.¹³¹ According to the OECD TPG, the PSM determines the profits to be split between an AE from the controlled transactions.¹³² This method looks at how profits would be split between unrelated parties, taking in account the information available as it were in the same party transactions.¹³³

The OECD TPG recommends using the contribution and residual analysis. The contribution analysis considers the total profits from controlled transactions, divided between an AE.¹³⁴ Looking at the comparables data when available would be appropriate, yet, it is mostly based on observing the functions performed by each AE in controlled transactions.¹³⁵ The residual analysis is divided into two stages, where the arm's length remuneration is determined for each party involved not taking into account unique intangibles held by the participants.¹³⁶ Secondly, it will take the remaining profits or loses and allocate to the parties involved, considering all the facts and circumstances.¹³⁷ In this stage, intangible property contributions are accounted for. The information related to the comparable transactions of independent enterprises may be relevant. Internal data may be also useful for this method, which can be accessed through the taxpayers financial or cost accounting.¹³⁸

¹²⁸ King, Elizabeth, pg. 29

¹²⁹ PWC, pg. 42

¹³⁰ Markam, Michelle, pg. 18

¹³¹ King, Elizabeth, *Transfer Pricing and Corporate Taxation: Problems, Practical Implications and Proposed Solutions*, pg. 29

¹³² OECD TPG, Para 2.108.

¹³³ PWC, pg. 42

¹³⁴ OECD TPG, Para 2.119.

¹³⁵ Ibid.

¹³⁶ OECD TPG, Para 2.121.

¹³⁷ Ibid.

¹³⁸ OECD TPG, Para 2.141.

This method provides flexibility by considering unique facts and circumstances of an AE.¹³⁹ The OECD TPG says that one of the biggest strength of this method is when the comparables are not available. This method would be most appropriate when both parties contribute unique intangibles to a transaction.¹⁴⁰ The weakness with this method is that it is difficult in application, due to the fact that it could be difficult to measure the profits and losses of all AE and making adjustments related to accounting principles.¹⁴¹

5.2.2. The United States – The Comparable Profit Split Method (CPSM) and the Residual Profit Split Method (RPSM)

The U.S. Section 482-(6) (a) states, “*In general. The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm’s length by reference to the relative value of each controlled taxpayer’s contribution to that combined operating profit or loss.*”¹⁴² The combined profit or loss should be obtained from “the most narrowly identifiable business activity,” where the most reliable data available. The U.S. regulations have two versions of this method: the comparable profit split method (CPSM) and the residual profit split (RPSM) method.

The CPSM looks at the profits of comparable transactions between two unrelated parties. The combined operating profits of uncontrolled parties engaged in similar transactions and activities to those of controlled parties in the relevant business activities.¹⁴³ “*Under this method, each uncontrolled taxpayer percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity.*”¹⁴⁴ Comparability factors are also important when using this method, particularly the similarity of contractual terms of controlled and uncontrolled parties, will determine of the functions allocations and risks.¹⁴⁵ This method cannot be used if the operating profit of the uncontrolled parties varies from the

¹³⁹ OECD TPG, Para 2.112.

¹⁴⁰ OECD TPG, Para 2.109.

¹⁴¹ OECD TPG, Para 2.114.

¹⁴² U.S. Treasury Regulations, Section 482-(6)(a)

¹⁴³ U.S. Treasury Regulations, Section 482- 6(c)(2)(i)

¹⁴⁴ Ibid.

¹⁴⁵ U.S. Treasury Regulations, Section 482- 6(c)(2)(i)(B)

controlled taxpayers (as a percentage of the combined assets).¹⁴⁶ The CPSM heavily relies on the external market benchmarks and all parties of the controlled transactions are evaluated.¹⁴⁷

The RPSM combines operating profit and loss from the relevant business activity allocated between controlled parties in two steps.¹⁴⁸ The first step allocates operating income to each party in order to provide a market return for its routine contributions,¹⁴⁹ looking at the market benchmarks of comparability. The second step would be allocating the residual profit to nonroutine intangibles of the controlled taxpayers. It measures the relative value of intangible property contributed by each party considered by the external benchmarks in order to find out the fair market value of intangibles. Furthermore, the relative value of the intangible contributions could be measured by the estimating capitalized costs of developing it. Also, if the development expenditures of intangible property are relatively constant over time and the useful life of intangibles are similarly the same, these actual expenses could be used to estimate the relative value of intangible contributions.¹⁵⁰ This second step does not rely on the market comparability factors.¹⁵¹

5.2.3. Analysis

The PSM relies on the external information in order to determine how profits are divided between uncontrolled parties. Even though, the PSM does not necessarily rely on comparables but the external information is used in the analysis. The U.S. CPSM relies on the external market benchmarks but not applicable if the operating profit is different in comparable transactions of unrelated parties. The OECD TPG suggests using the PSM method when unique intangibles are involved. The PSM is frequently discussed on the international scale, due to the fact it can be applied to non-routing intangibles when comparables do not exist.

¹⁴⁶ Ibid.

¹⁴⁷ U. S. Treasury Regulations, Section 482- 6(c)(2)(i)(D)

¹⁴⁸ S. Treasury Regulations, Section 482- 6(c)(3)(i)

¹⁴⁹ U.S. Treasury Regulations, Section 482- 6(c)(3)(i)(A). The routine contributions are same or similar to those performed by the uncontrolled parties where it is possible to identify market returns.

¹⁵⁰ U.S. Treasury Regulations, Section 482- 6(c)(3)(i)(B)

¹⁵¹ U. S. Treasury Regulations, Section 482- 6(c)(3)(ii)(B)

5.2.4. Practical Example – the GlaxoSmithKline United States

Prior to the GSK dispute in Canada, GSK also had a long dispute in the U.S. with the IRS. It is a very well known case in transfer pricing area, considered to be one of the longest¹⁵² and “ugly” disputes in transfer pricing history.¹⁵³ While GSK Canada dispute was related to the generic prices for the ingredient of Zantac production, the argument in the U.S was focused on the creation of marketing intangibles.

GSK, healthcare and research based pharmaceutical company is considered Europe’s top making drug company,¹⁵⁴ headquartered in the United Kingdom (UK), where most of R&D and drug developments was performed. GSK was developing six various products, among which Zantac drug accounted for 77 percent of the adjustments.¹⁵⁵ GSK UK granted the rights to sale, distribute and market the products to its subsidiary in the U.S. (see *Figure 1*).

The GSK’s tax returns were examined and the taxable income calculations pursuant to Section 482 of the IRC were questioned.¹⁵⁶ The issue raised was whether the value derived from the drug Zantac was from R&D in the UK or marketing activities in the U.S. The issue was whether the appropriate transfer price was used between the parent and the subsidiary. As the result of the dispute, in 2006 GSK agreed to pay approximately \$3.4 billion (including interest) to the IRS for the tax years from 1989 through 2005. This payment is considered to be the largest payment to the IRS.¹⁵⁷

In this case the IRS stated that Zantac’s sales performance was attributed to the marketing activities performed in the U.S. However, GSK argued that the value of the drug should be attributable to R&D in the UK. The dispute was regarding the value creation of the drug and whether the marketing costs were factored in the value of the intangible asset. In its analysis, the IRS used the residual PSM in order to evaluate the arm’s length payments of marketing intangibles of GSK U.S. to GSK UK. The IRS reduced GSK U.S. royalty payment to the GSK UK for the patent protection in the U.S. to the rates stated in the license agreement. The initial

¹⁵² IRS, can be accessed on www.irs.gov/newsroom/. This case was pending in the U.S. Tax Court for about sixteen years

¹⁵³ Fris, Gonnet, *A European View on Transfer Pricing After Glaxo*, pg. 1

¹⁵⁴ Ireland Business and Finance Portal can be accessed on www.finfacts.com/irelandbusinessnews/publish/

¹⁵⁵ Fris, Gonnet, pg.. 3

¹⁵⁶ GlaxoSmithKline Holdings (America) Inc., v Commissioner of Internal Revenue, Docket No 3-01-D., filed on July 5, 2001

¹⁵⁷ Internal Revenue Service, can be accessed on www.irs.gov, *Accepts Settlement Offer in Largest Transfer Pricing Dispute*

payment of royalty was considered as an important element of the IRS method used.¹⁵⁸ This approach allowed attributing the major part of profit from the sale of Zantac to GSK U.S. The IRS also stated that the royalties paid to GSK parent for the trademarks and marketing intangibles could not be deducted.

The profit based method was preferred by the U.S. tax authorities and the disagreement was in the relation to what income should be attributable in the U.S. and subject to the U.S. tax. The IRS has a power to penalize the taxpayers in the addition to the taxes owed, which creates another reason for companies to avoid the IRS as long as GSK did.¹⁵⁹ “Like many other transfer pricing disputes, the GSK case is “representative of the misunderstanding between taxpayers and tax administrations in relation to the interpretation and perceptions of value creation within a firm.”¹⁶⁰ The conflict shows that the consistency and data interpretation is highly important for the analysis of particular case.

5.3. Other Methods - Global Formulary Apportionment Method?

As one of the solutions to various problems involving the arm’s length principle, advised by some scholars and practitioners is the global formulary apportionment method. The formulary apportionment uses a formula to divide the net income of a corporation on a consolidated level.¹⁶¹ The formula based on some factors, such as payroll, sales, assets used in order allocate the taxable income by looking at AEs as a single entity.¹⁶² Thus, the concept is referred as unitary taxation, where MNEs would be taxed on the unitary tax basis.¹⁶³ This method may work well within the U.S. since most of the states in the U.S. use the formula to allocate corporate income for the purposes of federal taxation. However, the OECD is not a fond of this method since it raises some issues on a global level. As the OECD describes, the greatest concern with this method is that it is hard to implement in such a way that it will protect against double taxation and ensure single taxation.¹⁶⁴ This method would require a high level of international

¹⁵⁸ Colker, David and Sang, Kim, *GlaxoSmithKline v Commissioner: How Should \$10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?*, Business Tax Online News can be accessed on www.dlapiper.com/global/publications The article criticizes the IRS decision related to the GSK case

¹⁵⁹ Matthews, Robert Guy and Whallen, Jeanne, *Glaxo to Settle Tax Dispute with IRS Over U.S. Unit for \$3.4 Billion*, pg. 2

¹⁶⁰ Fris, Gonnet, pg. 5

¹⁶¹ McLure, Charles, *Replacing Separate Entity Accounting and the Arm’s Length Principle with Formulary Apportionment*. Individual corporations, all corporations of common ownership or only commonly owned corporations involved in set of economic activities, pg. 587

¹⁶² Markham, Michelle, pg. 569

¹⁶³ Kobetsky, Michael, *The Case for Unitary Taxation of International Enterprises*, pg. 205

¹⁶⁴ OECD TPG, Para 1.22.

cooperation and agreement. Some countries may want to consider different factors in the formula calculation and that would be hard to agree upon. Thus, it may create further obstacle and will not ease the transfer pricing rules. In terms of intangible property, the method may also be disputed due to the geographic location, since the base of income should be taxed where it originated.¹⁶⁵ Difficulty of identifying the location of intangibles might pose additional challenges.

6. Final Analysis, Remarks and Conclusion

6.1. Analysis

Even though various methodologies exist for transfer pricing purposes of intangible property, it does not mean that they are in theory and in practice easily applicable. Assets that are unique in nature are not only hard to define but also put an appropriate price. The arm's length principle is to be applied setting the transfer price for tangible and intangible property, and provision of services based on the market price. However, the high level of analysis and judgment must be done for determining the 'best method' or most 'appropriate method.' It is possible to conclude through looking at both the OECD TPG and the U.S. regulations that the CUP/CUT methods are favored over other methods when comparables can be found. This method has been preferred by the tax authorities in some well known court cases, such as GSK Canada and Roche Australia, while different methods were preferred by the taxpayers. The functional and comparability analysis are crucial when determining what method to be used in a particular situation. The GSK U.S. case shows that difference in data interpretations of facts and circumstances may greatly affect the situation for both the taxpayer and tax authorities.

The transactional profit based methods, in particular the PSM appears to be more widely used nowadays. The U.S. has an extensive description and guidance on how to apply this method. The OECD guidance is similar to the U.S. explanation of this method, except that it differs when it comes to the attribution of the residual profits to non-routine functions.

Specific discussions were addressed suggesting using other methods, such the formulary apportionment method. While this method could be more applicable in the U.S., it raises serious concerns, in particular on the international scale when determining geographic location of intangibles could be complicated.

¹⁶⁵ McLure, Charles, *Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment.*, pg. 592

6.2. Remarks – ‘Abusive’ Transfer Pricing

The discussion in this paper has focused mainly on the transfer pricing methodologies related to the intangible property. An important aspect that should be mentioned in regards to transfer pricing is ‘abuse.’ As it is stated by the OECD TPG transfer pricing should not be considered as avoidance or fraud. The notion of ‘abuse’ can have a different meaning in different domestic jurisdictions (*i.e.* civil law countries and common law countries). There are various counteracting measures taken to prevent abusive practices and one of them is the arm’s length approach. The main reason why governments use the arm’s length principle is that they assume that MNEs engage in transfer price manipulation.¹⁶⁶ “No country – poor, emerging or wealthy – wants its tax base to suffer because of transfer pricing.”¹⁶⁷

One of the issues in GSK U.S. dispute was also questioned whether the transfer pricing was used for the purpose of avoiding or evading the payment of income tax. Governments are concerned with aggressive transfer pricing where MNEs try to maneuver their prices. While the tax authorities and other nongovernmental agencies perceive transfer pricing as “suspicious” and “immortal”, MNEs and tax planners view transfer pricing “legal” and “morally acceptable.”¹⁶⁸ On another hand, the challenge is with the consistency of information used and functional analysis applied for methodologies when determining the transfer price. Uncertainties and inconsistency of data interpretation may generally occur when intangibles are present. MNEs as well as tax authorities use their own judgment when valuating such assets. Therefore, it may create dispute and disagreements on the amount of taxable income to be reported in certain jurisdiction.

After the GSK U.S. case, one of the biggest transfer pricing disputes, has not left Europe without notice. Transfer pricing issues have been more widely discussed on the European continent¹⁶⁹ and created further actions by the European community, by introducing the Code of Conduct in 2006 for the AE in the European Union.¹⁷⁰ This permits to accomplish more transparency and consistency, and in the future intends to focus on the crucial area such as dispute of avoidance and resolution.¹⁷¹

¹⁶⁶ Eden, Lorraine and Smith, Murphy, *The Ethics of Transfer Pricing*, pg. 3

¹⁶⁷ Neighbour, John, *Transfer Pricing: Keeping it Arm’s Length*, pg. 1

¹⁶⁸ Eden, Lorraine and Smith, Murphy, pg. 4

¹⁶⁹ Fris, Gonnet, pg. 1

¹⁷⁰ PWC, pg.164

¹⁷¹ PWC, 164

6.3. Conclusion

This thesis intended to describe and criticize applicability of methodologies provided by the OECD TPG and the U.S. regulations in relation to the intangible property. In particular, the observation of the most common methods has been done, where the importance of each method was highlighted in applicability to intangible property. An illustration through case law of Australia, Canada and the U.S. was made to show the problems of these methods in practice and the use of information in the determination of transfer price.

The notion of transfer pricing is based on the arm's length principle which has been recognized by many countries all over the world. While the arm's length principle is internationally used for the purpose of determining the price between inter-company transactions, it also creates serious concerns. The methodologies recommended by the OECD TPG and the U.S. regulations are based on the arm's length principle with the intention of valuating tangible and intangible properties, and provision of services.

The OECD TPG are not considered a legal binding for member and nonmember countries, however, it has been highly looked upon and used globally. The OECD TPG recognizes that valuation of intangibles is not an easy task and tries to provide guidance when certain method that could be used for such purposes, yet no specific recommendation is given. On another hand, the U.S. transfer pricing regulations state explicitly what methods to be chosen for the intangible property. While, the U.S. is considered to have sophisticated transfer pricing regulations, it uses the 'best method rule' which allows taxpayers and tax authorities to chose the method that is best applied taking in consideration the facts and circumstances. The U.S. also allows using other methodologies, as long as they follow 'the best method rule'.

Based on the observations through several important cases in transfer pricing history, such as the GSK Canada and the U.S., and the Roche Australia, it is possible to conclude that there is often misunderstanding between the taxpayers and tax authorities, specifically on methodologies applied to transfer pricing of the intangible property. While taxpayers prefer using certain method for the valuations, the tax authorities prefer using another one and often times the CUP/CUT method is favored. This method is based on high level of comparability and availability of the information. The challenge with this method is that often it hard to find comparables or availability of the data which may not exist in the market related to intangible property. This method is difficult to apply especially in the case where unique and valuable intangibles are present. Some suggested that the profit based methods could be another venue to approach when determining the price for intra-company transactions of intangibles. While the U.S. gives step by step guidance on how to apply this method and it is often used in finding the relative value of the non-routine intangibles. The OECD TPG suggests that this method is best to be applied when both parties contribute unique intangibles in a transaction.

Transfer pricing can be perceived as the way for MNEs to avoid paying taxes or being 'abusive' of the regulations. However, it is hard to announce that this is the main purpose of the businesses. Due to the uncertainties and inconsistencies in transfer pricing regime, it is challenge to come up with a most appropriate price and especially when intangible property is involved. While company may use transfer pricing as part of its tax planning it does not have to be considered illegal or unethical.

Figure 1. GSK company structure

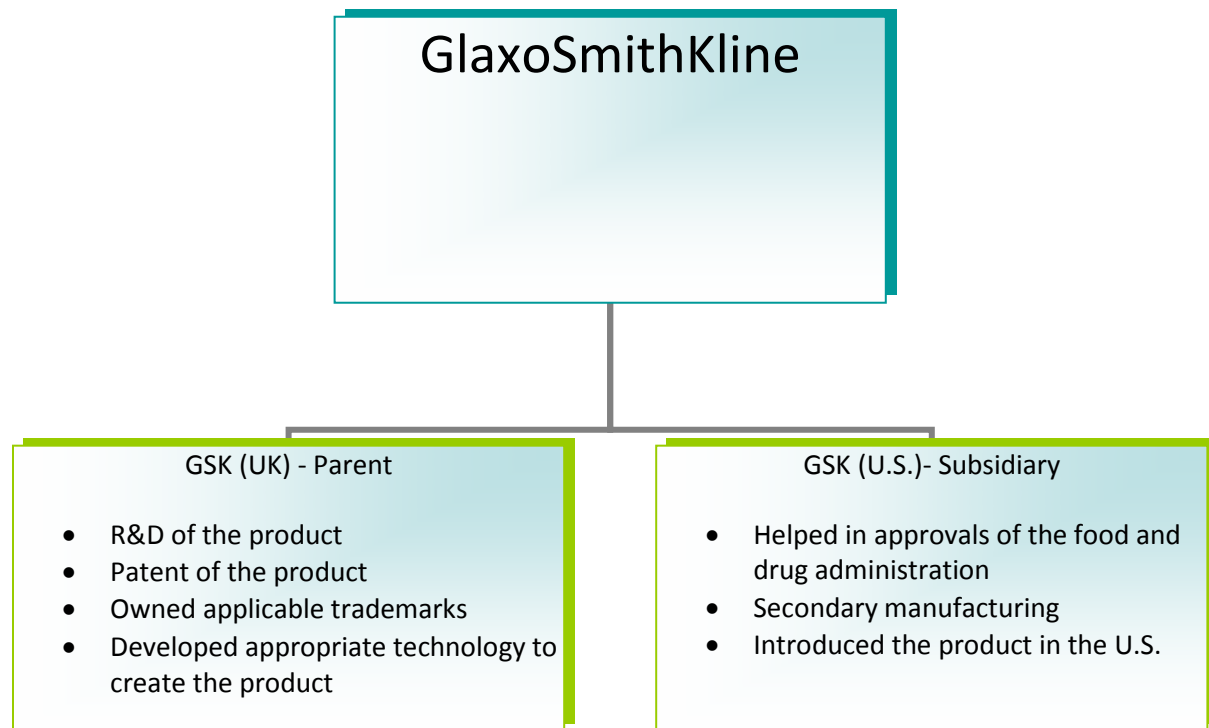
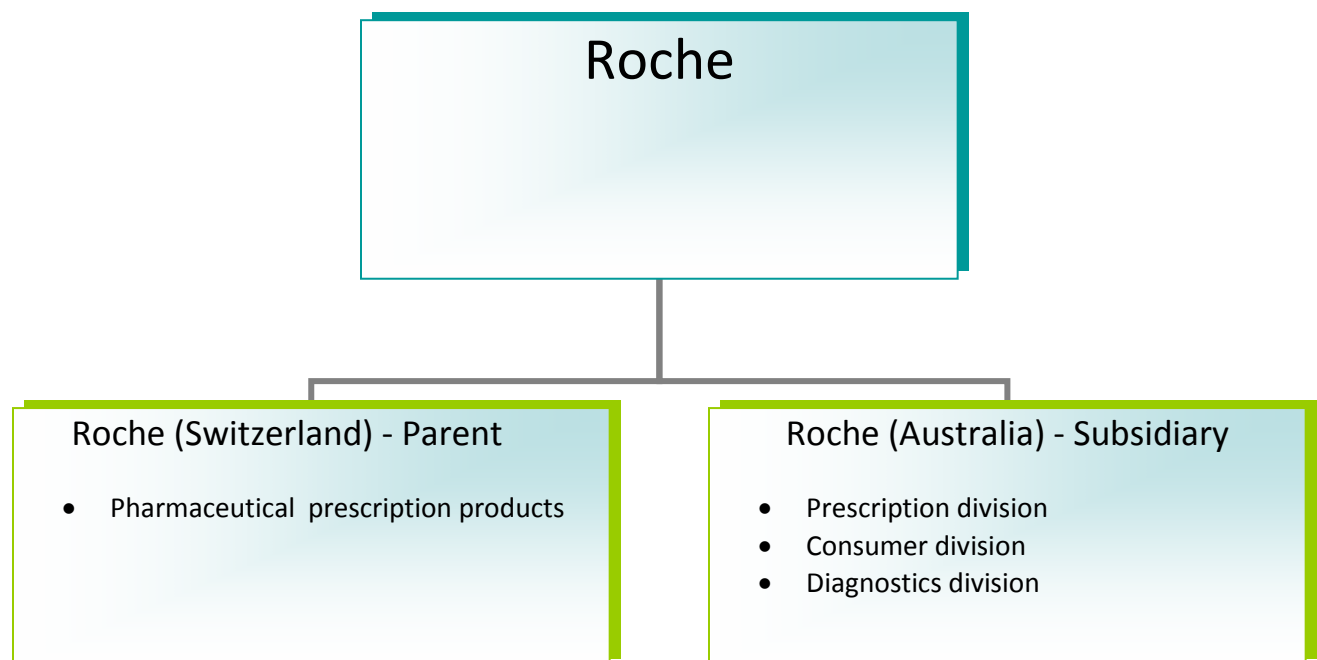


Figure 2. Roche company structure



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Sincerely,

Zhanna Gres

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