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# Definition and valuation of intangible assets for international transfer pricing purposes

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## Abbreviations

Art.	Article
BEPS	Base Erosion Profit Shifting
CCC	Community Customs Code
CIT	Corporate Income Tax
CPLM	Cost Plus Method
CUP	Comparable Uncontrolled Price
DTT	Double Tax Treaty
ECJ	European Court of Justice
EU	The European Union
GATT	General Agreement for Tariffs and Trade
Ibid.	Latin, short for <i>ibidem</i> , meaning "the same place"
Member States	Countries, members of the European Union
MNE	Multinational enterprise
OECD	Organization for Economic Cooperation and Development
Para.	Paragraph
Paras.	Paragraphs
RSM	Resale Minus Method
TP	Transfer Pricing
VAT	Value added tax
WTO	World Trading Organization

## 1. Introduction

According to the WTO data, multinational enterprises (MNEs) control about 70% of the worldwide trade.<sup>1</sup> A multinational enterprise could be defined as a group of associated companies, which are established in different countries.<sup>2</sup> The UNCTAD estimated in its World Investment Report that more than 63000 parent firms control about 690 000 affiliates worldwide.<sup>3</sup> For example, Apple, Coca-Cola, IBM, Samsung, Toyota, Nike are multinational enterprises. MNEs are planning their profitability and tax arrangements taking into account different aspects of business, features of economics, and the national and international tax rules. MNEs explore the markets and choose the most benefiting places for businesses, the most beneficial place to make research and development, the best place to manufacture products and to assemble them and so on. The choice of the allocation of these associated companies could be determined by different factors, which could be the low cost of production, low cost labor, economies on taxes, possibilities to use double tax treaties and so on.

Generally market forces determine business relations between independent enterprises. But if we consider MNEs, then we can see that relations between parties distort the objective market conditions. It is very often that MNEs use tax planning which allows to minimize the MNE's tax burden. The MNEs shift profits from one associated company to another trying to allocate expenses in the countries with high corporate income tax and to allocate profits in the countries with the low corporate income tax. This abusive practice got name among the OECD<sup>4</sup> countries "(tax) base erosion and profit shifting". As a result of this practice a state's budget of any state might get decreased tax revenue, and part of the profit move from one country to another. The role of transfer pricing rules and the arm's length principle is to provide the fair profit allocation, allowing a state to benefit from the productivity and manufacturing carried out in its territory. The arm's length principle could be explained as the obligation of the MNE to pay taxes as if there was the impartial, unprejudiced or unbiased approach in the choice of the business partner, when the only natural market forces and perspective profits may influence the choice. If the price of the transaction within a MNE is similar to the price, which independent companies, i.e. companies, which are neither associated nor influenced by common management then price is considered to be arm's length.

"In an international framework a properly calculated transfer price should 'reasonably' allocate profits resulting from such a transfer among all parties involved. Consequently, each jurisdiction should receive a "fair" proportion of the tax revenues based on these profits."<sup>5</sup>

At the beginning of the industrial age, the leading role of a company's success was indicated by the possession of tangible assets such as industrial equipment. Currently the focus has shifted to intangibles.<sup>6</sup> Nowadays, intangible assets like trademarks, patents, know-how, trade secrets play a significant role in the world's economy: industrial R&D is a driving force for the economics development, trademarks are the driving forces for the products on the market. Transfer of rights on intangible assets constitutes a very important field of business interests. In many industries intangible assets constitute the majority of the business's value. For example the Apple brand is estimated to be worth \$98 billions, the Coca Cola's brand worth \$79 billions, the IBM's brand worth \$78 billions.<sup>7</sup>

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<sup>1</sup> [http://www.gatt.org/trastat\\_e.html](http://www.gatt.org/trastat_e.html), accessed on 29<sup>th</sup> of April 2014.

<sup>2</sup> The definition is given in the Glossary of the OECD Guidelines.

<sup>3</sup> Data is given for the year 2000, Boos, M. "International transfer pricing. The valuation of intangibles", Kluwer Law International, the Netherlands, the Hague, 2003, p.5.

<sup>4</sup> Organization for Economic Co-operation and Development (OECD)

<sup>5</sup> *ibid.*, p.2.

<sup>6</sup> Verlinden I., Mondelaers Y., "Transfer pricing aspects of intangibles: at the crossroads between legal, valuation and transfer pricing issues", *International transfer pricing journal*, IBFD, January/February 2010, p.50.

<sup>7</sup> <http://www.interbrand.com/en/best-global-brands/2013/Best-Global-Brands-2013.aspx>, accessed on 30.04.2014.

The member countries of the WTO acknowledged the importance of liberalisation of international trade and significance of intangibles for international trade. As a result of negotiations, the General Agreement on Tariffs and Trade (GATT) was signed in 1947. It was followed by Marrakech agreement, establishing WTO in 1995. The GATT Trade-Related Aspects of Intellectual Property Rights (TRIPS), being part of the GATT, was signed in 1994. The TRIPS agreement contains minimum standards for different forms of intellectual property rights and its protection. The TRIPS agreement is the significant international tool, which allows setting up and developing the ways of national and international IP rights protection.

In the modern world the companies and especially international corporations endeavoring to succeed in a competitive environment, have to deploy soundly the intangible assets they possess. Intangible assets started to play the very significant role. For example a study performed by Handelsblatt focused on 127 German companies provided information that in 26.8% of all the companies analysed, the value of the goodwill accounted for more than 50% of the company's equity.<sup>8</sup>

It is acknowledged that one of the most difficult issues for a MNE is the establishment of appropriate transfer prices for tax purposes.<sup>9</sup> Things become even more complicated when it is necessary to establish transfer price for intangible assets. The price of intangible assets may be included to the price of the goods, or intangible assets could be the independent objects of contracts. "Most intangibles are unique assets, and their transfers rarely take place on external markets. Hence comparables for intangibles seldom exist. As a result, reliable, comprehensive, and internationally comparable data at company and country level are scarce. Such data, however, would be necessary to assure that the application of arm's length transfer pricing methods follow objective rules."<sup>10</sup>

There are two kinds of the transfer pricing: internal transfer pricing (transfer of intangibles within one country) and external transfer pricing when intangible assets are transferred cross-border between affiliated companies which are located in different countries. The following arm's length principle might be complicated if the countries do not have harmonized transfer pricing rules and approaches. Different countries might have different rules concerning taxation of multinational corporations, they might have different approaches for solving transfer pricing problems and countries might have different accounting rules. Multiple currencies involved in international trade and therefore in transfer pricing assessment and necessity to convert the price in foreign currency into the local currency make the practitioners think about calculation of different exchange rates in different days in different countries.

The OECD in its report indicated that transfer pricing issues pertaining to intangibles were identified as a key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification and valuation of intangibles for transfer pricing purposes.<sup>11</sup> To apply the arm's length principle, it is necessary to answer several questions: How should comparable transactions be identified? How should comparable transactions be adjusted, when they are not the same but reasonably similar? What should be done when comparables do not even exist, which is likely to be the case when it comes to intangible assets? Which of the provided methods is best to apply? How it should be documented why a certain method was chosen and not another one? When there is no legal certainty in the particular field it might entail problems of the tax law implementation and therefore the risks of penalties.

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<sup>8</sup> The study was made in 2008, KPMG report (<http://www.kpmg.com/PT/pt/IssuesAndInsights/Documents/Intangible-assets-and-goodwill.pdf>), p.15, accessed on 29th of April, 2014.

<sup>9</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, [www.IBFD.org](http://www.IBFD.org), tax research platform, accessed on 21<sup>st</sup> of April, 2014, para 11.

<sup>10</sup> Boos, M. "International transfer pricing. The valuation of intangibles", Kluwer Law International, the Netherlands, the Hague, 2003, p.12.

<sup>11</sup> OECD (2011), Transfer Pricing and Intangibles: Scope of the OECD Project 2011, Document approved by the Committee of Fiscal Affairs on 25 January 2011, Centre for tax policy and administration; point 1.

As far as the initial (basic) OECD Guidelines were released 19 years ago, being amended in 2010<sup>12</sup> it does not cover all the variety of modern business situations. It inflicts a high burden on taxpayers. In the OECD White paper on Transfer Pricing Documentation was given the example that one business representative complained that his company had gone from producing around ten transfer pricing documentation studies per year in the early 1990s to approximately two thousand separate transfer pricing studies by 2007.<sup>13</sup> For the same cross-border controlled transaction, taxpayers are often required to comply with the tax rules of two or more countries. Consequently taxpayers are required to submit two or more sets of transfer pricing reports. It also entails problems for MNEs to make corresponding adjustments in corresponding country as MNEs face jeopardy of double taxation.

All together it demonstrates that the valuation of intangible assets for transfer pricing purposes has a lot of problems, and compliance to the law is quite a challenging task for MNEs.

In the present thesis it will be considered how some intangibles (trademarks and patents) are defined and what are their characteristics, and the main approaches for valuation of intangible assets for international transfer pricing purposes will be considered.

### **1.1. Aim of the study**

The aim of this study is to analyse how some intangible assets are defined and evaluated for international transfer pricing purposes. The examples of legal regulation for two kinds of intangible assets will be given specially, i.e. trademarks and patents.

### **1.2. Problem and research questions**

The arm's length principle requires that MNE apply transfer prices in their controlled transactions that are in compliance with the prices that would have been applied to the same uncontrolled transaction between unrelated, independent enterprises under the same circumstances.<sup>14</sup> To comply with the arm's length principle the associated companies should pay corporate income taxes in the same amounts as if the transactions were between independent enterprises. The purpose of transfer pricing is to find a comparable transaction price, which could be settled between independent enterprises. The problem arises when it is necessary to find a similar transaction for intangible assets as intangibles are unique and are not traded freely on the open market. Also it is difficult to estimate the current and the perspective price of the intangible assets, as the prices are dependant on different circumstances.

In order to explore this further, the following research question will be addressed:  
How intangible assets (trademarks and patents) could be defined? What are the legal sources providing a legal regulation of intangibles, in particular trade marks and patents? What are the valuation rules for intangible assets for international transfer pricing purposes? What transfer pricing methods could be used for the valuation of intangibles? What are the factors and circumstances influencing the price?

### **1.3. Material and method**

The most commonly applied method for judicial research in general is a traditional legal dogmatic method. This descriptive and analytical technique will be used in the thesis. It shall be achieved by exploring provisions of the EU law in general, international agreements, provisions of the EU law

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<sup>12</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, [www.IBFD.org](http://www.IBFD.org), tax research platform, accessed on 21<sup>st</sup> of April, 2014.

<sup>13</sup> OECD White paper on Transfer Pricing Documentation (Public Consultation), July 2013.

<sup>14</sup> Art. 9 of the OECD Model Tax Convention on Income and on Capital (22 July 2010), Models IBFD.

and OECD documents. Transfer pricing field is an area, which is regulated by the national law of the Member States. There is no binding law on the European Union level, which could be obligatory for taxpayers in the transfer pricing filed.<sup>15</sup> Nevertheless all the countries are interested in harmonization of tax systems to avoid double taxation or non-taxation, and to avoid the tax base erosion and profit shifting. The arm's length principle, which will be described in the thesis, allows to allocate profit "fairly" and to keep taxes in the state, which is the resource for profit.

The OECD documents will be analysed in details. OECD documents are not the binding laws, they are recommendations, but as far as about 40 countries have taken the OECD models and recommendations as patterns for the national laws, including transfer pricing rules and the arm's length principle, they could be considered as basic and very important documents.

In order to explore the research question, the thesis will first start by introducing the definition of intangible assets (trademarks and patents), then the concept of transfer pricing will be considered; then the rules for the valuation of intangible assets will be analysed.

#### **1.4. Delimitation**

In this thesis the author will analyse only the European Union legislation. The laws of third countries will not be analysed. The documents issued by the OECD being the soft law, which are the very important resources for transfer pricing will be analysed in details. As far as there is no common definition of intangible assets, only two kinds of intangible assets (trademarks and patents) will be considered in the present thesis taking them as representatives of two main groups of intangible assets.

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<sup>15</sup> For corporate income tax purposes

## 2. TRANSFER PRICING

Transfer pricing refers to the setting, analysis, documentation and adjustment of profit allocation made between related parties. The Tax Convention on Income and on Capital<sup>16</sup> (the OECD Model) issued by the OECD contains provisions about transfer pricing and the arm's length principle. This convention is not a binding law, it is a recommendation, but as far as more than 40 countries have accepted this concept and made it the part of the local law, the OECD models and guidelines are taken as basic laws.

The role of the OECD model is to control a fair allocation of income. The concept of transfer pricing and definition of associated parties are presented in the art. 9(1) of the OECD Model:

[w]here

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
  - b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
- and in either case conditions are made or imposed between the two 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.

It is necessary to emphasize that the present article does not give the particular percent or details of the controlling power, it does not define exactly when the parties could be named as associated. The differences in interpretation can trigger dissimilar practices of the law enforcement.

The OECD Model contains article 9(2), being a ground for a corresponding adjustment for transfer pricing purposes:

[w]here a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Lasiński-Sulecki K. wrote that “even if parties to a tax treaty chose to base that treaty on a different model tax convention, the arm's length principle would still be included therein because the transfer pricing provisions found in major model tax conventions, are highly similar to the OECD Model and to one another.”<sup>17</sup> Analyses of Double Tax Treaties of different countries displays that treaties are very similar, which helps substantially for its implementation.

Another document, being the EU recommendation, with substantial role for the countries around the world, containing the transfer pricing rules, is the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010<sup>18</sup> (the OECD Guidelines). The concept of the arm's length is given in para. 1.6: the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a

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<sup>16</sup> OECD 2010 Model Convention on Income and on Capital, condensed version, July 2010, accessed on [www.IBFD.org](http://www.IBFD.org) on 20<sup>th</sup> of April, 2014, tax research platform.

<sup>17</sup> K. Lasiński-Sulecki, “Impact of Transfer Pricing Adjustments for VAT and Customs Law Purposes”, *International Transfer Pricing Journal*, 2013 (Volume 20), No. 3, IBFD, Tax research platform, (accessed 29<sup>th</sup> of April 2014).

<sup>18</sup> OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, [www.IBFD.org](http://www.IBFD.org), tax research platform, accessed on 21<sup>st</sup> of April, 2014.



single unified business.<sup>19</sup>

Also the OECD Guidelines deposes a number of methods to test whether the prices agreed between the parties are at arm`s length or not. For example, the comparable uncontrolled prices method<sup>20</sup>, the cost plus method<sup>21</sup>, the resale minus method<sup>22</sup>, the transactional net margin method<sup>23</sup> and the transactional profit split method<sup>24</sup>. It is settled in many countries that if parties do not comply with the arm`s length principle they are obliged to pay fines. Taxpayers could avoid paying fines if they submit to the tax authority a transfer pricing report, which proves that a price imposed between related parties comply to the arm`s length principle, or the company should make transfer pricing adjustment and to pay extra taxes to comply the arm`s length principle.

The OECD Model and the OECD Guidelines together make a framework for the fair corporate income allocation.

Paragraph 6.13 of the OECD Guidelines provides that the arm`s length principle applies to intangibles in a similar manner as to tangible assets and services. To determine the arm`s length price for intangibles, the assets used, functions performed and risks assumed should be analysed.

The transfer pricing aspects of intangibles are stipulated in Chapter VI of the OECD Guidelines. Then the OECD issued a document titled “Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions” (the Discussion Draft) dated June 2012. This Draft was not a final document; it was a proposal for discussion for the OECD Member countries. Based on the comments received from the OECD Members, OECD issued a Revised Discussion Draft. The Revised Discussion Draft has many changes and replaces the Discussion Draft. On 19<sup>th</sup> of July 2013 the OECD issued the White Paper and proposed to comment the interested companies and organisations. The discussed and approved final version of the above document will replace Chapter IV of the OECD Guidelines.

The preparation of transfer pricing documentation is burdensome for a MNE. The White Paper<sup>25</sup> surveys the current state of affairs regarding transfer pricing documentation, considers the purposes and objectives of transfer pricing documentation, and makes suggestions as to how transfer pricing documentation rules might be modified to make transfer pricing compliance simpler and more straightforward, while at the same time providing tax authorities with more focused and useful information for consideration in connection with transfer pricing risk assessment and transfer pricing audits.

Transfer pricing aspects constitute a part of the OECD Base Erosion and Profit Shifting Action Plan (BEPS Action Plan) released on 19 July 2013, which is of high importance for the OECD member states as it impacts substantially the financial situation of many members.

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<sup>19</sup> OECD Guidelines, para. 1.6.

<sup>20</sup> OECD Guidelines, p.24.

<sup>21</sup> Paras. 2.32-2.48 of OECD Guidelines.

<sup>22</sup> Paras. 2.14-2.31 of OECD Guidelines.

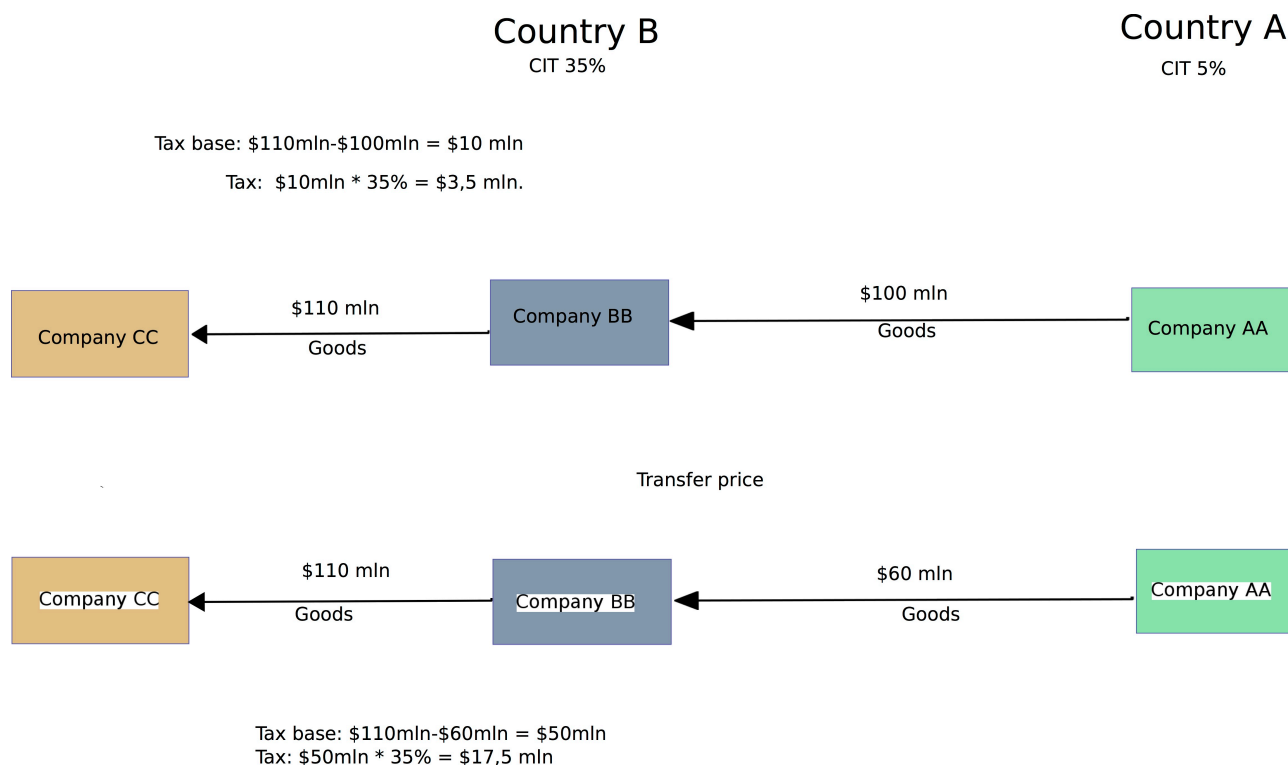
<sup>23</sup> Paras. 3.26-3.48 of OECD Guidelines.

<sup>24</sup> Paras. 3.5-3.25 of OECD Guidelines.

<sup>25</sup> White paper on Transfer Pricing Documentation (Public Consultation) dated July 2013, p.1.

The example of transfer pricing and arm's length principle application could be the following.

The focus is on the BB's company corporate income tax (CIT).



Explanation for the picture:

Companies AA and BB are affiliated.

We assume that the parent company BB is located in country B where the corporate income tax is 35%;

We assume that the subsidiary company AA is located in country A where the corporate income tax is 5% (tax heaven).

The production of the goods is made by the company AA in country A.

The buyer of the goods is the company BB in country B.

The goods are sold for \$100mln from AA to BB.

Later BB is selling the goods to any company CC for \$110mln.

The accounting records of the BB company will be the following.

$\$110\text{mln}$  (sale to CC company) -  $\$100\text{ mln}$  (expenses paid to AA) =  $\$10\text{ mln}$

Tax base is  $\$10\text{ mln}$ .

Tax is to be calculated as  $\$10\text{mln}$  (tax base) \* 35% (tax rate) =  $\$3,5\text{mln}$  (tax to be paid)

As far as companies (AA and BB) are affiliated the arm's length principle should be applied and prices should be adjusted for the corporate income tax purposes. After applying the CUP (Comparable Uncontrolled Price) method it was found that the open market value for the same goods for the companies which are similar to AA and BB amounts to  $\$60\text{ mln}$ .

After the transfer pricing adjustments the accounting records of the BB company will be the following.

$\$110\text{mln}$  (sale to CC company) -  $\$60\text{ mln}$  (expenses paid to AA) =  $\$50\text{ mln}$

Tax base is  $\$50\text{ mln}$ .

Tax is to be calculated as  $\$50\text{mln}$  (tax base) \* 35% (tax rate) =  $\$17,5\text{mln}$  (tax to be paid).

As a result the tax to be paid without the arm's length principle amounts to  $\$3,5\text{mln}$ .

The tax to be paid with arm's length principle application amounts to  $\$17,5\text{ mln}$ .

The difference is impressive. After the arm's length principle application the tax increases on \$14 mln. We considered only one example (one transaction) of one company. If many companies make similar transactions regularly during the long periods of time, these practices entail substantial losses for the countries with the high corporate income tax (tax base erosion and profit shifting).

### 3. DEFINITION AND CHARACTERISTICS OF INTANGIBLE ASSETS

#### 3.1. Introduction

The vague nature of the intangible assets concept creates problems in identifying intangibles in practice. There is no definition of intangible assets given on the EU binding law level. Also there is no definition of intangible assets in the OECD documents, which are already in force. The improving draft to the OECD Guidelines contains definition of the intangible assets, but improvements are not approved and officially published yet. The binding law and definitions could be found on the EU level law for each kind of intangibles separately: for trademarks, patents, know how, trade secrets, industrial designs and so on.

Also it is necessary to distinguish what purpose the definition should serve, as there are major differences, depending on why one needs to characterize the concept. On the one hand, there is an accounting, legal and tax aspects on the international level; on the other hand, there are vast arrays of different interpretations, depending on the countries' domestic legislation.

The milestone transfer pricing case for intangible assets is *GlaxoSmithKline case*<sup>26</sup>, which occurred from some lack of common understanding of the concept of intangible assets. This case illustrates the importance of the clear definition of intangible assets and intellectual property rights. Several definitions and descriptions can be found in different resources, their summary states the following: "Intellectual property rights are the legal rights which aim at safeguarding creators and other producers of intellectual goods and services by granting them certain (limited) rights to control the use made of those creations by other parties."<sup>27</sup>

Another definition could be the following: "intangible assets are nonphysical assets that allow an enterprise to earn profits above the profits the enterprise would have earned with only its physical assets. Intangible assets help the enterprise to prevail and succeed in a competitive environment".<sup>28</sup> Neither the current chapter VI of the OECD Guidelines nor the Discussion Draft defines the intangibles. Revised Discussion Draft on Transfer Pricing Aspects of Intangibles, which was released in July 2013 (the Revised Discussion Draft) provides a definition of intangibles that is transfer pricing specific. The Revised Discussion Draft also provides examples of what would and what would not constitute an intangible. According to para. 40 of the Revised Discussion Draft the intangibles are something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

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<sup>26</sup> Joined ECJ cases C-501/06P, C-515/06P and C-519/06P *GlaxoSmithKline*.

<sup>27</sup> Verlinden I., Mondelaers Y., "Transfer pricing aspects of intangibles: at the crossroads between legal, valuation and transfer pricing issues", *International transfer pricing journal*, IBFD, January/February 2010, p.50.

<sup>28</sup> Boos, M. "International transfer pricing. The valuation of intangibles", Kluwer Law International, the Netherlands, the Hague, 2003, p.7,8.

The Revised Discussion Draft sets the requirements to qualify the assets as an intangible:

- it must not be a tangible asset or a financial asset;
- it must be capable of being used in commercial activities;
- its use or transfer would be compensated in transactions between independent parties;
- it needs not be an intangible for accounting purposes;
- it needs not be an intangible for general tax or treaty withholding purposes;
- it needs not be legally protected; and
- it needs not be separately transferable.

The OECD distinguishes two major groups of intangibles in the OECD Guidelines:

- trade intangibles (also referred as the technical or manufacturing intangibles)<sup>29</sup>; and
- marketing intangibles<sup>30</sup>.

Marketing intangibles are the intangibles which help to promote products or services (trademarks, trade names, client lists, know how of marketing and so on. The OECD Guidelines defines trade intangibles as commercial intangibles other than marketing intangibles.

### **3.2. Trademarks**

Trademarks (trade names, logos, catch-phrases and images) play a very important role for the products and services promotion. Here could be a discussion of the role of the marketing and the role of commercials. It is commonly acknowledged that marketing is the vital component for the business, its development and profits.

A product's 'image' may be developed over many years, and many brands, such as Microsoft, BMW, Rolls-Royce, H&M, Nestle and Coca Cola are worth millions of dollars today as they are associated in consumer's minds with different favourable characteristics: utility, quality, reliability, prestige, comfort and taste.

The legal sources for the trademarks regulation are the following: Paris Convention, 1883; Section 2 of the Agreement on trade related aspects of intellectual property rights (TRIPS), 1994<sup>31</sup>; First Council Directive 89/104/EEC of 21 December 1988, to approximate the laws of the Member States relating to trade marks, amended by Directive 2008/95/EC; Council Regulation 40/94 on the Community Trade Mark with amendments 207/2009 (the Trade Mark Regulation); Directive 2004/48/EC of 29 April 2004, on the enforcement of intellectual property rights; National law of the Member States.

The definition or characteristics of trademarks are given in art.15 of the TRIPS agreement and in art. 2 of the Trade Mark Directive 2008/95/EC<sup>32</sup>. According to the Directive a trademark may consist of any signs capable of being represented graphically, particularly words, including personal names, designs, letters, numerals, the shape of goods or of their packaging, provided that such signs are capable of distinguishing the goods or services of one undertaking from those of other undertakings. A trademark could be declared protected as a result of registration (art. 6 of the Trade

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<sup>29</sup> The OECD Guidelines' Glossary.

<sup>30</sup> The OECD Guidelines' Glossary.

<sup>31</sup> The TRIPS agreement contains minimum standards for different forms of intellectual property rights and its protection. The TRIPS agreement is a significant international tool, which allows setting up and developing ways of protection of national and international IP rights.

<sup>32</sup> Directive 2008/95/EC to approximate the laws of the Member States relating to trade marks (Codified version).

Mark Regulation)<sup>33</sup> or use (para.5 of the Trade Mark Directive 2008/95/EC). Registration or use of trademarks enables its owners to prevent other companies from using the trademarks for the similar goods or services.

A trademark could have different territorial power. It could be acknowledged on the territory of one Member State, if it is registered according to the local law. It could be acknowledged on the territory of the European Union (Community Trade Mark) if it is registered in the Office of Harmonization of Internal Market (OHIM) or on multiple territories if it is registered in the World Intellectual Property Organization (WIPO).

According to para 6.4 of the OECD Guidelines the value of a trademark depends upon many factors, including the reputation and credibility of the trade name, quality of the goods and services provided, the degree of quality control and on-going R&D, distribution and availability of the goods or services, the extent and success of the promotional expenditures incurred in order to familiarise potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies), the value of the market to which the marketing intangibles will provide access.

It is not expensive to register a new trademark, but it takes time, efforts and expenses to make it valuable. It is very often that the amount of investment to the trademark promotion is proportional to the profits gained as a result. For example massive advertising campaigns and investment to the trademark entail its recognition and popularity of the goods. Nevertheless to keep the value of the trademark on the high level, the company should continue paying for the advertisements, should control the quality of the goods or services, work with feedbacks, in another words it is necessary to safeguard the good reputation of the brand and goods. Sometimes a patent itself could be a trademark.

Trademarks may be used only with the owner's permission for the relevant product or services. A trademark may be licensed for some or all of the goods or services for which it is registered (or used). A licence may be exclusive or non-exclusive (art 22.1 of the Trade Mark Regulation). A trademark may be sold, or otherwise transferred by one person to another. There may be various kinds of licensing contracts. A distributor may be allowed to use a trademark without a licensing agreement in selling products manufactured by the owner of the trademark, but trademark licensing also has become a common practice, particularly in international trade. Thus, the owner of a trademark may grant a licence to the trademark to another enterprise to use for goods that it produces itself or buys from other sources.

Determining an arm's length royalty rate could be a difficult task as there are big varieties of licensing agreements. Licensing agreements may be exclusive or non-exclusive, may have geographic limitations, and may have different time limitations. Also obligations, risks, liabilities, transportation and insurance costs could be distributed between parties in different proportions. All these parameters will influence the royalty rate.

A trademark may continue indefinitely; its protection will disappear only under special circumstances (voluntary renunciation, no renewal in due time, cancellation or annulment following a judicial decision, etc.).<sup>34</sup>

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<sup>33</sup> Council Regulation 40/94 on the Community Trade Mark with amendments 207/2009 on the Community trade mark (codified version).

<sup>34</sup> OECD Guidelines, para 6.8.

### 3.3. Patents

The longest standing, best known, and arguably, economically most valuable form of protection of rights provided by the law of intellectual property comes in the form of the patent. A patent is, in essence, the grant of a monopoly to an inventor who has used his or her skill to invent something new. The monopoly is not absolute; patents are only granted for a limited period and are accompanied by public disclosure enabling others in the field to consider, and perhaps subsequently improve on, it. Patents may cover entirely new products or, more often, enhancement to pre-existing products, or they may cover a new or improved process for performing an activity.<sup>35</sup> The existence of patents' protection helps to the developments of different sectors of industries, as the owners of the patents can be sure that their inventions are protected and their copying is illegal. Those countries that have poor legal protection of patents are often not considered as a place of business for the companies that have valuable patents as the companies-owners of the patent try to avoid reverse engineering and massive production of their product.

The legal sources for patents are the following: Paris convention, 1883; Patent Cooperation Treaty, 1970 (filing procedure); European Patent Convention or the Convention on the Grant of European Patents (1973), which provides a legal framework for the granting of European patents via single harmonized procedure<sup>36</sup>; section 5 of TRIPS Agreement, 1994; Regulation No 1257/2012 dated 17.12.2012 implementing enhanced cooperation in the area of the creation of unitary patent protection.

Characteristics of patents are given in art. 27.1 of the TRIPS agreement: "...patents shall be available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step and are capable of industrial application. ... without discrimination as to the place of invention, the field of technology and whether products are imported or locally produced." Patents may create a monopoly in certain products or services whereas trademarks alone do not, because competitors may be able to sell the same or similar products so long as they use different distinctive signs.<sup>37</sup>

Two authorities in the European Union can register a patent. First is a patent authority of a Member State. This patent will have protection on the territory of this state. The second way to register a patent is to apply to the European Patent Office (EPO), which is not a European institution, it is a private organisation. The EPO represents a patentee as an agent in many Member States and the patent owner can get his patent registered in several countries through EPO without applying to each and every country he is interested to be presented.

In order to promote and facilitate the economic exploitation of an invention protected by a local national patent or by the European patent with unitary effect, the proprietor of that patent may offer it to be licensed. To that end, the patent proprietor may file a statement with the national patent office or with the European Patent Office that he is planning to grant a license and his monopoly on the IP rights will not be absolute (para. 15, art. 2, 8 of the Regulation No 1257/2012).

Patents are often obtained through risky and costly research and development (R&D) activities, and the developer generally tries to recover the expenditures on these activities and obtain a return thereon through product sales, service contracts, or licence agreements.<sup>38</sup> Company Apple has obtained about 1300 patents to protect their rights for one product – an iPhone<sup>39</sup>. It is very often that patents of different companies are dependable from each other and companies practise cross licensing (for example smartphone producers or pharmaceutical companies).

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<sup>35</sup> Torremans P., Holyoak and Torremans Intellectual Property Law, 7<sup>th</sup> edition, Oxford University Press, 2013, p. 45.

<sup>36</sup> [http://en.wikipedia.org/wiki/European\\_Patent\\_Convention](http://en.wikipedia.org/wiki/European_Patent_Convention)

<sup>37</sup> OECD Guidelines, para 6.8.

<sup>38</sup> OECD Guidelines, para 6.3.

<sup>39</sup> <http://ip-science.thomsonreuters.com/m/pdfs/iphone-report.pdf>

Income from using trademarks and patents can be closely connected, and if the transfers to another company only trademark or patent it might be difficult to find a transfer price for it. Also the following features of the patent should be analysed: is it a product or a process patent, what is its geographical opportunities, its duration, is it ordinary or a key (market leading) patent. “An entirely new and distinctive ‘breakthrough’ patent may make existing patents obsolete.”<sup>40</sup>

#### 4. VALUATION OF INTANGIBLE ASSETS

The correct valuation of intangible assets is a difficult and controversial issue. The key question to solve is how to establish the transfer prices of intangible assets that are transferred across the border but within multinational networks. According to the OECD Guidelines the MNE should apply the arm’s length standard and make the valuation of intangible assets resulting to the similar taxation of associated enterprises and independent enterprises for the similar transaction.

The arm’s length standard assumes that one can find market comparables as a benchmark against which to measure the transfer price. While this may be achievable with tangible products (and even then, there are difficulties), with intangible assets, arm’s length transactions occur much less frequently or may simply not exist at all.<sup>41</sup>

Intangible assets are difficult to value for several reasons. First, they are seldom traded on external markets; second, they are often transferred in bundles with tangible assets; and third, they are sometimes even difficult to detect. Because of these difficulties professionals try to track intangibles by certain proxies such as royalties, license fees and dividends. In any case a valuation process must include a thorough analysis of an intangible, its surrounding circumstances, companies analyses and analyses of the market.

Transfer pricing assessment includes the analyses whether the particular intangible constitute the value driver for the company or not. If the intangible assets play an important role for the company’s prosperity, then such role might enhance the market value of intangibles. “A value driver is an activity or organizational focus which enhances the perceived value of a product or service in the perception of the consumer and which therefore creates value for the producer”<sup>42</sup>. The similar notion is presented in the Glossary of the OECD Guidelines, in particular “profit potential” of the assets. Profit potential is the expected future profit. In some cases it may encompass losses.

The value of the intangible will depend upon many factors: (1) popularity of the products on the market; (2) existence of competitors which produce similar products; (3) whether an intangible has a driving value in the specific industry; (3) duration of protection; (4) uniqueness; (5) market capacity; (6) buyers abilities; (7) economic circumstances of the countries where is product is supposed to be lodged; (8) possibilities of legal protection of IP rights on intangibles in cases of infringements.

Possession of any intangible asset itself does not mean that one is valuable. It is necessary to make an analysis whether an independent party is ready to pay for its exploitation. It might happen that intangible asset has an economic value for the owner but does not have value on the market. “The

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<sup>40</sup> Markham M., *The transfer pricing of intangibles*, Kluwer Law International, the Netherlands, 2005, p.28.

<sup>41</sup> Boos, M. “International transfer pricing. The valuation of intangibles”, Kluwer Law International, the Netherlands, the Hague, 2003, p.11, ix.

<sup>42</sup> Verlinden I., Mondelaers Y., “Transfer pricing aspects of intangibles: at the crossroads between legal, valuation and transfer pricing issues”, *International transfer pricing journal*, IBFD, January/February 2010, p.50.

demand-fulfilling characteristics are the main drivers of market value, because even if intangible involves substantial technical or intellectual sophistication, it has no economic market value if there is no demand for it. To the opposite, the cost of very valuable patent will be close to zero after several sudden deaths of patients (for example Lipobay patented by Bayer) ”.<sup>43</sup>

Taxpayers and tax authorities might pursue opposing objectives and have different approaches when they value intangibles for the transfer pricing purposes which entails differences of interpretation of circumstances and differences in the valuation results.

Also ”intangibles often interact with or are embedded in tangible or financial assets, which make demarcation lines between the various types of assets relatively blurry.”<sup>44</sup> The most controversial issue in the context of intangible valuation is the application of an appropriate valuation method.

#### **4.1. Transfer pricing valuation methods**

The transfer pricing methods provided in chapter II of the OECD Guidelines that are usually used for the valuation of tangible assets and services apply to intangibles on the same basis.

The purpose of a transfer pricing method is to find out a way to set or to test transfer prices for the inter-company transactions between associated enterprises. A company should choose a transfer pricing method itself. A company may choose a mix of methods, but it should provide reasons and argumentation why the chosen methods were used. Also if it is stipulated in the national legislation, a company may use a method which is not described in the OECD Guidelines, but again a company should provide the explanation about the choice.

However the OECD Guidelines makes recommendation of the choice of the methods. Firstly, a company should use the method that is the most appropriate to the circumstances of the case. Secondly, the Comparable Uncontrolled Price method should be the first choice if applicable. Third, the transactional methods have preferences over profit methods.

Some of the transfer pricing methods are one-sided (the CUP method, TNM method), while others are two-sided. The particularity of one-sided methods is that they apply to one party (tested party) to a transaction, while two-sided methods apply to two (or more) parties to a transaction.

The problem is that it is rare indeed for there to be a comparable or matching transaction carried out by uncontrolled third parties. Therefore, in most cases there is no arm’s length price with which the price charged by the MNE may be compared. Also even if there are independent third parties carrying out broadly similar transactions, there is a range of prices at which a willing buyer and a willing seller would do business. There is not one arm’s length price, but a whole range of arm’s length prices;<sup>45</sup> the OECD does not offer the guidance what is the right price.

##### **4.1.1. Comparable Uncontrolled Price method (CUP)<sup>46</sup>**

The CUP method is a two-sided TP method. The rationale of the method is to set the price of a controlled transaction on the basis of an uncontrolled transaction. The CUP method sets inter-company prices in the closest possible way to prices actually paid in uncontrolled transactions. The

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<sup>43</sup> Boos, M. “International transfer pricing. The valuation of intangibles”, Kluwer Law International, the Netherlands, the Hague, 2003, p.7,9

<sup>44</sup> Boos, M. “International transfer pricing. The valuation of intangibles”, Kluwer Law International, the Netherlands, the Hague, 2003, p.7,9, p.20.

<sup>45</sup> Markham M., The transfer pricing of intangibles, Kluwer Law International, the Netherlands, 2005, p.31.

<sup>46</sup> OECD Guidelines, p.24.



major problem of the CUP method is the high standard of comparability that it requires to be applicable. Adjustments may have to be performed, but such adjustments cannot correct all the differences between controlled and uncontrolled transactions.<sup>47</sup> It is highly likely that intangible assets cannot be priced directly on the basis of uncontrolled transactions without adjustments.

Internal CUP method refers to the price of a good or intangible charged between a group member and an independent party. External CUP method refers to the price of a comparable good (or intangible) between two unrelated parties.<sup>48</sup>

#### **4.1.2. The Resale Minus Method (RSM)<sup>49</sup>**

The resale price method is a one-sided TP method. The rationale of the method is to set the transfer price of a certain goods (or intangibles) based on the gross margin that should be earned by the distributor at arm's length.<sup>50</sup>

#### **4.1.3. The Cost Plus Method (CPM)<sup>51</sup>**

The cost plus method is a one sided TP method and consists in selling a good (or intangible) at a price that corresponds to the costs incurred in the production of the goods (or intangibles), to which a profit mark-up is added. The rationale of the cost plus method is to set a transfer price that covers certain costs and lets supplier earn an arm's length mark-up. The level of mark-up is dependent on the functions performed, the risks assumed and the assets used by the company selling goods or providing services. Consequently, product comparability is less important than with the CUP method.<sup>52</sup>

#### **4.1.4. The Transactional Net Margin Method (TNMM)<sup>53</sup>**

The transactional net margin method is a one-sided TP method. It focuses not on the gross margin (as the resale price method does) but on the net margin of the tested party, i.e. it includes the operating expenses in the margin that is measured. The rationale of the TNMM is to set the transfer price of a certain good (or intangible) based on the net margin that should be earned by the tested party arm's length, in relation to a particular item of the financial statements of the tested party. However, according to the para. 2.59 of the OECD Guidelines the TNMM should be applied only if the tested party does not develop or own intangibles as part of the transaction that is being priced. Indeed, the profitability of the tested party would then be much more difficult to assess and it may be impossible to find relevant comparable companies, so in such a situation the profit split method may have to be favoured.<sup>54</sup>

Application of TNMM allows using a lower level of the income statement; some differences in accounting standards are mitigated. For example, it is quite possible that the same cost is recorded as 'cost of goods and services' in one country, while it is recorded as an operating expense in another country. This makes it difficult to compare companies from different countries at the gross margin level. Consequently, the TNMM eases the comparison of companies resident in countries that apply different accounting standards, which may be beneficial both when setting prices for different group companies and when performing benchmarking analyses. Also focusing on the net

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<sup>47</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.40.

<sup>48</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.43.

<sup>49</sup> Paras. 2.14-2.31 of OECD Guidelines.

<sup>50</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.43.

<sup>51</sup> Paras. 2.32-2.48 of OECD Guidelines.

<sup>52</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.46.

<sup>53</sup> Paras. 3.26-3.48 of OECD Guidelines.

<sup>54</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.50.

margin reduces the need of product comparability and tolerates some functional differences, as differences in the functions performed “are often reflected in variations in operating expenses”.<sup>55</sup>

#### **4.1.5. The Transactional Profit Split Method (TPSM).<sup>56</sup>**

The profit split method is a two-sided TP method, as it consists in splitting profits and losses between at least two parties. When no independent comparable transactions are available, or when a transaction is particularly complex, the profit split method may be the only solution to set transfer prices between associated enterprises. In fact associated enterprises can enter into unique or complex transactions that may not take place between independent parties, thus making it impossible to find comparable independent transactions.<sup>57</sup> This method relies on internal data rather than on data derived from comparable uncontrolled transactions.<sup>58</sup>

The profit split method may also be relevant to take into account certain synergy effects that may be achieved through inter-company transactions. In such situations, because no prices or margins can be set on the basis of comparable independent transactions, the only solution left may be to actually split between the associated enterprises the operating profits (or losses) that result from a given business activity, as independent companies would split profits or losses when cooperating in common projects.<sup>59</sup>

Examples of profit split methodologies are the split of profits on the basis of the value added by each party to a certain product or service, the costs incurred by each party, or the ownership in intangibles. Which profit are to be split between the parties to the profit split arrangement should also be determined. The profit to be split often excludes those connected to routine functions, as such profits could more easily be remunerated on the basis of the other transfer pricing methods. Therefore, in practice the profit split method is frequently applied after remunerating the routine functions performed by the parties or by other associated enterprises. This is referred to as ‘a residual profit split analysis’, since the profit that are split are those that are left after remunerating the relevant routine functions.<sup>60</sup>

This method is specially recommended by the Revised Discussion Draft for the OECD guidelines for application for transactions with intangibles.

Conclusion for transfer pricing methods could be the following.

The issue of the arm’s length principle cannot be resolved by rigidly applying predetermined rules – approaches need to be tailored to the individual facts and circumstances of each case.<sup>61</sup>

Nevertheless the Revised Discussion Draft notes that:

- the application of one-sided methods, for example the resale price method or TNMM, is generally not reliable for directly valuing intangibles (para. 159);
- cost-based valuations are generally not reliable if used to determine the arm’s length price for partially developed intangibles (para. 161);
- valuation techniques can be used either as part of one of the five approved methods or as a separate mechanism for determining an arm’s length price; and

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<sup>55</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.52.

<sup>56</sup> Paras. 3.5-3.25 of OECD Guidelines.

<sup>57</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.58.

<sup>58</sup> Valente P., “Transfer Pricing: valuation of intangibles and simplification – a summary of key issues at the international level”, IBFD, *European Taxation*, CFE News, December 2012.

<sup>59</sup> Monsenego J., Introduction to transfer pricing, Studentlitteratur AB, Lund, printed in Denmark, 2013, p.59.

<sup>60</sup> *ibid*, p.59.

<sup>61</sup> Markham M., *The transfer pricing of intangibles*, Kluwer Law International, the Netherlands, 2005, p.30.

- valuations of intangibles contained in purchase price allocations performed for accounting purposes are not determinative for transfer pricing purposes, and should be utilized in a transfer pricing analysis with caution and careful consideration of the underlying assumptions (para.173).

Section D.3 of the Revised Discussion Draft provides some specialized guidance on arm's length pricing in situations where valuation is extremely uncertain. As such, the Revised Discussion Draft states that in this uncertain cases the controlled taxpayers should follow the practices that would lead to an arm's length result.

"The current transfer pricing methods for intangibles are perceived to impose a high burden on taxpayers, since comparables are hard to identify and the choice of an appropriate method is difficult to justify."<sup>62</sup>

## **4.2. Factors, influencing the price**

### **4.2.1. Functional analysis**

In transactions between two independent enterprises, the contract price usually reflects the scope of obligations and liabilities and the functions that each enterprise performs. Para 1.42 of the OECD Guidelines says that in determining whether controlled and uncontrolled transactions or entities are comparable, a functional analysis is necessary. The role of functional analysis is to identify and compare the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. For this purpose, it is necessary to understand the structure and organisation of the MNE and to analyse how the most important functions are spread. It will also be relevant to determine the legal rights and economic owner of the intangibles.

Pursuant to para 1.43 of the OECD Guidelines the functions that taxpayers and tax administrations might need to identify and compare different features which pertain to the goods (services) and which influence the intangible price i.e., design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. The functional analyses should also include the analysis of frequency, nature, and value of the functions performed.

### **4.2.2. Assets**

The Revised Discussion Draft states that group members which contribute assets used in the development, enhancement, maintenance and protection of an intangible are entitled to relevant returns (para.82 of the Revised Discussion Draft). Funding is listed as one type of asset. The Revised Discussion Draft stipulate that a party which provides investment, but does not take substantial responsibilities, does not control the risks or does not perform other functions, generally does not receive returns equivalent to those investors which also perform and control important functions and bears and controls important risks associated with the funded activity.

Para. 83 of the Revised Discussion Draft provides that funding and risk-taking could be integrally related, but at the same time suggests analysing them separately, as there is no standard set of risks

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<sup>62</sup> Boos, M. "International transfer pricing. The valuation of intangibles", Kluwer Law International, the Netherlands, the Hague, 2003, p.12.

assumed in the funding of intangibles and because the risks assumed will vary based on, for example, contractual terms and the conduct and solvency of the relevant group members, and therefore must be determined on the basis of all the facts and circumstances.

### **4.2.3. Risks**

The types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.<sup>63</sup>

The Revised Discussion Draft makes reference in paragraphs 9.10 through 9.46 to assessing the allocation of intangible-related risks among members of an MNE. In order for a member of an MNE that is the legal owner of intangibles to be entitled to intangible-related returns, it must either (para.86 of the Revised Discussion Draft): bear and control the risks associated with the development, enhancement, maintenance and protection of intangibles.

Some specific risks that may be important for intangibles are listed in paragraph 87 of the Revised Discussion Draft, namely: risks related to the development of intangibles; the risk of product obsolescence; infringement risk; and product liability. Finally, in para 1.46 of the OECD Guidelines it is emphasized that there should be no mismatch between the contractual allocation of risks and the allocation of the relevant risk-associated costs among related enterprises.

The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties.<sup>64</sup> For example the distributor which undertakes obligations pertained to the product quality and liability claims and which organizes the marketing campaigns itself with his own money normally is remunerated with the higher compensation than the distributor, which operates only as an agent without taking any meaningful risks.

### **4.2.4. Contractual terms**

If the parties are independent from each other then contractual terms normally reflect objectively the functions performed by the parties and the risks assumed. Some obligations can be provided in the letters between parties, minutes or other documents which are considered to be the part of the contract by the parties and by applicable legislation.

It might be the case that between associated enterprises could have place unwritten agreements and implicit obligations. To make a reasonable transfer pricing analysis it is necessary to consider the situation in complex and try to build the whole picture of the parties' relations. Definitely it is necessary to start from the contract provisions and the parties' conduct.

In practice, information concerning the contractual terms of potentially comparable uncontrolled transactions may be either limited or unavailable, particularly where external comparables provide the basis for the analysis.<sup>65</sup> The unavailability of a contract for a comparison and deficiency in information will have different influence depending on the type of transaction and the method used. For example if we analyse licensing agreement for the use of trademark and if we take the CUP method, then the contractual provisions are the main sources for the analyses and without a contract and knowledge of the functions performed and risks assumed, the geographical scope, exclusivity, duration of licence it would be difficult or impossible to make a transfer pricing analysis.

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<sup>63</sup> OECD Guidelines, para 1.46.

<sup>64</sup> OECD Guidelines, para 1.47.

<sup>65</sup> OECD Guidelines, para 1.54.

#### **4.2.5. Economic circumstances**

The price for the same goods or services may be different in different markets as a price depends on many factors. Thus when a company is trying to find an arm's length price for the similar goods it might happen that the prices vary from a market to a market substantially. In such a situation it is necessary to find the similar markets or to make necessary adjustments in the transfer pricing analysis to eliminate the effects of differences if the markets are not similar.

According to para. 1.55 of the OECD Guidelines economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (*e.g.* retail or wholesale); the date and time of transactions; and so forth.

Also it is necessary to pay attention to the business cycles (season, product, economic) whether they influence the price.

The geographic market is another economic circumstance that can affect comparability. The identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant.<sup>66</sup>

#### **4.2.6. Business strategies**

Transfer pricing analysis should be made not only for the sale of goods and services, but also prices should be examined in situations when a MNE is implementing special business strategies, which substantially influence the MNE's prices and profit allocation. The transactions structuring, M&A and special financial relationships with associated companies must also be examined in determining comparability for transfer pricing purposes.

“Business strategies would take into account many aspects of an enterprise, such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, duration of arrangements, and other factors bearing upon the daily conduct of business. Business strategies also could include market penetration schemes.”<sup>67</sup>

#### **4.2.7. Recognition of the actual transactions undertaken**

A tax administration's examination of a controlled transaction ordinarily is based on the transaction actually undertaken by the associated enterprises as it has been structured by them (para. 1.64 of the OECD Guidelines).<sup>68</sup> If the transaction structured and described in a contract differs from the transaction implemented in reality, then according to para 1.65, 1.66 of OECD Guidelines, the tax authority is empowered to estimate a “real transaction”.

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<sup>66</sup> OECD Guidelines, para 1.57.

<sup>67</sup> OECD Guidelines, para 1.59.

<sup>68</sup> L. Helderman, E. Sporken, R. Okten and M. Kanter, “A New Era in Determining Arm's Length Compensation for Intangibles? A Comparative Overview of Existing and Possible Future Transfer Pricing Principles”, *Transfer Pricing Journal*, 2013 (Volume 20), No. 6.

#### 4.2.8. The effect of government policies

Pursuant to para 1.73 of the OECD Guidelines there are some circumstances in which a taxpayer will consider that an arm's length price must be adjusted to account for government interventions such as price controls (even price cuts), interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, antidumping duties, or exchange rate policy.

#### 4.2.9. Use of customs valuations

As far as the customs authorities are making analyses of the cross-border transactions similar to the arm's length examinations maintained by tax authorities, in particular the customs is checking whether the price written in the customs declaration by the exporter/importer is close to the open market price. Transfer pricing in the custom realm deals with the customs valuation of goods in transactions between associated parties.

“The aim of customs transfer pricing rules is not comparable with the aim of art.9 of the OECD Model. Customs transfer pricing counteracts avoidance that would be very easy in transactions between associated enterprises. While the aim of the transfer pricing for corporate income tax purposes is to allocate profit.”<sup>69</sup>

It might be useful for tax authorities to have access to the customs databases and documents (customs declarations, contracts, goods' specifications and so on) as they contain valuable information on transactions.

If the parties are independent to each other the customs exploit the transaction value of the goods. First the customs examines “circumstances of sale” to check whether the traders are associated companies. Second, the customs is checking the prices of the transactions. Usually, the customs have databases with data on prices of different goods. If it is found by a taxpayer or by the customs that the transaction price does not comply with the arm's length principle, the customs determines the customs value by applying, in a hierarchical order, one of the following alternate valuation methods: transaction value of identical or similar goods<sup>70</sup>, deductive value<sup>71</sup>, computed value<sup>72</sup>, or fall-back method<sup>73</sup>.

#### 4.2.10. Evaluation of separate and combined transactions

As a common rule the arm's length examination is maintained on the transaction-by-transaction basis. But it isn't very often that “separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis”<sup>74</sup>. For example the price of the goods depends on the amount of the yearlong supply, or by the end of the year the company gets a big discount if the amount of the goods purchased exceeds a definite level.

Also it might be problematic to make the evaluation if the cost of goods are closely connected to the guarantee or mandatory servicing of the goods and rights to use a trademark.

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<sup>69</sup> Lasiński-Sulecki K., “*Impact of Transfer Pricing Adjustments for VAT and Customs Law Purposes*”, International Transfer Pricing Journal, 2013 (Volume 20), No. 3, para 4.1, IBFD, Tax research platform, (accessed 11<sup>th</sup> of May 2013).

<sup>70</sup> Art. 30(2)(b) of the CCC.

<sup>71</sup> Art. 30(2)(c) of the CCC.

<sup>72</sup> Art. 30 (2) of the CCC.

<sup>73</sup> Art.31 of the CCC.

<sup>74</sup> OECD Guidelines, para 3.9.

#### **4.2.11. Useful information for determining transfer pricing**

It is very difficult to determine the constant parameters for the arm's length scrutiny as the transactions and MNEs differ substantially. For instance, "Australia issued over 150 different questionnaires for multinational companies focusing on transfer pricing risks associated with business restructuring, profitability, financing and services in the mining industry."<sup>75</sup> The information relevant to an individual transfer pricing enquiry depends on the facts and circumstances of the case.

However, it is possible to name certain features common to any transfer pricing examination: "the nature of the transaction, the basis on which the transaction is priced, an outline of the business, the structure of the organisation, the ownership linkages within the MNE group, the amount of sales and operating results from the last few years preceding the transaction, the level of the taxpayer's transactions with foreign associated enterprises."<sup>76</sup>

#### **4.2.12. Legal ownership and economic ownership**

To make a reasonable transfer pricing analysis of transaction intangibles it is necessary to identify the owner (owners) and/or beneficiary owner, i.e. to detect a company, which gets benefits of the intangibles' exploitation. There could be one company, which is an owner with a registered patent or a trademark. There could be several owners, which contributed to the creation or development of an intangible. It is necessary to distinguish a legal owner and an economic owner. The economic owner could be in other words investor. The legal owner can have the patent or trademark with its name or to get the rights through the contract. For example there could be situations that a legal owner transfers its rights to an agent or a trust fund or to a partnership, or signs long-term licensing agreement. The OECD Guidelines do not give any recommendations how to examine these situations. It is highly likely that taxpayers and tax authorities should make careful analyses and give reasonable argumentations for the calculations of the arm's length prices.

Paragraph 65 of the Revised Discussion Draft states that to examine a transaction for its compliance to the arm's length principle the written contracts are important and the legal ownership referred to in such written contracts will be respected only if it is consistent with substance; legal rights and contractual agreements form the starting point. However, entitlement to intangible-related returns should be determined based on functions performed, risks assumed and assets employed; and a member of an MNE need not physically perform all of the functions related to the development, enhancement, maintenance and protection of an intangible by its own employees in order to be entitled to retain returns attributable to the intangibles, provided that it: exercises control over any outsourced functions and assumes risks related to those functions.<sup>77</sup>

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<sup>75</sup> OECD White paper on Transfer Pricing Documentation (Public Consultation), July 2013, p.15.

<sup>76</sup> *ibid*, para 5.18.

<sup>77</sup> L. Helderman, E. Sporken and R. Okten, "The Revised OECD Discussion Draft on Transfer Pricing Aspects of intangibles", *International Transfer Pricing Journal*, 2014 (Volume 21), No. 1.

## 5. DISCUSSIONS AND CONCLUSION

The main idea of transfer pricing and the arm's length principle is an examination of a transaction and adjustment of taxes due if the traders are not independent from each other and if their association influenced a contract price. A MNE should submit a report and demonstrate the comparable prices, which could be internal or external, and to provide the argumentation on the methods used and comparables given.

It is admitted in the OECD Guidelines (para. 1.10, 1.12) that independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm's length principle difficult to apply because there is little or no direct evidence of what conditions would have been established by independent enterprises. Also the data available could be incomplete or difficult to interpret, or it may be difficult to obtain for its geographical location.

Unlike the sale of goods where where hundreds, thousands, or even millions of the exact same product may be sold, it is very often that intangible assets are unique and it is difficult to find the comparables for them. Also the same intangible can have absolutely different price in different markets. For example in one country the trademark could be heavily promoted and well known, but in another country its value could be close to zero as it could be absolutely unknown.

The comparability should include different parameters. For example, analysis of a market, its size and features, business (sector of industry), an intangible itself (its potential), geography of an intangible protection. In some cases value will be difficult to determine at the time of the transaction. "An intangible, by its particular nature as an item of intellectual, scientific or artistic property, has problems of uncertainty and risk attached to its value. Its commercial success will be difficult to evaluate at the outset, and the price may include an attempted recoupment of years of research."<sup>78</sup>

It is difficult to compare internal transactions of a MNE with transactions between independent enterprises as the main advantage of the corporation is economies of scale. A corporation may reduce its costs and expenditures by optimization of processes. As a result the goods produced by a corporation can be objectively cheaper than the goods produced by an independent company which does not have associated companies and which turnover is much smaller. "The essence of an MNE is the potential to act as one entity in the world market and so to gain competitive advantages. The higher efficiency usually realized within MNEs is not recognized by the arm's length principle."<sup>79</sup> The OECD Guidelines in para 6.13 acknowledge that associated enterprises may, for valid and legitimate business reasons, structure an inter-company transfer of intangibles in a manner that independent enterprises would not contemplate. It can be offered to make necessary adjustments to the transfer prices if similar situations are under examination.

Also the problem arises in relation to the transfer of intangibles, which are so-called 'package deals', where a single charge is made for a variety of things. A company might sell goods, licence intellectual property and provide technical services, all for an undifferentiated payment. Tax authorities may want to deal with the various parts of the transaction separately.<sup>80</sup> At the same time the OECD Guidelines in para. 1.42 recommends to make an examination on transaction-by-transaction basis but it is acknowledged that there can be transactions which are so closely linked that they cannot be adequately evaluated on a separate basis.

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<sup>78</sup> Markham M., *The transfer pricing of intangibles*, Kluwer Law International, the Netherlands, 2005, p.26.

<sup>79</sup> *ibid*, p.30.

<sup>80</sup> *ibid*, p.70.



As far as transfer pricing law is not harmonized on the European Union level and the existing transfer pricing documentation requirements could be different in different countries, it is complicated for a MNE to prepare different sets of documents for the same transaction and to change them according to the local rules and to translate it into different languages. It could be much easier for MNEs having massive international business if the transfer pricing rules were harmonized in the OECD countries.

The OECD Discussion Draft recognizes multiple problems pertained to the valuation of intangible assets. There were some steps made to improve the situation. For example it is discussed now that unification of the global accounting standards would substantially improve the situation. Also the Brookling Institute has recommended “to move from cost-based accounting to a value-based model for intangible assets, using performance-based indicators. The study has suggested developing standardized ways of reporting value drivers. The volatility of the value of intangible assets necessitates a methodology that overcomes the static nature of the balance sheet.”<sup>81</sup>

In the transfer pricing context, it is significant that at a time when companies are investing in a new trademark or innovation, the accounting records do not reflect the true value of a trademark or patent. There is a need for information and a need for the improved measurement and disclosure of intangibles. Current the Generally Accepted Accounting Principles (GAAP) recognise internally generated intangibles as costs to be expensed, or as the cost of acquired intangibles. The real value (open-market value) of intangible could be absolutely different from the value written in the accounting records of a company. This detracts from the quality of information provided in the balance sheet. There is a great desire for standardised intangibles-related information.<sup>82</sup> At the same time International Financial Reporting standards (IFRS) require instead that certain internally generated intangibles be capitalized. As a result of such inconsistencies, most enterprises heavily investing in intellectual property show accounting records which are fundamentally in contrast with business reality.<sup>83</sup>

According to the White Paper<sup>84</sup> to make a justifiable valuation of intangible assets for international transfer pricing purposes a MNE should analyse the following facts and circumstances: (a) a description of the MNE’s strategy for the development, ownership and exploitation of intangibles (risk allocation), including location of principal R&D facilities and location of R&D management (for patents); (b) a list of material intangibles or groups of intangibles of the MNE group and details as to which companies are entitled to returns from relevant intangibles; (c) a list of important related party agreements related to intangibles, including cost contribution arrangements, important license agreements and principal research service agreements (for patents); (d) a description of the group’s transfer pricing policies related to R&D and intangibles; (e) a description of any material transfers of interests in intangibles during the relevant year, including the entities, geographies, and compensation involved; (f) a justification of the method used; (g) an indication whether the local entity has been involved or affected by business restructuring or intangibles transfers in the present or immediately past year and explain aspects of such transactions affecting the local entity.

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<sup>81</sup> Markham M., *The transfer pricing of intangibles*, Kluwer Law International, the Netherlands, 2005, p.66.

<sup>82</sup> Markham M., *The transfer pricing of intangibles*, Kluwer Law International, the Netherlands, 2005, p.67.

<sup>83</sup> Cottani G., “Valuation of intangibles for direct tax and customs purposes: is convergence the way ahead?”, *IBFD, International Transfer Pricing Journal*, September/October 2007.

<sup>84</sup> OECD White paper on Transfer Pricing Documentation (Public Consultation), July 2013, p.23.

## Conclusion

Transfer pricing is one of the most important and controversial issues for MNEs. An examination of any transfer pricing transaction will necessarily include an analysis of the arm's length principle. According to the Ernst&Young transfer pricing report<sup>85</sup> 95% of the world's countries have transfer pricing rules in their law. Transfer pricing becomes a "new culture of taxation". The substantial increase of the intangible assets' role in the international trade brought new challenges for MNEs.

It was acknowledged in the OECD Guidelines that one of the most difficult transfer pricing issues involves the area of intangibles. At the same time "intellectual properties attracted a lot of attention, since they are considered to be the type of intangibles that represent the central resource for creating wealth in almost all industries"<sup>86</sup>, being "the key value drivers"<sup>87</sup>.

Within the questions raised in the beginning of the thesis the following conclusions could be reached. The definition of trademarks and patents and their characteristics are given in the international treaties, in the EU law (in Regulations and Directives) and in the local law of the Member States. The trademarks could be registered in the Member States' registers, in the EU register (OHIM) or to have protection in multiple countries if registered in the WIPO. Patents could be registered in the Member States' registers directly or through the European Patent Office. The OECD Guidelines do not contain definition of intangible assets. The Revised Discussion Draft proposes the characteristics of intangible assets. Different countries may have different approach to defining the intangible assets. Different approaches in defining intangible assets in different states may entail problems for the transfer pricing analysis. Also differences in accruing cost of intangibles in different accounting systems could cause problems for the law implementation. It might be offered to make steps to harmonization of the definition of intangible assets and harmonization of corresponding accounting rules.

In terms of methods the OECD in the OECD Guidelines and the Revised Discussion Draft for the OECD Guidelines acknowledges that transfer pricing methods stipulated by the OECD Guidelines, which are normally used for goods and services are applicable for intangibles. In the Revised Discussion Draft it is pointed out that the CUP method and the profit split method are recommended as the most suitable methods for transactions with intangibles.

A market price is the outcome of unique negotiations, and most of intangibles are unique consequently the main problem for arm's length principle application and valuation of intangibles is the lack of comparable transactions. MNEs and tax authorities both face problems of finding comparable suitable transaction between independent enterprises. It is very often that the desirable information about transactions between independent companies could have confidential status. To make a proper analysis of a transaction and the legal obligation of compliance to the arm's length principle requires a massive analyses of the companies, its structures, and their functional performances. It means that the taxpayer should have a lot of different data about other companies' businesses.

The analysis of the value of intangibles for transfer pricing purposes should include: functional analysis, investment resources analysis, ownership analysis, risks allocation analysis, contractual terms analysis, structure of the business analysis, business strategy analysis, the effect of government policy analysis and others depending on the case. "The resolution of the transfer pricing issues may be deemed dependent on a solid understanding of the facts and the specific

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<sup>85</sup> <http://www.klart.se/v%C3%A4der-amsterdam.html>, p.9.

<sup>86</sup> Boos, M. "International transfer pricing. The valuation of intangibles", Kluwer Law International, the Netherlands, the Hague, 2003, p.17.

<sup>87</sup> KPMG report (<http://www.kpmg.com/PT/pt/IssuesAndInsights/Documents/Intangible-assets-and-goodwill.pdf>), p.15, accessed on 29th of April, 2014.

context of each separate case”<sup>88</sup> and it is necessary to have understanding of the particular industrial sector, markets, to know substance and characteristics of an intangible and its comparables; to make argumentation for the chosen transfer pricing method and to determine the appropriate valuation parameters.

The main problem of transfer pricing of intangibles is legal uncertainty and a wide range of discretion and interpretation of circumstances of transaction, markets and methods. It would be easier for taxpayers if the law had clear instructions on the controversial aspects of transfer pricing of intangibles, and if tax authorities had flexible approach without demands of absolute precision in reaching an arm’s length price. It might be helpful if tax authorities and taxpayers had coordinated approach in the valuation of intangibles and signing of the advanced pricing agreements were easy procedure.

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<sup>88</sup> OECD (2012), “Dealing Effectively with the Challenges of Transfer Pricing”, OECD Publishing (OECD-iLibrary Books, Papers & Statistics), ISBN 9789264169074, <http://dx.doi.org/10.1787/9789264169463-en>, accessed on 29.04.2014.

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