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Transfer Pricing: Entitlement to Intangible Related Returns

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Abbreviations

Art.	Article
DD	Discussion draft
e.g	exempli gratia
IBFD	International Bureau of Fiscal Documentation
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital
para.	paragraph
pg.	page
R&D	Research and Development
TPG	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

1 Introduction

1.1 Background

The Organization for Economic Co-operation and Development ("OECD") has produced Transfer Pricing Guidelines ("TPG") to help both business and tax administrations apply the arm's length principle, introducing the separate entity approach for pricing the internal transactions. The individual members of the group should be taxed as though they have taken place between unrelated parties, on the basis that they act on the arm's length in their intra-group transactions. However, the relationship between the group members of a Multi National Entity ("MNE") group differs from the one that unrelated parties would have while operating on the open market. The usage of special conditions in the intra-group relations may affect the correct application of the arm's length principle, which the OECD member countries have adopted in order to eliminate the differences in the levels of profit within members of the MNE group while applying this special conditions to the intra-group transactions.¹

On the other hand, OECD had adopted the Model Tax Convention on income and on capital ("MTC"), having the Article 9 as being a guiding principle determining the arms length principle for transfer pricing purposes. As per Article 9 of the OECD Model Tax Convention, where the conditions made or imposed between two associated enterprises differ from those that would be made between independent enterprises, then any profits that would, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.² The latter is applicable to profits attributable to the group entities with regard to development and use or transfer of intangibles. However, Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, but any further details with regard to transfer pricing issues are not being discussed within the OECD Model Tax Convention, but by the OECD TPG.³ The OECD member states have chosen these international taxation principles to serve the purpose of both securing the appropriate tax base in each jurisdiction and avoiding double taxation, aiming to solve or at least minimize any conflict between the MNE's and the tax authorities, supporting the international trade.

In applying the foregoing principles to the taxation of MNEs, the establishment of the appropriate transfer prices within the intra-group transactions is considered to be the most difficult issue.⁴ The increase of the global economy has affected the importance of MNE groups by uprising significant issues related to transfer pricing that the MNE's and tax administrations around the globe have to manage. The resolution of the transfer pricing issues may be deemed dependent on a solid understanding of the facts and the specific context of each separate case, and it may be relevant for settling down the disputes between the MNE's and the tax administrations frequently involving large amount of tax that may or may not be

¹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010

² OECD (2010) *Model Tax Convention on Income and Capital Full Version 22 July 2010*; Article 9

³ OECD (2010) *Commentary on the OECD Model Tax Convention on Income and Capital*; Comments on Article 9 of the OECD MTC

⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; para. 11

due to be paid.⁵ On one hand MNE groups fear double taxation with regard to transfer pricing adjustments and on the other hand, may choose the manner of allocation of global profits by organizing their internal functions which may result in minimizing the tax due.⁶

Putting the issue in a broader perspective, the disputes between the tax authorities of different countries would potentially lead to possible double taxation of the corporate profits of the MNE groups, which may lead to decreased level of international trade and eventually decreased global tax base and tax revenues. In this view, it is of an importance that countries agree on increasing the harmonization of their legislation with the principles established by OECD, but also to achieve agreement with regard to dispute resolution.⁷

The key concern area identified by OECD was the definition, identification and valuation of intangibles for transfer pricing purposes and insufficient international guidelines within the area has been detected.⁸ In this regard, the identification of the parties that would be entitled to the return derived from intangibles, respectively the intangible related returns, is deemed to be one of the crucial aspects in determining the arm's length conditions within a MNE group. Following a transaction within MNE group members, determining the legal owner of a legally protected asset is an issue that needs to be put light on, despite that in case of an MNE group is possibly the lease complicated. However, not only the legal owner of an intangible is entitled to intangible related returns, at arm's length, with regard to the development or exploitation of that intangible, especially because the other party might have incurred significant risk and expenses related to the development of an intangible or the enhancement of its value.⁹ As per Article 9 of the OECD MTC each associated enterprise should obtain an arm's length share in the benefits derived from the intangible. In determining the arm's length share an agreement of independent parties in comparable situation should be considered.¹⁰ Therefore not only the legal ownership of the intangible should be taken into a consideration, but also the "economic ownership" arising from the development or exploitation of an intangible should be considered for the appropriate attribution of the economic benefits.¹¹

The OECD performs periodical updates to the TPG and the major revision has been completed in 2010. Clearer guidelines on transfer pricing of intangibles could overcome the uncertainty for both MNE's and tax authorities.. In January 2011, the OECD Committee on Fiscal Affairs approved a scoping document for a new project looking at the transfer pricing aspect of intangibles. Further, on 6 June 2012, the OECD published the Discussion Draft "Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions", containing amongst other a proposed revision of Chapter VI of the TPG¹² The transfer pricing aspect of the transactions involving intangibles between associated enterprises are to be examined in the scope of the arm's length principle

⁵OECD (2012),*Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264169463-en>

⁶ OECD (2012), *Dealing Effectively with the Challenges of Transfer Pricing*, OECD Publishing.
<http://dx.doi.org/10.1787/9789264169463-en>

⁷ Andrea Musselli and Donatella Marchetti Hunter; *Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issue*; INTERNATIONAL TRANSFER PRICING JOURNAL MAY/JUNE 2007 pg.165

⁸ OECD (2011), *Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011*; point 1

⁹ *Ibid.* point 23

¹⁰ *Ibid.* point 24

¹¹ *Ibid.* point 25

¹² *Ibid.* point 4

set out by Article 9 of the OECD MTC.¹³ In order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis: "(i) the identification of specific intangibles; (ii) the identification of the party(ies) that should be entitled to retain the return derived from the use or transfer of the intangibles; (iii) the nature of the controlled transactions and whether they involve the use of intangibles and/or lead to the transfer of intangibles between the parties; and (iv) the remuneration that would be paid between independent parties for the use or transfer of such intangibles".¹⁴ In June 2012 OECD published a Discussion Draft "Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions" ("Discussion Draft"). The latter emphasizes the issue of the parties entitled to retain the revenue deriving from intangibles provided through the concept of intangible related returns.

1.2 Purpose

Transactions concerning intangibles, respectively intellectual property are playing an increasingly significant role, and consequently require special attention regarding the identification, valuation and transfer of intangibles for its tax treatment within the transfer pricing context. When determining the arm's length conditions, the transfer pricing aspects of intangibles may be guided following four parts, respectively the identification of intangibles, the identification of parties entitled to the intangible related returns, the determination of whether the controlled transaction involves the use or transfer of intangibles, and the remuneration to the parties entitled to the intangible related returns.¹⁵ The purpose of this thesis is to identify and discuss the issues with regard to the entitlement of the income arising from the development and use or transfer of the intangible property within the MNE group members. The application of the arm's length principle with regard to allocation of the benefits as provided within the Art. 9 of the OECD MTC will be considered. Following the importance of the future enhancement of the harmonization of the legislation of the countries with the OECD principles, the OECD documents will be considered, especially the Chapters I-III, VI, VIII and IX of the OECD TPG, as well as the Discussion Draft with regard to Chapter VI will be observed in order to determine whether they provide for provisions that may be deemed useful with regard to the entitlement to intangible related returns concept and for consistency with regard to it.

1.3 Method and Materials

1.3.1 Method

The TPG in their current version do not provide for a specific guidance for determining which members of the MNE group are entitled to intangible related returns. Neither the special provisions of Chapter VI "Special Considerations for Intangible Property" of the TPG provide so. However, following the specific concepts introduced within the TPG,

¹³ *Ibid.* point 9

¹⁴ OECD (2012), *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*; para. 4

¹⁵ *Ibid.*

certain guidance may be found in Chapters I-III of the TPG, Chapter VIII "Cost Contribution Arrangements" of the TPG and Chapter IX "Transfer Pricing Aspects of Business Restructurings" of the TPG.

Within this thesis the Transfer Pricing Guidelines in the current version will be studied in relation to the entitlement to intangible related returns, having the Discussion Draft as a sideline guide introducing some possible issues that may be relevant to intangible related returns, following that it does not represent a complete draft nor constitutes a part of the Transfer Pricing Guidelines. A significant issue of the entitlement to intangible related return of an enterprise over an intangible that does not own has been considered within the Discussion Draft, introducing the concept of economic ownership, in opposition to the legal ownership over the intangible.¹⁶ The legal ownership, including the registration and the contractual agreements are the starting point for determining of the members of the MNE group entitled to intangible related returns. Further, the actual conduct of the parties is to be considered, following the concept of economic ownership. The parties performing the functions and bearing the risks, as well as bearing the costs related to the development, enhancement, maintenance and protection of the intangibles are entitled to obtain profits attributable to intangibles. However, passive bearing of costs related to the development, enhancement, maintenance and protection of a party does not create entitlement to intangible related returns.¹⁷ References will be drawn to Chapters I-II, VI, VIII and IX of the TPG, as well as to Article 9 of the OECD MTC. Secondary sources such as articles and doctrine will be used in order to support the thesis.

1.3.2 Legal value of the OECD documents

The OECD Model Tax Convention¹⁸ as per its legal value is commonly referred to as "soft law" and is not a binding legal act. However, numerous of the OECD member countries following the intention of eliminating double taxation, when concluding the bilateral conventions, conform with the provision of the OECD MTC.¹⁹ Even more, such practice has been extended over the non- OECD member countries as well by using the OECD MTC as a basic document of reference.²⁰ By conclusion of the bilateral treaty it becomes a legally binding document for both of the contractual parties. Following the above, the Commentaries on the provisions of the MTC has facilitated the enforcement and the interpretation of the OECD MTC provision themselves, between the bilateral tax treaty parties.²¹ Departing from the OECD MTC is not excluded by any meanings, however should the parties decide to follow the provisions of the MTC it might be useful for both parties to follow the interpretation as given by the Commentaries. The enforcement and the interpretation is considered to be important part towards the harmonization of the bilateral conventions, and therefore the "naked" application of the MTC provision would be incomplete if the

¹⁶ OECD (2011), *Transfer Pricing and Intangibles: Scope of the OECD Project 2011*, Document approved by the Committee of Fiscal Affairs on 25 January 2011; para. 23

¹⁷ OECD (2012), *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*; preface to Chapter B

¹⁸ OECD (2010) *Model Tax Convention on Income and Capital Full Version 22 July 2010*

¹⁹ OECD (2010) *Commentary on the OECD Model Tax Convention on Income and Capital*; Introduction para.13

²⁰ OECD (2010) *Commentary on the OECD Model Tax Convention on Income and Capital*; Introduction para.14

²¹ OECD (2010) *Commentary on the OECD Model Tax Convention on Income and Capital*; Introduction para.15

Commentaries, putting a light on the provisions, are not been followed. Therefore, the MTC and the Commentaries may be deemed as being "one package".²²

Further to the Legal value of the OECD documents, the Transfer Pricing Guidelines have significant influence both on taxpayer and tax authorities, their application is not obligatory for the OECD member states and they do not have the status of a law. The aim of the OECD TPG is to support both taxpayers and tax administration by offering mutually acceptable solutions to transfer pricing problems and to lead to a consensus of the interpretation of the arm's length principle as provided in Article 9 of the OECD MTC.²³ The significance of the OECD TPG as a source of law is described in the Commentary on Article 9 of the OECD MTC:

"The Committee has spent considerable time and effort (and continues to do so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement."²⁴

With regard to the above, the TPG constitute an integral part of the Commentary on Article 9 of the OECD MTC. The Council laid down the application of the Commentary as an independent recommendation to the member countries; therefore, such recommendation would apply to the TPG as well. Thus, the TPG must be considered as having the same value as source of law as the Commentary for the purposes of applying and interpreting tax treaties²⁵ Even though, it is not binding under international law, the TPG along with the Commentary constitute a primary means of interpretation under Article 31 of the Vienna Convention (VCLT).²⁶

Following the above mentioned, despite its not binding legal value, the MTC with the Commentaries, as well as the TPG are broadly used and aim toward harmonization on the way to elimination double taxation, and therefore would be considered in this thesis.

On the other hand, the Discussion Draft presented by OECD does not represent a complete draft nor constitutes a part of the Transfer Pricing Guidelines. However, together with the Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011, it does represent the intention of the OECD towards introducing updates with regard to the guidance in the area of intangibles within the TPG.²⁷ Thus, the Discussion Draft will be used only as a sideline guide introducing some possible issues that may be relevant to intangible related returns.

²² IBFD, "The Legal Status of the OECD Commentaries" 2008 pg.22-23

²³ Jens Wittendorff, "Transfer Pricing and the Arm's length principle in the International Tax Law" Kluwer Law International 2010, pg. 247

²⁴ OECD (2010) *Commentary on the OECD Model Tax Convention on Income and Capital*; Commentary on Article 9 para.1

²⁵ Jens Wittendorff, "Transfer Pricing and the Arm's length principle in the International Tax Law" Kluwer Law International 2010, pg. 246

²⁶ *Ibid.*

²⁷ OECD (2011), *Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011*; para. 8

1.4 Delimitations

This thesis is limited to the legal perspective of transfer pricing and intangibles and does not investigate any in depth valuation of intangibles nor different methods that are possible to be applied when calculating the arm's length prices.

Despite the high importance of the issues arising from the "Interest and Royalty" Directive²⁸ and transfer of royalties,²⁹ the thesis does not investigate in depth any problems that might arise when allocating royalties nor does examine the Article 12 of the OECD MTC. However, some aspects relevant to the entitlement to intangible related returns might be considered.

The thesis will not include separate investigation of any national legislation. The focus is being put on the OECD TPG and any possible amendments to it with regard to entitlement to intangible related returns. The proposed definition of intangibles will be discussed; however, it will not address all the problems related to it. The Article 9 of the OECD MTC will be considered.

1.5 Definitions

Arm's length principle is international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention.³⁰

An **"associated enterprise"** is an enterprise that satisfies the conditions set forth in Article 9, sub-paragraphs 1a) and 1b) of the OECD Model Tax Convention³¹

Multinational enterprise group (MNE group) is a group of associated companies with business establishments in two or more countries.³²

Multinational enterprise (MNE) is a company that is part of an MNE group.³³

Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises³⁴

²⁸ Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states

²⁹ See Cécile Brokelind, *Royalty Payments: Unresolved Issues in the Interest and Royalties Directive*, EUROPEAN TAXATION MAY 2004, pg. 252-258; Sandra Martinho Fernandes, Roberto Bernales, Suat Goeydeniz, Bob Michel, Oana Popa and Emanuela Santoro; *A Comprehensive Analysis of Proposals To Amend the Interest and Royalties Directive – Part 2*; EUROPEAN TAXATION NOVEMBER 2011; pg. 445 - 464

³⁰ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; Glossary, pg. 23

³¹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; para. 11

³² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 Glossary; page 27

³³ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; Glossary; page 27

³⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; para. 11

1.6 Outline

Chapter 2 of the Thesis points out some aspects of the definitions or lack of definitions of intangibles and aim to present the concept of intangible related returns and the entitlement to it. Potential issues that arise from the definitions are presented.

Chapter 3 describes the relation between the arm's length principle as provided within Article 9 of the OECD MTC and the entitlement to intangible returns. Following the arm's length principle as provided in Article 9 of the OECD MTC, the economic substance of the transaction should be considered, as well as the control over the important functions in order to provide for entitlement to intangible related return.

Chapter 4 aims to present the factors relevant to the entitlement to intangible related returns and the potential conflict between some of the existing provisions of the TPG and the concept of entitlement to intangible related returns.

Chapter 5 provides for the transfer pricing issues related to intangible related returns, containing the OECD approach towards the concept and aims to discuss the identified problems that may arise from the concept.

Chapter 6 contains the conclusion of a necessity for further guidance with regard to the entitlement to intangible related returns concept.

2 Definitional aspects of intangibles

2.1 General comments

The lack of proper definition of intangibles, and consequently their identification has been to some extent a cause for numerous transfer pricing disputes. The current version of the OECD TPG does not contain a definition of 'intangibles' for transfer pricing purposes. However, the Discussion draft provides for such a definition.³⁵ Despite that the term intangible property might be considered to be more precise, within this thesis the term 'intangible' will be used as referring to intangible property. The term 'property' *inter alia* refers to something that is owned or is capable of being owned, and the definition of the intangibles, as provided with the Discussion Draft, refers to something that "is capable of being owned or controlled for use in commercial activities"³⁶.

Further, another controversial issue for transfer pricing purposes is to determine the parties that are entitled to intangible related returns. In order to be able to discuss this issues, it is of an importance to understand the concept of intangible related returns following the aim of OECD to provide for a certain definition of the term. The OECD scoping document favours the concept of economic ownership over the legal ownership, but imposing a right of an enterprise to economic benefits derived from an intangible that does not own. However, the Discussion draft does not by any means disregard the legal ownership and the compensation should be based on the arm's length principle in accordance with the Article 9 of the OECD MTC.³⁷

2.2 Definition of intangible

The importance of shedding some light on the notion of intangibles is highly important for transfer pricing purposes. The tax authorities might and in practice usually are intrigued by differences in the profit of MNE's, without there being an empirical evidence available to explain this.³⁸ The identification and the clear definition of intangibles are of an importance for MNE's in order higher earnings to intangibles to be attributed to a specific member of the MNE. However, the concept of intangibles following their specific nature creates problems in practice.³⁹ There have been various attempts for defying the term intangible property, all made dependant of the area of one's interest, the purpose of the definition, as well as the

³⁵ OECD (2012), *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*; para. 5

³⁶ OECD (2012), *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*; para. 5

³⁷ Loek Helderma and Eduard Sporken; *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; *International Transfer Pricing Journal*, 2012 (Volume 19), No. 6; pg. 385

³⁸ Isabel Verlinden and Yoko Mondelaers; *International Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*; Issue: *International Transfer Pricing Journal*, 2010 (Volume 17), No. 1; pg.49

³⁹ Isabel Verlinden and Yoko Mondelaers; *International Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*; Issue: *International Transfer Pricing Journal*, 2010 (Volume 17), No. 1; pg.50

country where one is located. That makes the categorization of the intangibles rather unclear.⁴⁰

"The TPG currently do not contain a definition of 'intangibles' for transfer pricing purposes."⁴¹ The identification of intangible property as presented in paragraph 6.2 of the TPG is that the term "includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets." Such identification made by descriptive listing of the most common types of intangibles as seen in paragraph 6.2 of the TPG could be insufficient and rather limited and could not replace a definition of intangibles. The latter description embraces commercial intangibles, which may be categorised as (i) trade intangibles, created through research and development (R&D) activities⁴² and (ii) marketing intangibles, containing "trademarks and trade names that support the marketing of a product or service customer lists, distribution channels, unique names, symbols or pictures which are valuable for marketing of the company's products."⁴³ Not only that intellectual property sometimes cannot be categorised in one of the categories, but also it could be challenging to categorize the income arising from one or the other category of intangible.⁴⁴

Contribution to the definition of intangibles within the Discussion draft, the OECD provides for intangibles as being "something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities".⁴⁵ In a matter involving intangibles for transfer pricing analysis the determination of the third party conditions should be applied, rather than focusing on legal or accounting definitions.⁴⁶

The OECD states the obvious, that intangibles for transfer pricing purposes are not always recognized as intangible assets for accounting purposes.⁴⁷ The value of an intangible is not always reflected into the balance sheet as sometimes costs related to creation of intangibles are expensed rather than capitalised for accounting purposes. The value of an item and the returns that should be attributed to it is affected by the availability and extent of legal, contractual, or other forms of protection.⁴⁸

⁴⁰ Isabel Verlinden and Yoko Mondelaers; *International Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*; Issue: International Transfer Pricing Journal, 2010 (Volume 17), No. 1; pg.50

⁴¹ OECD (2011), *Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011*; para. 12

⁴² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter VI, par 6.3.

⁴³ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter VI, para. 6.4.

⁴⁴ Isabel Verlinden and Yoko Mondelaers; *International Transfer Pricing Aspects of Intangibles: At the Crossroads between Legal, Valuation and Transfer Pricing Issues*; Issue: International Transfer Pricing Journal, 2010 (Volume 17), No. 1; pg.52

⁴⁵ OECD (2012), *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*; para. 5

⁴⁶ *Ibid.*

⁴⁷ OECD (2012), *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*; para. 6

⁴⁸ OECD (2012), *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*; para. 7

2.3 Definition of intangible related returns

A compensation for the *contribution* to the value of intangibles of the various functions, assets and risks of the members of the MNE group should be consistent with the intangible value they create. The intangible related returns are identified as returns that should follow the contribution to the value of intangibles.⁴⁹

The intangible related return to a particular intangible is defined as *economic return* from business operations involving the *use* of intangible remaining after deduction of costs and routine returns. In fact, the costs and expenses related to the business operations and returns to business functions, assets other than the particular intangible and risks taking into account appropriate comparability adjustments should not be considered when calculating the intangible related returns.⁵⁰

The intangible related returns following the contribution to the value of intangibles has not been directly addressed within the TPG. The contributions have been regarded in Chapter II of the TPG in the contribution analysis used in the profit – split method where the profits are divided based upon the relative value of the function performed, assets used and risks assumed by each member of the MNE group, following the arm’s length principle.⁵¹ However, determining the value of the contribution that each of the associated enterprises make to the controlled transaction is challenging.⁵² Chapter VI of the TPG provides for guidance on determining the arm’s length consideration for intra-group transfer of intangible property however, does not discuss the contribution to the value of intangibles by the members of MNE group.⁵³ The share of rights in the developed property has been discussed within the Cost Contribution Agreement (CCA) Chapter VIII of the TPG, whereas the most frequently encountered type of CCA is the one for joint development of intangible property. The separate rights obtained may constitute actual legal ownership over the intangible or economical ownership when all the participants are co-owners while one of the participants is the legal owner.⁵⁴ Under the arm’s length principle, the value of each participant’s contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances.⁵⁵ The application of the arm’s length principle would take into account, the contractual terms and the economic circumstances, e.g. the sharing of risks and costs.⁵⁶

⁴⁹ OECD (2012), *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*; preface to Chapter B

⁵⁰ OECD (2012), *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*; para. 28

⁵¹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; para. 2.119

⁵² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010; para 2.120

⁵³ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 Chapter VI

⁵⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 para 8.6

⁵⁵ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 para. 8.14

⁵⁶ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 para 8.14

The term 'contribution' to the value of the intangible as used in the preamble of the Discussion Draft is rather vague, despite its potential significance. As presented in the paragraph above, some overlapping relationship with the use of the term 'contribution' is to be found in Chapter II of the TPG referring to the profit split method and in Chapter VIII of the TPG referring to the cost contribution agreements.

In the context of Chapter II of the TPG, a 'contribution analysis' used in the profit – split method where the profits are divided based upon the relative value of the function performed, assets used and risks assumed by each member of the MNE group, following the arm's length principle. This provision provides for certain consistency with the intangible related returns concept, as the profit split method is suited for situations where both parties contribute valuable intangibles and it is highly unlikely that this contributions will not achieve the threshold criteria for returns from intangibles as seen by Section B of the Discussion Draft.⁵⁷

At its current version Chapter VIII provides for cash contributions in the intangibles developed following a CCA that will potentially result in effective ownership interest.⁵⁸ However, cash contributions will not fully satisfy the intangible related returns concept. Contribution in limited sense may imply to simple bearing of costs.⁵⁹ Section B of the Discussion Draft highlights that simple bearing of costs does not give the party entitlement to intangible related return, and gives importance to the functions performed, assets used and risks borne.⁶⁰ However, even the functions, assets and risks may not by themselves lead to intangible related returns unless they are considered relevant for creating a value to the intangible and are seen as a contribution themselves.⁶¹ Thus, the need for further clarifications of the term contribution would be required in order to shed some light on the intangible related return concept.

As per the guidance provided by the Discussion Draft, an attempt to define the attribution of returns to intangibles has been made. However, some interpretation issues may arise. The term 'economic return' is rather new in the TPG and most likely applies to the profit or loss attributable of particular intangible, but that is not clearly stated.⁶²

The definition also, refers only to the use of intangibles, but not to their transfer. It may suggest that the attribution of intangible related returns should only refer to transactions involving the use of intangibles where there is not transfer; however that will leave the issue of transfer transactions pending when it comes to attribution of intangible related returns. The

⁵⁷ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012; pg.108

⁵⁸ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 para 8.4

⁵⁹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; July 2010 Chapter VIII

⁶⁰ OECD (2012), *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*; part B

⁶¹ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012; pg. 108

⁶² OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012; pg.271

returns with respect to an intangible may be positive, negative, or zero.⁶³ The assessment of entitlements to intangible related return should be made in an objective manner, irrespective of whether it leads to the sharing of a profit or loss, following that the practice in loss-making situations some tax authorities claim that a guaranteed profit should be attributed to a member of a MNE group.⁶⁴

2.4 Entitlement to intangible related returns

The concept of intangible related returns suggests that such returns should follow the contributions to the value of the intangibles, as mentioned in the point 2.3 of this Thesis. The concept may be omitted by following the approach to requiring the various functions, assets and risks of the MNE members to be consistent with the intangible value they create.⁶⁵

According to the OECD, when determining which members of the MNE group are entitled to intangible related returns, the following factors should be considered: (i) the legal contractual terms (ii) the alignment of functional contributions with the legal rights and (iii) whether services rendered within the MNE group in relation to developing, enhancing, maintaining and protecting intangibles are compensated on arm's length basis.⁶⁶

Having the definition of intangibles as 'capable of being owned and controlled' and the concept of intangible related returns in mind, there are 'concepts' than need to be further considered as may be deemed relevant for the entitlement to intangible related returns.

The 'concept of ownership' embraces both legal and economic ownership. Identifying the owner of the intangibles is the first step to determine the arm's length transfer prices, but also may reflect the entitlement to the economic benefits arising from the intangible. The TPG do not provide for clear guidance with regard to establishing the owner of the intangibles. However, they stress the importance of the ownership over the legal rights of the intangibles, managed by contracts and licenses, and the ownership related to the contribution to the development of high-value intangibles made by members of the MNE group, legal ownership and economic ownership, accordingly.⁶⁷ The legal ownerships in terms of the contractual agreement, which illustrates the intention of the contracting parties of the ownership allocation, should be the starting point to the ownership analysis. With respect to intangibles that can be registered or protected, the ownership as manifested in those registers usually corresponds to the ownership as provided within the contractual agreement. However, the MNE group member entitled as a registered owner is by far of a less importance between the

⁶³ OECD (2012), *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*; para. 28

⁶⁴ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012; pg. 61

⁶⁵ OECD (2012), *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*; preface to chapter B

⁶⁶ OECD (2012), *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* para.29

⁶⁷ Giammarco Cottani, *Valuation of Intangibles for Direct Tax and Customs Purposes: Is Convergence the Way Ahead?*; INTERNATIONAL TRANSFER PRICING JOURNAL SEPTEMBER/OCTOBER 2007 pg. 286

members of the group, unlike it is between unrelated parties. Consequently, the registration as a manifest for the legal ownership is not necessarily as strong within the group.⁶⁸

The 'economic ownership' follows the contribution to the development of the intangibles, and the return of such contribution is obtained in addition to any functional activity performed. The parties performing and controlling part or all the functions and bearing or controlling part or all of the risks, will be entitled to part or all of the intangible related returns.⁶⁹ This implies that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitle an entity within an MNE group to retain the benefits or returns with respect to intangibles. The latter has been provided within the Discussion draft as well.⁷⁰ Such view of the legal ownership and bearing of the costs tends to depart from the arm's length principle and Chapter IX of the TPG.⁷¹ On one hand, the OECD provides for the importance to consider which entities have born the relevant costs, when evaluating the entitlement to intangible related returns, and on the other hand, when it comes to the development, enhancement, maintenance and protection of intangibles bearing the costs, in and of itself, does not create an entitlement to intangible related returns. Nevertheless, the costs incurred within the development, enhancement, maintenance and protection of intangibles should play an important role.⁷²

The legal ownership over the intangible should be respected unless it clearly deviates from the 'economic substance' of the transaction and the conduct of the parties. In cases of such deviation from the legal arrangement, the objective should be to determine what a reasonable allocation between unrelated parties would be in the respective circumstances. In effect, similarities can be withdrawn from the allocation of risks concept and the allocation of intangible related returns, expressing the need for balance between peoples functions and capital, cost bearing and legal ownership.⁷³ The risk allocation is a significant part of the functional analysis and has already been established within the provisions of Chapter IX of TPG.

The 'concept of control over the functions' is considered relevant for the entitlement to intangible related returns. The concept of control implies to key decision making and risk taking activities. Following a quite extensive description the Discussion Draft in some cases points to physically performing certain key functions, as well as listing examples that demonstrate a capacity to make strategic decisions, “design”, “control” and “manage” key functions such as R&D programs and related budgets, “protect” the rights in intangibles, and

⁶⁸ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 245

⁶⁹ Loek Helderma and Eduard Sporken, *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; International Transfer Pricing Journal, 2012 (Volume 19), No. 6; pg 385

⁷⁰ OECD (2012), *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*; preface to Section B

⁷¹ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.57

⁷² Loek Helderma and Eduard Sporken; *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; International Transfer Pricing Journal, 2012 (Volume 19), No. 6; pg 385

⁷³ Caroline Silberstein, Mary C. Bennett, Gregg D. Lemein, *The OECD Discussion Draft on the Transfer of Intangibles (Revision of Chapter VI of the OECD Transfer Pricing Guidelines) – Detailed Comments*, Klower Law International BV, The Netherlands, INTERTAX Volume 4, Issue 2, pp. 69

maintain quality control over others that have been delegated to implement decisions and perform functions in a subordinate role.⁷⁴ The draft proposes that although the costs incurred to perform those important functions regarding intangibles should be borne by the parties claiming entitlement to the intangible-related returns, the ‘bearing of the costs related to the development, enhancement, maintenance and protection of the intangibles does not, in and of itself, create an entitlement to intangible returns.’ Such perception of the cost bearing may depart from the arm's length principle.

In short, as per the OECD, a member of an MNE group is to be entitled to intangible related returns if in substance: (i) performs and controls important functions related to the development, enhancement, maintenance and protection of the intangibles; (ii) bears the risks and costs related to developing and enhancing the intangible and (iii) bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.⁷⁵ However, the concept of intangible related returns as presented within the Discussion Draft does not make a clear difference between the entitlement to intangible related returns from intangibles already developed and the entitlement to intangible related returns from new intangible development. The entitlement to returns from fully developed intangibles subsequently transferred in an arm's length transaction is mostly unclear and misleading.

⁷⁴ OECD (2012), *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* para. 40-41

⁷⁵ Loek Helderma and Eduard Sporken; *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; *International Transfer Pricing Journal*, 2012 (Volume 19), No. 6; pg 385

3 The Arm's length principle and Intangible related returns

3.1 General comments

In order to successfully apply the arm's length principle to transactions related returns arising from intangibles, assessment to what unrelated parties do or would have done in comparable circumstances should be considered. Following the arm's length principle as provided in Article 9 of the OECD MTC, the economic substance of the transaction should be considered, as well as the control over the important functions in order to provide for entitlement to intangible related return.

3.2 The arm's length principle

The arm's length principle as provided within the TPG is an international transfer pricing standard set forward in the Article 9 of the OECD MTC.⁷⁶ The Arm's length principle has been defined as:

*" [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."*⁷⁷

When associated enterprises tract with each other, the possibility to determine prices of goods or services may not be directly influenced by the market forces and therefore may deviate from the actual market prices, which is unlikely to happen between independent parties. However, that does not by default imply that associated enterprises have sought to manipulate their profits as there may be a genuine difficulty to determine the actual market price in the absence of market forces between associated enterprises.⁷⁸

This general guidance of the arm's length principle apply for determining the transfer prices between associated parties for intangibles as well, however the practice has shown that in the case of intangible related transactions it is challenging for the arm's length principle to be applied.⁷⁹

When examining if certain transaction is at arm's length, the tax administration should regard the actual transaction undertaken. Only in extraordinary circumstances the transaction may be

⁷⁶ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter I para 1.1

⁷⁷ OECD (2010) *Model Tax Convention on Income and Capital Full Vertsion 22 July 2010*, Article 9.1.

⁷⁸ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter I, par 1.2

⁷⁹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter VI, par 6.13

re-characterized by the tax administration.⁸⁰ The terms of the contract play a major role into determining the actual transaction undertaken, but may not suffice to prove it.⁸¹ The contractual allocation of entitlement to intangible related returns despite the contractual terms and registrations being in accordance with the functions, risks and costs, may be disregarded by the tax authorities, which may potentially lead to double taxation or double non-taxation⁸²

3.3 Intangible related returns at arm's length

The interpretation and implementation of the arm's length principle as set out in Article 9 of the OECD MTC is and should be supported by the provisions of the TPG. Departure from the arm's length principle would create certain legal concerns regarding the application of the TPG in interpreting bilateral tax treaties and increase the risk of potential double taxation. When it comes to dealing with allocation of intangible related returns, neither the current version of the TPG nor the Discussion Draft to Chapter VI provide for a clear reference to what independent parties would do, that would guide MNE's and tax authorities for implementation of the arm's length principle. Furthermore, when analysing the Discussion Draft text, despite the clear statement that "does not reflect an intention to depart from the principles of Article 9"⁸³, it may be interpreted as departing from the arm's length principle, following the proposition that the ownership and bearing the costs of the development of the intangible cannot be determining factors in allocating intangible related returns without the performance of, or control over, functions related to the activities of development, enhancement, maintenance and protection of the intangible.

The transactions between unrelated parties regarding legal ownership and function control could establish balance to transaction between associated parties, by providing guidance with regard to the issues concerning entitlement to intangible related returns. The starting point to analysing transactions is to certain extent developed in Chapter IX of the TPG when referring to the allocation of risks. A two step process for ascertaining the arm's length allocation of risks is been developed including: (i) determining the alignment of the economic substance with the contractual terms and (ii) determining if the arrangements would have been adopted by independent enterprises in comparable situations.⁸⁴ The economic substance concept is relevant for the arm's length principle and with regard to the intangible related returns should follow the provisions of the TPG as provided in paragraphs 1.64-1.69. Further, the factors than need to be considered when determining the arm's length principle should be the ability to control and bear the risks. If there is a reliable evidence of an allocation of intangible related returns between unrelated parties it should be considered into such allocation between

⁸⁰ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter I, par 1.64 - 1.69

⁸¹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter IX, par 9.164

⁸² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter IX, par 9.164 - 9.167

⁸³ OECD (2012), *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*; preamble to Section B

⁸⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter IX, par 9.169.

ssociated enterprises. Only in case when such evidence could not be provided, the intangible related returns may be assessed by the relevant factors as set out above.⁸⁵

In short, introducing a clear reference to what independent parties would do in comparable circumstances regarding allocation of intangible related returns might be needed and it should be linked to evidenced allocation of intangible related returns between unrelated parties. In case of a absence of such evidence, the allocation that would have been expected to be performed should be considered; respectively the performing of the functions, bearing the risks and the costs should be considered.

⁸⁵ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.349

4 Factors relevant to the entitlement to intangible related returns

4.1 General comments

According to the OECD, the key factors when determining the entitlement to intangible related returns are (i) the legal contractual terms (ii) the alignment of functional contributions with the legal rights and (iii) whether services rendered within the MNE group in relation to developing, enhancing, maintaining and protecting intangibles are compensated on arm's length basis.⁸⁶

4.2 The terms of the legal arrangements

The analysis of the entitlement to intangible related returns should have the legal arrangements, respectively legal registrations and contractual arrangements, as a starting point of such entitlement.⁸⁷ However, the legal arrangements should not lack of economic substance of the transaction or the arrangement and the contractual relationship between the parties should be supported by their actual conduct.⁸⁸

4.2.1 Overview of relevant TPG provisions

Contractual arrangements are the starting point for determining which party to a transaction bears the risk associated with it.⁸⁹ The contractual terms generally define how risks are to be divided by the parties, and the examination of the risks in an Article 9 of OECD MTC context, starts from examination of the contractual terms.⁹⁰ Should the contractual terms not be stated in written, the contractual relationship of the parties must be deducted from their conduct and the economic principles that generally govern relationships between independent enterprises.⁹¹ The contractual allocation of risk should be consistent with the economic substance of the transaction.⁹²

Following the concept of intangible related returns, a related party may be entitled to intangible related returns should it incurred significant risk and expenses related to the development of enhancement of the value of the intangible, despite the fact of not being an owner of the intangible. The TPG provide for a support to the above with regard to marketing

⁸⁶ OECD (2012), *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*; para. 29

⁸⁷ OECD (2012), *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*; para.30

⁸⁸ OECD (2012), *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*; para.30

⁸⁹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Chapter XI para.9.11

⁹⁰ *Ibid.*

⁹¹ *Ibid.*

⁹² *Ibid.*

activities undertaken by enterprises that do not owe the trademarks or the trade names. In order to determine whether the marketer is entitled to intangible related returns, the rights and obligations implied by the agreement between the parties should be referred to.⁹³ In case where the distributor bears the costs for the marketing activities without them being reimbursed to him by the owner of the marketing intangible, has the right to share the benefits of the increased value of the intangible at arm's length based on the substance of the rights, which most commonly are defined in the agreement between the parties.⁹⁴ In such cases the legal ownership is not disregarded neither by the Article 9 of the OECD MTC nor by the TPG.

Tax authorities should not disregard the contractual terms and the actual transactions or substitute other transactions for them, in other than exception circumstances, such as where (i) the economic substance of a transaction (i.e. capital) differs from its form (i.e. loan) or (ii) while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.⁹⁵

4.2.2 Conclusion

The contractual arrangement, which illustrates the intention of the contracting parties of the ownership allocation, should be the starting point to the ownership analysis. With respect to intangibles that can be registered or protected, the ownership as manifested in those registers usually corresponds to the ownership as provided within the contractual agreement. However, the MNE group member entitled as a registered owner is by far of a less importance between the members of the group, unlike it is between unrelated parties. Consequently, the registration as a manifest for the legal ownership is not necessarily as strong within the MNE group.⁹⁶ Further, it is generally possible to identify which amongst the related parties is the legal owner of a legally protected asset. However, despite not being entitled with the legal ownership over the intangible, a related party may be entitled to intangible related returns should it incurred significant risk and expenses related to the development of enhancement of the value of the intangible.⁹⁷

Thus, the parties conduct should be in accordance with the contractual terms. For transfer pricing purposes, where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity that is entitled to use and to exclude other to use the intangible, is the one that is entitled to intangible related returns of the respective intangible.⁹⁸ The focus is given to the use of the intangible, respectively the entity which uses the intangible with regard to the entitlement to intangible related returns in case when the conduct of the parties is in alignment with the contractual arrangements. The conduct of the parties however is not sufficiently defined and may lead to re-characterization of a

⁹³ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 6.37

⁹⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 6.38

⁹⁵ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.65

⁹⁶ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012; pg. 245

⁹⁷ OECD (2011), *Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011*; para 23

⁹⁸ OECD (2012), *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*; para. 35

transaction at will by the tax authorities and eventually lead to double taxation or double non-taxation.

4.3 Alignment of functional contributions with legal rights

The Discussion Draft stresses the importance of the conduct of the parties and its alignment with the terms of the registrations or contracts for the purpose of evaluating which members of an MNE group are entitled to intangible related returns. In order for the conduct to be examined it is necessary the functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles to be considered.⁹⁹ Where the conduct of the parties is not in line with the contractual terms, all or part of the intangible related returns should be attributed to the entities that perform the functions, bear the risks and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles. Thus, a primacy has been given to the conduct of the parties.¹⁰⁰ In substance, the member of a MNE group will be entitled to intangible related return should it (i) perform and control important functions related to the development, enhancement, maintenance and protection of the intangible property and control other related functions performed by other parties that are compensated on an arm's length basis; (ii) bear and control the risks and costs related to developing and enhancing the intangible property; and (iii) bear and control risks and costs associated with maintaining and protecting its entitlement to intangible property-related returns.¹⁰¹

4.3.1 Overview of relevant TPG provisions

In examining the risk allocation between associated enterprises and its transfer pricing consequences, it is important to review not only the contractual terms but, amongst other, the conduct of the parties and whether it is in alignment with the contractual allocation of risks.¹⁰² The examination of whether the actual conduct of the related parties confirms to the terms of the contract is of importance following that in case of independent parties they will seek to hold each other to the terms of the contract.¹⁰³

The examination of risks in the context of the functional analysis is found at paragraphs 1.47-1.51 of the TPG. The examination of the arm's length of a transaction of the risk allocation should be compared to uncontrolled transaction in similar circumstances. Where no comparables are found where no comparables are found to support a contractual allocation of risk between associated enterprises, it should be determined whether that might be expected

⁹⁹ OECD (2012), *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*; para. 37

¹⁰⁰ Ibid.

¹⁰¹ OECD (2012), *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*; para. 54

¹⁰² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.12

¹⁰³ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.13

to be agreed upon between unrelated parties. The notion of control over risk and the financial capacity to assume risk has been developed by the TPG to serve the purpose of the latter.¹⁰⁴

A tax administration is entitled to challenge the alleged contractual allocation of risk between associated enterprises if it is not consistent with the 'economic substance' of the transaction. "A purported allocation of risk between associated enterprises is respected only to the extent that it is consistent with the economic substance of the transaction."¹⁰⁵ Therefore, the conduct of the parties should be examined to acknowledge whether it conforms to the risk allocation. However, the re-characterization of the actual transaction undertaken is limited to exceptional cases.¹⁰⁶ In such exceptional cases, "the examination of a controlled transaction ordinarily should be based on the transaction actually undertaken by the associated enterprises as it has been structured by them"¹⁰⁷.

On the other hand, the concept of 'economic ownership', despite the lack of precise definition, is introduced in relation to cost contribution arrangements, and may not always follow the legal ownership over the intangible that would result in a license or similar agreement. The cost contribution agreement for joint development of intangible property usually provides for separate rights to exploit the intangible property to each participant.¹⁰⁸ This separate rights may constitute an actual legal ownership, which would entitle one participant as a legal owner of the intangible, but economically all the participants are co-owners.¹⁰⁹

4.3.2 Conclusion

The legal ownership over the intangible should be respected unless it clearly deviates from the economic substance of the transaction and the conduct of the parties. In cases of such deviation from the legal arrangement, the objective should be to determine what a reasonable allocation between unrelated parties would be in the respective circumstances. The Discussion Draft gives primacy to the conduct of the parties, focusing on the physical performance through its own employees of the important functions related to the development, enhancement, maintenance and protection of the intangibles, in case when functions are in alignment with the claims to intangible related returns. In practice, however, such functions and activities between unrelated parties may be outsourced or subcontracted, with a clear legal arrangement of the ownership of the subsequently developed intangible.¹¹⁰ Not recognizing such right to associated enterprises would deviate from the arm's length principle and could potentially lead to double taxation.

The principles developed by Chapter IX of the TPG regarding the risks and control may be appropriate to be followed in case of the entitlement to intangible related returns. The concept of control of risks is proposed to be relevant when determining the party entitled to intangible

¹⁰⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.19 - 9.32

¹⁰⁵ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.166

¹⁰⁶ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.64-1.69

¹⁰⁷ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 9.168

¹⁰⁸ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 8.6

¹⁰⁹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 8.6

¹¹⁰ OECD (2012), *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*; pg. 8

related returns. This concept clearly states the importance of active control as a criterion for assessment of the entitlement to intangible related returns. In line with this, the Discussion Draft states that bearing costs related to the development, enhancement, maintenance and protection of intangible related returns does not, in and of itself, create an entitlement to intangible related returns”¹¹¹ This in a way shades some light over the intangible ownership, especially to the notion of economic ownership which tends to be in favour of the parties who have funded the intangible related costs.¹¹² It should be noted that the notion of control of risks as stated within the paragraph 47 of the Discussion Draft by large extent contradicts the basic principles of Cost Contribution Agreements, where the contributions made, entitle the party to share of the intangible related returns. In such case parties might not actively control the activities. Therefore, a clear distinction must be made between the active control over the intangible activity and the passive participants in the CCA, otherwise Chapter VIII of the TPG would be made inoperable.¹¹³

However, the specificity of the CCA by which each participant shares the expected benefits (determined ex-ante) in correlation with its contribution, may not be applied by analogy to the concept of entitlement to intangible related returns.¹¹⁴ In cases between unrelated parties, it is common that only one of the factors will be taken into consideration, and that is less likely to be the economics of the transaction as opposed to registrations held and contract entered into.¹¹⁵

In this context, when adopting the notion of control over risks certain caution should be taken in relation to the research and development activities, respectively the activities of creating intangible assets. Outsourcing of the research and development by way of contract R&D is done in practice between independent parties following the lack of competence of the principal to conduct such functions. In that sense, apart from some high management control, no other control over the could be established. Therefore, the meaning of the term control might be crucial. Despite the fact that the contractor/service provider is using its particular competence to decide how to reach the objectives outlined, should not influence the allocation of the intangibles for TP-purposes and the attribution of intangible returns.¹¹⁶

¹¹¹ OECD (2012), *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*; para. 47.

¹¹² OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 614

¹¹³ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 615

¹¹⁴ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.355

¹¹⁵ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.356

¹¹⁶ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 246

4.4 Arm's length compensation for services rendered

Determining whether certain types of activities result in an entitlement of intangible related returns or should receive an arm's length payment for the services provided is considered to be an important issue. Condition for concluding that the contractual and other arrangements of an MNE group are aligned with the conduct of the parties is that the parties that do not claim entitlement to intangible related returns, should be provided with an arm's length compensation for the functions they perform.¹¹⁷ An important issue in that sense is whether the marketer/distributor should be compensated as a service provider, i.e. for providing promotion and distribution services, or whether he should share in any present and future intangible related returns attributable to the trademarks and related intangibles.¹¹⁸ The analysis of this issue requires assessment of the obligations and rights implied by the legal registrations and agreements between the parties, of the functions undertaken, the risks assumed, the assets used, and the costs incurred by the parties, and of the compensation provided for the functions, risks, assets and costs of the marketer/distributor.¹¹⁹ The same principles apply to the performance of R&D functions by a member of an MNE group.¹²⁰

4.4.1 Overview of relevant TPG provisions

The expected return for performing distribution activities would differ in case the distributor overtakes the responsibility and bears the risk for marketing and advertising activities than the one where such responsibility is not undertaken. In the former the return would be expected to be higher. The distributor acting merely as an agent would usually be reimbursed for its costs and would be expected to receive income appropriate for its activity. Limited return would be provided to the contract manufacturer or researcher that do not bear any meaningful risk.¹²¹ For applying the arm's length principle to controlled transactions, the comparability analyses as provided within the paragraphs 1.33 - 1.37 should be considered. The comparability factors deemed important as per OECD include the (i) "characteristics of the property or services transferred", (ii) "the functions performed by the parties (taking into account assets used and risks assumed)", (iii) "the contractual terms", (iv) "the economic circumstances of the parties", and the (v) "business strategies pursued by the parties."¹²² The selection and the application of the most appropriate transfer pricing method is provided within Chapter II of the TPG and it should be considered for its application on a case by case basis.

¹¹⁷ OECD (2012), *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* para. 48

¹¹⁸ Loek Helderma and Eduard Sporken; *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; *International Transfer Pricing Journal*, 2012 (Volume 19), No. 6; pg. 385

¹¹⁹ OECD (2012), *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* para. 50

¹²⁰ OECD (2012), *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* para. 51

¹²¹ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.47

¹²² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.36

4.4.2 Conclusion

The situation is somewhat clear in case of an agent, controlled by the entity that is entitled to intangible related returns and being reimbursed for the activities performed as he does not bear or control the risks associated with the development of the trademark or other intangibles. Less obvious is a situation of a distributor. Entitlement to market share of the profits derived from the use of the trademark, will depend on the substance of the rights of the party, respectively the distributor may have the ability to obtain benefits made dependant of the functions performed, risks borne and costs incurred in the development of the value of the intangible. Such share of the profits does not lead to ownership over the marketing intangible, respectively it could not be by default translated into something capable of being owned and controlled.¹²³

The situation of intangibles developed through R&D is deemed to be more complex. However, Discussion Draft sheds more light on the type of activities that do not result in an entitlement to intangible property-related returns if the intangibles are developed through R&D activities for transfer pricing purposes. The entitlement to intangible related returns should be made dependent on case by case basis and should follow the way of independent parties operate at arm's length. The entitlement to intangible related return by no meaning should be considered as default, as it may be reflected as remuneration for manufacturing or charged as service provision.¹²⁴ In case when the parent company conduct all the research and development, and its wholly owned subsidiary performs the patent administration work, but has no technical personnel for R&D nor incurs any of the R&D expenses, it is not entitled to intangible related returns. In such case, the subsidiary is entitled to a payment for the services provided and not to intangible related returns because (i) neither bears nor controls risks related to intangible property development or enhancement; and (ii) it does not perform or control any functions related to intangible property development or enhancement and does not bear any expenses related to the development or enhancement of intangible property.¹²⁵

¹²³ Caroline Silberztein, Mary C. Bennett, Gregg D. Lemein, *The OECD Discussion Draft on the Transfer of Intangibles (Revision of Chapter VI of the OECD Transfer Pricing Guidelines) – Detailed Comments*, Klower Law International BV, The Netherlands, INTERTAX Volume 4, Issue 2, pp. 72

¹²⁴ *Ibid.*

¹²⁵ Rezan Okten; *A Comparative Study of Cost Contribution Arrangements: Is Active Involvement Required To Share in the Benefits of Jointly Developed Intangible Property?*; INTERNATIONAL TRANSFER PRICING JOURNAL JANUARY/FEBRUARY 2013

5 Transfer pricing issues related to intangible related returns

5.1 General comments

The introduction of the concept of entitlement to intangible related returns it may be deemed of an importance and it is to shed some light over the issues related to intangibles and the split of the profits arising from intangibles. This chapter attempts to canalize the OECD approach and point out the issues that may arise in relation to it, and canalize issues identified in the previous chapters of the thesis.

5.2 The OECD approach

Chapter VI is to provide guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles. The key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities.¹²⁶ Following the lack of definition of the term 'intangible' the OECD makes an attempt to define and shed some light over it, rather than focusing on accounting or legal definitions, the important transfer pricing issue would be the determination of the conditions agreed between unrelated parties. In that sense, the word 'intangible' is intended to address something which is not a physical asset or a financial asset capable of being owned or controlled.¹²⁷ The intangible related return to a particular intangible is defined as economic return from business operations involving the use of intangible remaining after deduction of costs and routine returns. In fact, the costs and expenses related to the business operations and returns to business functions, assets other than the particular intangible and risks taking into account appropriate comparability adjustments should not be considered when calculating the intangible related returns.¹²⁸ The functions performed, assets used, and risks assumed by the parties are deemed relevant for transfer pricing purposes. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more.¹²⁹

Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns and if such do not exist should be driven out of the conduct and the economic principles that generally govern

¹²⁶ OECD (2012), *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* para. 2

¹²⁷ OECD (2012), *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* para. 5

¹²⁸ OECD (2012), *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* para. 28

¹²⁹ OECD (2012), *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* preface to section B

relationships between independent enterprises.¹³⁰ For transfer pricing purposes, where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity that is entitled to use and to exclude other to use the intangible, is the one that is entitled to intangible related returns of the respective intangible.¹³¹ Where the conduct of the parties is not in line with the contractual terms, all or part of the intangible related returns should be attributed to the entities that perform the functions, bear the risks and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles. Thus, a primacy has been given to the conduct of the parties.¹³² When evaluating the alignment between a contractual claim to entitlement to all or part of the intangible related returns attributable to an intangible, and the conduct of the parties, examination of functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles is necessary.¹³³ In substance, the member of a MNE group will be entitled to intangible related return should it (i) perform and control important functions related to the development, enhancement, maintenance and protection of the intangible property and control other related functions performed by other parties that are compensated on an arm's length basis; (ii) bear and control the risks and costs related to developing and enhancing the intangible property; and (iii) bear and control risks and costs associated with maintaining and protecting its entitlement to intangible property-related returns.¹³⁴

5.3 Definitional aspects

The TPG currently do not contain a definition of 'intangibles' for transfer pricing purposes. The identification of intangible property as presented in paragraph 6.2 of the TPG is that the term "includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets." Such identification made by descriptive listing of the most common types of intangibles as seen in paragraph 6.2 of the TPG could be insufficient and rather limited and could not replace a definition of intangibles. The latter description embraces commercial intangibles, which may be categorised as (i) trade intangibles, created through research and development (R&D) activities and (ii) marketing intangibles, containing "trademarks and trade names that support the marketing of a product or service customer lists, distribution channels, unique names, symbols or pictures which are valuable for marketing of the company's products."

The definition of intangibles the Discussion Draft as stated above, is a very broad and does not attempt to define in detail all the potential classes or categories of intangibles. It also deviates from the term "intangible property" which has been settled with the current Chapter VI of the TPG, but however following that the intangible can be owned, controlled or transferred it in fact is a property. However, that is not clearly stated.

¹³⁰ OECD (2012), *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* para. 30.

¹³¹ OECD (2012), *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* para. 35

¹³² OECD (2012), *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* point 37

¹³³ OECD (2012), *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* para. 8-47

¹³⁴ OECD (2012), *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* para. 54

The intangible related return to a particular intangible is defined as economic return from business operations involving the use of intangible remaining after deduction of costs and routine returns. In fact, the costs and expenses related to the business operations and returns to business functions, assets other than the particular intangible and risks taking into account appropriate comparability adjustments should not be considered when calculating the intangible related returns.¹³⁵ The concept of intangible related returns should follow the contribution to the value of intangibles. However, the term 'contribution' to the value of the intangible as used in the preamble of the Discussion Draft is rather vague, despite its potential significance. Some overlapping relationship with the use of the term 'contribution' is to be found in Chapter II of the TPG referring to the profit split method and in Chapter VIII of the TPG referring to the cost contribution agreements.

5.4 Legal and economic ownership

Having the concept of intangible related returns in mind, the concept of legal/economic ownership should be further considered as may be deemed relevant for the entitlement to intangible related returns.

The legal ownerships in terms of the contractual agreement, which illustrates the intention of the contracting parties of the ownership allocation, should be the starting point to the ownership analysis. With respect to intangibles that can be registered or protected, the ownership as manifested in those registers usually corresponds to the ownership as provided within the contractual agreement. Within a MNE group it is possible that despite the contribution of more companies only one company retains the legal rights. Therefore, the MNE group member entitled as a registered owner is by far of a less importance between the members of the group, unlike it is between unrelated parties. Consequently, the registration as a manifest for the legal ownership is not necessarily as strong within the group.¹³⁶

Thus, for transfer pricing purposes the concept of economic ownership of a increasing importance. The concept of economic ownership, despite the lack of precise definition, is introduced in relation to cost contribution arrangements, and may not always follow the legal ownership over the intangible that would result in a license or similar agreement.¹³⁷ In that sense, the economic ownership follows the contribution to the development of the intangibles, and the return of such contribution is obtained in addition to any functional activity performed. The parties performing and controlling part or all the functions and bearing or controlling part or all of the risks, will be entitled to part or all of the intangible related returns.¹³⁸ However, the concept of economic ownership could not as simply be transferred to the concept of intangible related returns. An important issue in that sense is whether the marketer/distributor should be compensated as a service provider, or as a party entitled to intangible related returns. The analysis of this issue requires assessment, not only

¹³⁵ OECD (2012), *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* para. 28

¹³⁶ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 245

¹³⁷ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 8.6

¹³⁸ Loek Helderma and Eduard Sporken; *International Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*; *International Transfer Pricing Journal*, 2012 (Volume 19), No. 6; pg 385

to functions undertaken, the risks assumed, the assets used, but of the obligations and rights implied by the legal registrations and agreements between the parties and the costs incurred by the parties.

Not regarding the legal ownership and bearing of the costs tends to depart from the arm's length principle and Chapter IX of the TPG.¹³⁹ Clear reference to the position, that allocation of intangible related returns should be consistent with an allocation that was agreed upon two arm's length parties in the circumstances, should be provided to support the arm's length allocation between related parties. Without such reference the concept of economic ownership over the legal relationships, which may lead to potential re-characterization outside the strict guidance as provided with TPG (para. 1.64 – 1.69) and potentially lead to double taxation or double non-taxation.

5.5 Legal and economic substance

Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns and if such do not exist should be driven out of the conduct and the economic principles that generally govern relationships between independent enterprises.¹⁴⁰ However, the legal arrangements should not lack of economic substance of the transaction or the arrangement and the contractual relationship between the parties should be supported by their actual conduct.¹⁴¹

The legal ownership over the intangible should be respected unless it clearly deviates from the economic substance of the transaction and the conduct of the parties. In cases of such deviation from the legal arrangement, the objective should be to determine what a reasonable allocation between unrelated parties would be in the respective circumstances.

Tax authorities should not disregard the contractual terms and the actual transactions or substitute other transactions for them, in other than exception circumstances, such as where (i) the economic substance of a transaction (i.e. capital) differs from its form (i.e. loan) or (ii) while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner.¹⁴² When examining if certain transaction is at arm's length, the tax administration should regard the actual transaction undertaken. Only in extraordinary circumstances the transaction may be re-characterized by the tax administration. The terms of the contract play a major role into determining the actual transaction undertaken, but may not suffice to prove it. The contractual allocation of entitlement to intangible related returns despite the contractual terms and registrations being in accordance with the functions, risks and costs, may be disregarded by the tax authorities, which may potentially lead to double taxation or double non-taxation.

¹³⁹ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.57

¹⁴⁰ OECD (2012), *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* para 30.

¹⁴¹ OECD (2012), *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* para.30

¹⁴² OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* para. 1.65

5.6 Control of risks (functions)

In substance, the member of a MNE group will be entitled to intangible related return should it (i) perform and control important functions related to the development, enhancement, maintenance and protection of the intangible property and control other related functions performed by other parties that are compensated on an arm's length basis; (ii) bear and control the risks and costs related to developing and enhancing the intangible property; and (iii) bear and control risks and costs associated with maintaining and protecting its entitlement to intangible property-related returns.¹⁴³

The parties performing the functions and bearing the risks, as well as bearing the costs related to the development, enhancement, maintenance and protection of the intangibles are entitled to obtain profits attributable to intangibles. However, passive bearing of costs related to the development, enhancement, maintenance and protection of a party does not create entitlement to intangible related returns. The "concept of control over the functions" is considered relevant for the entitlement to intangible related returns. The concept of control implies to key decision making and risk taking activities. Following a quite extensive description the Discussion Draft in some cases points to physically performing certain key functions.

The starting point to analysing transactions is to certain extent developed in Chapter IX of the TPG when referring to the allocation of risks. The arm's length allocation of risks is also related to determining if the arrangements would have been adopted by independent enterprises in comparable situations.¹⁴⁴ The factors than need to be considered when determining the arm's length principle should be the ability to control and bear the risks. This concept might be useful with transactions involving intangibles. If there is a reliable evidence of an allocation of intangible related returns between unrelated parties it should be considered into such allocation between associated enterprises. Only in case when such evidence could not be provided, the intangible related returns may be assessed by other relevant factors.¹⁴⁵

It should be noted that the notion of control of risks by large extent contradicts the basic principles of Cost Contribution Agreements, where the contributions made entitle the party to share of the intangible related returns. In such case parties might not actively control the activities. Therefore, a clear distinction must be made between the active control over the intangible activity and the passive participants in the CCA, otherwise Chapter VIII of the TPG would be made inoperable.¹⁴⁶

¹⁴³ OECD (2012), *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* para. 54

¹⁴⁴ OECD (2010) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Chapter IX, par 9.169.

¹⁴⁵ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg.349

¹⁴⁶ OECD (2012) *The Comments received with respect to the Discussion Draft Revision of the special considerations for intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and related provisions*; 29 October 2012 pg. 615

6 Conclusion

6.1 General comments

The OECD TPG aims to support both taxpayers and tax administration when facing a transfer pricing difficulties by offering mutually acceptable solutions to transfer pricing problems and to lead to a consensus of the interpretation of the arm's length principle as provided in Article 9 of the OECD MTC. TPG are broadly used and aim toward harmonization on the way to elimination double taxation. Therefore, it is of an importance that the TPG provide for a consistence and clear guidelines with regard to transfer pricing issues. The importance of shedding some light on the notion of intangibles is highly important for transfer pricing purposes. Further to this, introducing the concept of entitlement of intangible related returns should support the intention of OECD of overcoming transfer pricing difficulties in cases of transfer of intangibles. However, in order for the goals to be achieved, the coherence with the already established provisions and consistence within the TPG text should be achieved.

6.2 Issues related to the definitions

A definition of intangibles for transfer pricing purposes is not being provided for within the current version of TPG. Instead, identification of the intangibles has been made by descriptive listing of the most common types. Contribution to the definition of intangibles within the Discussion draft, the OECD provides for intangibles as being "something which is not a physical asset or a financial asset, and which is capable of being owned or controlled for use in commercial activities". The definition of intangibles the Discussion Draft as stated above, is very broad and does not attempt to define in detail all the potential classes or categories of intangibles. It may be convenient to make a distinction between situations that include transfer of valuable intangibles in opposite to the ones that do not include such.

By providing cleared definition of intangibles, the concept of intangible related returns following the contribution to the value of intangibles, would be made clearer. However, the term 'contribution' to the value of the intangible as used in the preamble of the Discussion Draft is rather vague, despite its potential significance. Some overlapping relationship with the use of the term 'contribution' is to be found in Chapter II of the TPG referring to the profit split method and in Chapter VIII of the TPG referring to the cost contribution agreements. Determining the value of the contribution that each of the associated enterprises make to the controlled transaction is challenging. The functions, assets and risks may not by themselves lead to intangible related returns unless they are considered relevant for creating a value to the intangible and are seen as a contribution themselves. Thus, the need for further clarifications of the term contribution would be required in order to shed some light on the intangible related return concept.

The lack of clear definitions may lead to missguidance to the tax authorities and the tax payers, and pottential discrepances and differences in the interpretation of the unclear definition.

6.3 The need for clarifications

Within a MNE group it is possible that despite the contribution of more companies only one company retains the legal rights. Therefore, the MNE group member entitled as a registered owner is by far of a less importance between the members of the group, unlike it is between unrelated parties. Consequently, the registration as a manifest for the legal ownership is not necessarily as strong within the group. Thus, for transfer pricing purposes the concept of economic ownership of a increasing importance. The concept of economic ownership, despite the lack of precise definition, is introduced in relation to cost contribution arrangements, and may not always follow the legal ownership over the intangible that would result in a license or similar agreement. However, the concept of economic ownership could not as simply be transferred to the concept of intangible related returns. An important issue in that sense is whether the marketer/distributor should be compensated as a service provider, or as a party entitled to intangible related returns. The analysis of this issue requires assessment, not only to functions undertaken, the risks assumed, the assets used, but of the obligations and rights implied by the legal registrations and agreements between the parties and the costs incurred by the parties. Therefore, a cleared guidance with regard to the economic ownership over the intangible should be developed by OECD taking into consideration the entitlement to intangible related return concept.

The legal ownership over the intangible should be respected unless it clearly deviates from the economic substance of the transaction and the conduct of the parties. In cases of such deviation from the legal arrangement, the objective should be to determine what a reasonable allocation between unrelated parties would be in the respective circumstances. Thus, the economic substance concept in relation to entitlement to intangible related returns should be more closely linked to the guidance already developed within the TPG with regard to the relation of the economic substance with the arm's length principle. Disregarding the contractual terms by tax authorities should be limited to exceptional cases as provided within para. 1-64 - 1.69 of the TPG and para. 9.161 - 9.194 of TPG. Without such reference to the concept of economic substance, potential re-characterization by the tax authorities outside the strict guidance may potentially lead to double taxation or double non-taxation.

The entity that does not bear or control the risks associated with the activities related to development, enhancement, maintenance and protection of intangibles would not be entitled to intangible related returns, but should be reimbursed for the activities performed. Dependant on the substance of the rights of the party, an entitlement to share of the profit derived from the use of the intangible may be provided, such as in the case of the distributor. However, such share of the profits does not lead to ownership over the marketing intangible, respectively it could not be by default translated into something capable of being owned and controlled. The entitlement to intangible related returns should be made dependent on case by case basis and should follow the way of independent parties operate at arm's length. The entitlement to intangible related return in case of R&D activities by no meaning should be considered as default, as it may be reflected as remuneration for manufacturing or charged as service provision, following that the outsourcing of such activities between unrelated parties are to be met in practice. Further guidance with regard to the arm's length compensation to the services rendered should be provided. Clear distinction should be made between the entitlement to intangible related returns and the reimbursement to the distributor/ researcher for the services provided.

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