

Intangibles in a Transfer Pricing Context: Where Does the Road Lead?

The author considers the main features of intangibles in a transfer pricing context, as well as the conceivable consequences from a company perspective. Topics covered include ownership concepts; various practical valuation methods and related challenges; and different interpretations by tax authorities in various countries.

1. Introduction

The importance of intangibles for sustainable business success has been growing for decades and across various industry sectors. Consequently, this topic plays an ever increasing role in cross-border transactions within multinational enterprises. The OECD, as well as tax authorities in different countries, are intensely discussing the question as to what should be considered arm's length in this context. Moreover, the international debate on tax base erosion and profit shifting¹ (BEPS) and adequate countermeasures has provided additional momentum to this development. It may well be assumed that the publication of the revised chapter VI on transfer pricing aspects of intangibles in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), planned for September 2014, is eagerly awaited by company representatives, tax authorities and tax advisors alike.

This article deals with the main features of intangibles in a transfer pricing context, as well as the respective conceivable consequences from a company perspective. This article first provides the necessary background, outlining the importance of intangibles and relevant stakeholder groups, as well as transaction types linked to transfer pricing. Next, a definition and certain characteristics of intangibles and their value creation cycle are considered, followed by a discussion that sheds some light on the importance of different ownership concepts with regard to intangibles. Practical methods and challenges encountered in their valuation are highlighted, and current developments at the OECD and UN levels are discussed, with regard to certain differences in the interpretation of the arm's length principle regarding intangibles in a transfer pricing context. Finally, practical conclusions are pre-

sented, along with the outlook on potential consequences for companies in their intercompany cross-border dealings in intangibles.

2. Background

Intangibles have become increasingly relevant for business success since the 1970s. And to some extent, this development can be traced in different industries following the ratio of the value of intangibles as a percentage of the total market capitalization of either company or, alternatively, in relation to their book value.² Also, several megatrends, such as rapid globalization, deregulation in certain sectors (e.g. telecommunications and aviation) and technological change, spurred by massively growing Internet coverage and consequentially enhanced information availability ("digitalization"), greatly contribute to this development. Google Glass, home automation and individualized medical therapies are only a few vivid examples of this trend.

In parallel, many national economies – depending on their maturity level – are undergoing an evolution from an industrialized economy to a more information- and knowledge-based economy. On one hand, this is reflected in growing contributions by the service sector to the gross national product of countries. On the other hand, the ever increasing importance of collecting and intelligently analysing massive amounts of data on the Internet, or drawn from other sources ("datability"³), is clearly pointing in this direction. The latter features support the creation of tailored offers for more individualized "buyer profiles" that are established for potential and current customers, and also enable new or better insights for more effective and efficient company planning, management, control and decision making. In this regard, companies benefit from competitive and differentiation advantages conveyed by certain intangibles as such, or in combination with other (in)tangibles and/or services. Following this introductory consideration of the special significance of intangibles⁴ in today's business world, the discussion below will look at

* Head of Global Transfer Pricing, Finance Tax Group, Henkel AG & Co. KGaA, Düsseldorf. He can be contacted at martin.lagarden@henkel.com. The views expressed in this article are those of the author and do not necessarily reflect those of Henkel. © Dr Martin Lagarden.

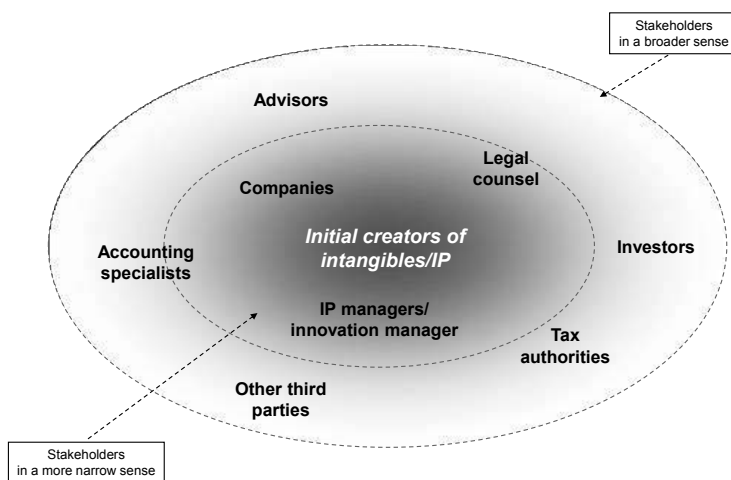
1. Compare e.g. OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD, available at <http://www.oecd.org/tax/beps.htm>, accessed 13 June 2014.

2. Compare e.g. M. Adams, *Intangible Asset Performance and Financial Results* (2009) slide 3, available at <http://de.slideshare.net/maryadamsica/intangible-asset-performance-and-financial-results#>, accessed 13 June 2014; J. Gerzema, *The Brand Bubble*, 21 Marketing Research 1 (2009), at 6; Ocean Tomo, *2010 Intangible Asset Market Value Study Results* (2011), available at <http://www.oceantomo.com/productsandservices/investments/intangible-market-value>, accessed 13 June 2014.

3. Compare e.g. BITKOM, *Big Data im Praxiseinsatz: Szenarien, Beispiele, Effekte*, whitepaper published by Bundesverband Informationswirtschaft, Telekommunikation und neue Medien e. V. (2012), available at http://www.bitkom.org/de/publikationen/38337_73446.aspx, accessed 13 June 2014.

4. The term is used in its broadest sense here.

Figure 1: Relevant stakeholders related to intangibles and IP in a transfer pricing context



correspondingly relevant stakeholders and transaction categories in a transfer pricing context.

2.1. Relevant stakeholder groups

Various stakeholder groups play a distinct role with regard to intangibles, intellectual property (IP) and arm's length transfer prices, as shown in Figure 1.

Stakeholders in a more narrow sense are, first and foremost, the "initial creators" of intangibles and IP themselves, such as researchers and developers, designers, inventors, marketing managers, advertising professionals, business strategists, authors and artists. These people⁵ are the original source of a variety of intangibles and IP. However, IP and innovation managers inside and/or outside a company, as well as legal counsel (e.g. patent, trademark and copyright counsel; specialists in competition or bankruptcy law) also deal more or less closely with the establishment, maintenance, protection, circumvention or utilization of intangibles in the form of IP. It is obvious that all intangibles are ultimately "people-bound" and based on decisions taken by the stakeholders involved. Nevertheless, also enterprises as a whole (as "institutional" creators and/or users of intangibles and IP, and as transaction parties regarding respective assets) can be considered stakeholders in a more narrow sense.

Within the range of stakeholders in a broader sense, one should consider investors (providers of capital outside the company); accounting specialists (e.g. the International Accounting Standards Board (IASB), International Valuation Standards Council (IVSC) or national auditing bodies such as the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer*, IDW), as well as accounting specialists inside the company); representatives of national tax authorities (in finance ministries or tax audit teams); advisors on tax and transfer pricing, and corporate finance (in a valuation context), in the fields of innovation, strategy or publicly funded research and development (R&D);

5. As individuals or in teams, which may also comprise members of different stakeholder groups as shown in Figure 1 (e.g. patent counsel in R&D project teams).

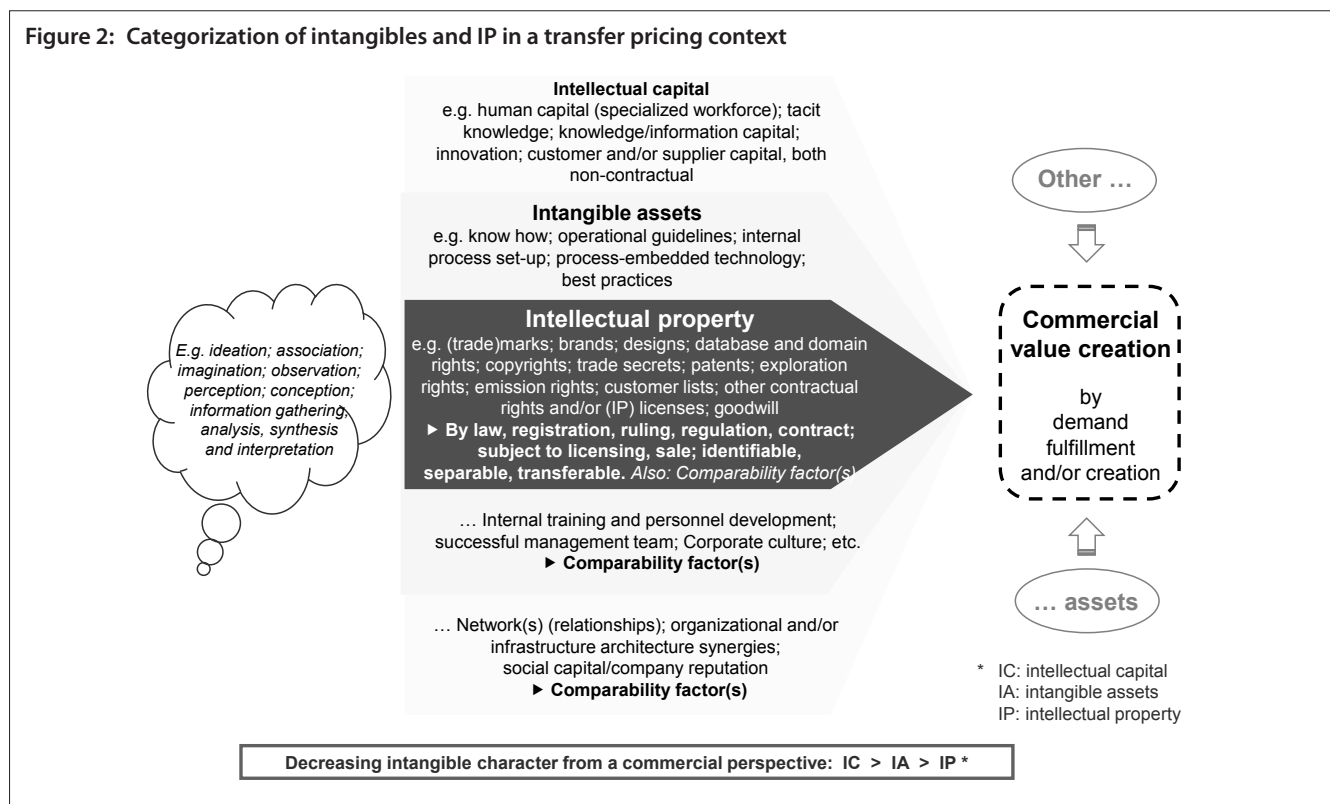
and finally other third parties, especially international bodies such as the World Intellectual Property Organization (WIPO), OECD, International Fiscal Association (IFA), World Trade Organization (WTO) and the World Customs Organization (WCO).

The borderline between stakeholders in a narrow sense and those in a broader sense may, of course, not always be entirely straightforward and clear cut. With regard to transfer prices, however, the relevance derived from such distinction and individual grouping suggested, is emerging from the fact that those stakeholder groups will have their own interests and follow their own goals.⁶ They are normally concerned with different aspects of the topic; and have developed their own terminologies and instruments to deal with intangibles in order to answer specific questions and to address unique challenges in their respective field of expertise related to intangibles and IP. Unfortunately, this also creates the risk of misunderstandings and diverging interpretations, when certain terms or methods are used detached from their initial subject-specific context and when the question as to whether any clarification or adjustment is advisable before those terms and methods are applied in dealing with transfer pricing-related problems is no longer considered at all.⁷

In summary, it is highly relevant for transfer pricing specialists, without a doubt, to consider and employ the experience and findings that other fields of expertise have accumulated with regard to intangibles and IP. Simply adopting and applying this knowledge base without questioning its fitness for the purpose can, however, lead to conclusions which may be no longer compatible with the arm's length principle. And it is easy to imagine that this will cause conflicts between taxpayers and tax authorities.

6. Compare e.g. M. Lagarden, *Brand Valuation in Business Practice – Part 1*, 19 *Transfer Pricing Intl. J.* 4 (2012), at 252; M. Lagarden, *Markenbewertung in der Unternehmenspraxis* (1st ed., Gabler Verlag/Springer Fachmedien Wiesbaden GmbH 2011), at 32.
7. J. Henshall, *Global Transfer Pricing: Principles and Practice* (2nd ed., Bloomsbury Professional Ltd. 2013), sec. 6.81, at 97.

Figure 2: Categorization of intangibles and IP in a transfer pricing context



2.2. Relevant transactions

Cross-border transactions within multinational enterprises involving intangibles and IP can be grouped into three major categories, namely (i) acquisition or sale, (ii) licensing and (iii) R&D cost sharing.

In an *acquisition or sale*, a transfer of ownership⁸ takes place. Before concluding the transaction, an arm's length price will be established in one way or another, including a valuation or some kind of value estimation, and be negotiated between the parties to the transaction. In this situation, it is relevant whether individual IP items "as such" are a subject of the transaction or a potentially inseparable bundle of intangibles and IP. Also, the transaction may comprise a combination of certain IP and other (in) tangible goods or services. Moreover, it needs to be considered whether the transaction is "stand alone" or happens in the context of a business restructuring or function transfer. Finally, the point in time when the transaction takes place can have an impact on the value of the IP and intangibles in question.⁹

Licensing involves the contractual right to use certain IP,¹⁰ but without a transfer of ownership in the IP. Consequently, the licensor continues to be the legal owner of the licensed IP. The considerations on pricing, IP bundling and the combination of IP and other goods or services remain unchanged in the case of licensing, as mentioned above. Moreover, by way of licensing, an additional timing effect can be realized in comparison to an acquisition or sale, as effectively a distribution of an agreed transaction

price over several periods can be achieved. This may be reasonable in economic terms, for example in the case of function transfers, and may also be well in line with domestic tax regulations.

Finally, *R&D cost sharing* deals with the joint development and/or utilization of IP (and/or intangibles),¹¹ namely the pooling concept. This rather complex set-up creates several challenges, such as the valuation and pricing of pre-existing relevant IP (and/or intangibles) when an R&D pool is formed for the first time, the pricing of entry or exit fees for (potentially additional) pool participants over time, the establishment of (an) arm's length allocation key(s) for ongoing R&D expenses incurred by pool members and also the question of ownership of the IP that is newly created in the pool. The latter will become a hot topic, at least upon dissolution of an R&D pool or the exit of participating companies.¹²

The discussion below focuses on the question as to how one can get a better grip on the object of the transaction.

3. What Is the Subject of the Discussion?

Intangibles of economic relevance can be encountered in a variety of manifestations, which can be categorized based on their degree of intangibility from a commercial perspective, as shown in Figure 2:¹³

8. I.e. legal and/or contractual ownership.

9. See sec. 5.

10. Potentially bundled together with, or linked to other IP and/or intangibles also.

11. The same remark as in *supra* n. 10 applies.

12. Compare e.g. T. Stradinger, *Classification of Cost Allocation Agreements*, 41 Intertax 12 (2013), at 665-675; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines) (OECD 2010), chap. VIII, International Organizations' Documentation IBFD.

13. Compare also J. Henshall, *OECD Review of Chapter VI: Intangibles*, Transfer Pricing Intl. J. (27 Aug. 2010), at 10; and Henshall (2013), *supra* n. 7, sec. 6.20 et seq., at 82.

Table 1: Value-driving and value-limiting characteristics of intangibles and IP

Value driving	Value limiting
Simultaneous usability	Rapid devaluation (possible), e.g. due to newer (technological) developments or (market) trends
No wear and tear upon utilization	High fixed costs upon initial creation; relatively low(er) marginal costs upon deployment at a later point
Flexible scalable deployment	Other contributory assets (may be) required for utilization
Employment in different fields of application (potentially possible)	Limited options for protection and enforcement of ownership, thereby factual limitation of ownership
Network and/or spill-over effects	Investment risk(s)

Under the heading of *intellectual capital*, the broad outer arrow comprises intangibles such as company reputation and social capital, innovation; human capital; tacit knowledge or knowledge/information capital; organizational synergies; and non-contractual relations to customers or suppliers. Such intangibles are not legally codified and, as such, are also not the subject of transactions between independent third parties. Nevertheless, they could be considered as relevant factors in a comparability analysis,¹⁴ in answering the question as to what could be the arm's length prices for cross-border transactions between affiliated companies, or in analysing and documenting their respective function and risk profiles.

The next arrow groups together intangible assets such as corporate culture; know-how; operational guidelines; best practices; internal process set-ups or process-embedded technology; training and personnel development measures; and a successful management team. With regard to intellectual capital, the intangible assets mentioned in this category are neither legally codified, nor traded between independent third parties. Again, they may be relevant as comparability factors, as they may also contribute in some way or to some extent to the difference between success or failure in affiliated as well as independent companies in competitive markets.

The central arrow in Figure 2 includes intellectual property (IP), such as patents, (trade)marks, different types of rights (e.g. copyrights and/or licences) covering the utilization of patents, of literary works, databases, exploration of natural resources or trade secrets or designs. In contrast to the two categories outlined above, intangibles falling under IP can explicitly be registered, contractually codified or legally protected, depending on national laws and/or supranational regulations. Therefore, those assets may be the object of a transaction in acquisitions, sales or licensing per se. Consequently, they are subject to transactions between independent third parties and/or affiliated companies, quite often in combination with other IP items, (in)tangibles or services. Finally, they will also be considered as relevant factors in a comparability analysis. Depending on the industry sector, the relevance of intangibles and IP for business success will be viewed differently. From an empirical perspective, however, the top five consistently seem to be company reputation; human capital; knowledge capital; brands; and customer rela-

tions.¹⁵ Obviously, not all of these belong to the third category of intellectual property, which can be considered to be "least intangible" from a commercial (i.e. trade) perspective.

If one takes a closer look now at characteristic features of intangibles and IP, it becomes obvious that – depending on the respective situation and in addition to a number of objectively and/or subjectively value-driving factors – one also must consider certain value-limiting factors, as shown in Table 1.¹⁶

This is well in line with the OECD view, as stated in its current revised discussion draft on intangibles and transfer pricing: "[...] not all intangibles give rise to premium returns in all circumstances".¹⁷ However, depending on the respective interests of stakeholders involved, fact patterns will be presented and/or interpreted differently. And this observation is valid not only for price negotiations among independent third parties, but also between affiliated companies and in discussions between taxpayers and tax authorities – or even among tax authorities in different countries.

In order to better understand the role and importance of intangibles, one can also refer to the value creation cycle as shown in Figure 3 which provides various reference points that can be considered when establishing a comparability analysis in practice. In this way, the cycle can support the explanation and assessment as to whether prices established for a cross-border transfer or utilization of intangibles and IP between affiliated companies can be considered arm's length.

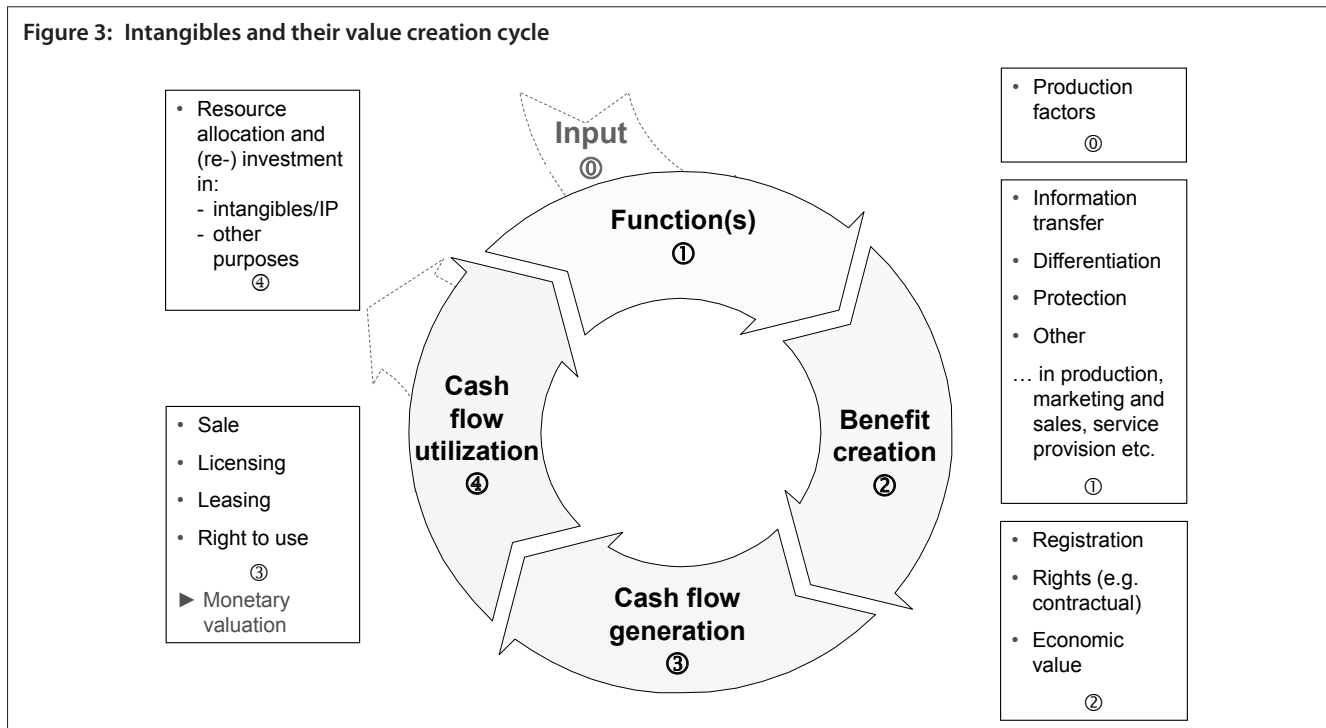
The basic production factors of knowledge, labour and capital constitute the input to the cycle at the outset ((0)). Subsequently, intangibles serve certain functions in different business areas, as displayed in box (1). Under "other", one can summarize functions that may, to some extent, be regarded as being derived from information transfer, such as serving as an intrinsic motivator of personnel; attracting attention of potential employees or investors; or signalling risk reduction. General benefits arising from these func-

14. OECD (2010), *supra* n. 12, chap. I, D.1 and chap. III.

15. M. Lagarden, *Brand Valuation in Business Practice – Part 2*, 19 Intl. Transfer Pricing J. 5 (2012), at 303, Journals IBFD.

16. Compare e.g. L. Hepers, *Entscheidungsnützlichkeit der Bilanzierung von Intangible Assets in den IFRS* (1st ed., Josef Eul Verlag, 2005), at 32 et seq.

17. OECD, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles: 30 July 2013* (OECD 2013), chap. VI, sec. 44, available at <http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf>, accessed 23 June 2014.

Figure 3: Intangibles and their value creation cycle

tions served by intangibles are summarized under (2). The benefits may then contribute to various sources of cash flow generation in the next stage of the cycle (3). At this point, monetary valuation is introduced. However, it may not be only the intangible or IP item in isolation which needs to be considered for valuation purposes, but also other contributory assets¹⁸ and/or a combination of the intangible or IP with another transaction.¹⁹ The challenge here is to identify and isolate the incremental cash flows attributable to the intangible or IP item itself.²⁰ Finally, cash flows can be utilized in different ways (4) – closing the loop either by reinvesting funds in the creation of new intangibles and IP or, alternatively, by allocating monetary resources generated to other purposes (for example tax payment), thus leaving the cycle for the company, at least from a mid-term perspective.

Based on the outline provided so far, the following aspects tentatively define intangibles for transfer pricing purposes:

- lack of physical substance (i.e. separation from tangible goods);
- non-monetary character (i.e. separation from financial assets);
- identifiability (i.e. precondition for transfer);
- separability (i.e. precondition for transfer);
- controllability (e.g. in contrast to certain local market features);
- future economic relevance/utility (i.e. basic value criterion); and
- different conceivable forms of ownership.²¹

Moreover, intangibles and IP may be categorized with reference to contrasting terms, such as “ground breaking (or

break through)” as opposed to “me too” on one hand, or alternatively “ground breaking (or break through)” versus “incremental”, on the other. This broad characterization gains importance when companies are looking for relevant comparable data to assess and document the arm’s length character of transactions involving their intangibles and IP, respective prices or other conditions negotiated; the timing within the lifecycle of the intangibles when a valuation is actually conducted; or the selection of an applicable valuation method “fit for the purpose”.²²

If one is looking for actual references for transactions involving intangibles as a valid reflection of the arm’s length principle, those examples should ideally be derived from an observation of comparable transactions between independent parties in the marketplace. This reservoir, however, provides only very scarce information and data, as intangibles and IP are (very) rarely traded as such in active markets. Instead, these assets are much more often subject to transactions involving their combination with other tangible goods or services, between independent and/or affiliated market participants. Moreover, legal regulations in the area of IP and copyrights also provide certain answers to the question as to which rights may specifically be conveyed by which types of intangibles, thus forming the basis for their trading between market participants. And finally, several judicial decisions (case law) provide useful guidance in various countries (most notably in the United Kingdom and in the United States), with regard to an assessment of arm’s length behaviour from a juridical perspective, referencing which criteria are considered significant and valid in this context.²³

For Henkel, as a branded company in the consumer goods and industrial adhesive applications sectors, brands and

18. Tangible and/or intangible.

19. E.g. a service provision.

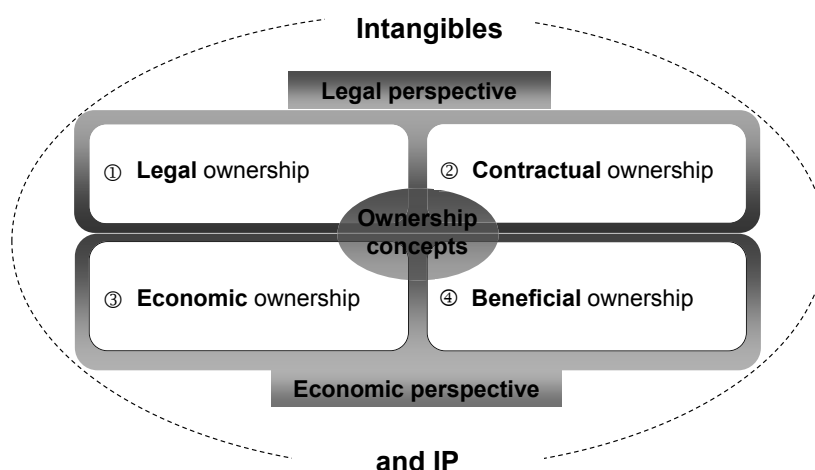
20. See sec. 5.2.

21. See sec. 4, below.

22. Henshall (2013), *supra* n. 7, secs. 6.91-6.95, at 100 et seq.

23. Compare e.g. Henshall (2013), *supra* n. 7, sec. 6.29, at 84 et seq.

Figure 4: Ownership concepts related to intangibles and IP in a transfer pricing context



technologies (patented and non-patented) are two types of IP of prime importance for sustainable business success. However, these types of intangibles are “framed” and enhanced by human capital, customer relations and company reputation (i.e. intangibles, but no IP) which are, conversely also emerging from brands and technologies in the long term.

Up to this point, the above discussion provides a practical framework for an identification and characterization of intangibles and IP in a transfer pricing context. When this has successfully been achieved, the next question concerns to whom those intangibles and IP belong and what consequences are then linked with this ownership.

4. (No) Question of Ownership?!

The term “ownership” describes a comprehensive bundle of rights and duties over a certain property or economic good. Ownership may be distinguished from possession, which is the intentional, practical control of a person over a thing. If ownership has been legally codified in the case of IP (e.g. in the form of a patent being granted by, or a brand being registered with the relevant national office), the owner is endowed with a right to exclude other third parties from utilization or disposition of the IP item.²⁴ This right of exclusion is restricted, however, in terms of content, time (duration) and geographic coverage. Moreover, the official registration of IP (e.g. brands, patents or corresponding licensing agreements) with the respective national patent and trademark office²⁵ and/or with the authorized public economic authority²⁶ or a bank,²⁷ may be required as a basis for cross-border licence payments for the utilization of IP by a local licensee to the licensor.

Upon dealing with intangible assets and IP in a transfer pricing context, one will encounter different ownership

concepts, as shown in Figure 4. These concepts may be altogether valid for a single (sole) owner. Alternatively, there may be many owners to which either individual or several ownership concepts could be attributed.

This variety creates room for interpretation related to the question regarding to whom which “kind of ownership rights” may be assigned and, more importantly, which share of corresponding remuneration (if any) could possibly be linked to the intangible asset or IP. With regard to an arm’s length pricing of cross-border transactions involving relevant intangibles and IP, this interpretational leeway is a source of conflict between taxpayers and tax authorities in various countries, but also between tax authorities of the countries involved, in advance pricing agreements (APAs) and/or in mutual arbitration procedures (MAPs). This can be seen in a range of international transfer pricing disputes over the last 10 years, which have led, in some cases, to multi-billion dollar tax payments for the multinational company groups involved (e.g. GlaxoSmithKline in the United States and Vodafone in India).

4.1. Where is the difference between the ownership concepts related to intangibles?

Legal ownership (1) is conveyed by application, enrolment or registration at, and/or issuance by the relevant national public body (e.g. a national patent and trademark office). Depending on the IP item under consideration and the desired legal title, this may not only be a formal administrative act (or by way of mere declaration, in the case of copyrights). Rather, this takes place after a detailed review process of the intangible submitted only, for example, with regard to its protectability, commercial applicability, novelty and the underlying inventive step, in the case of patents.

The outcome of this process is a valid claim basis for the legal owner, under applicable domestic laws. And this claim basis is enforceable in litigation against infringing parties. It is also per se tradable between market participants within the context of the three main transaction

24. Copyright is an exception in this regard, as the right to exclude other parties is, in this situation, already conveyed upon initial creation of the IP item (e.g. software source codes, literary works or pieces of art), that is, without prior registration or granting process.

25. Compare current legal requirements in Brazil or in Russia.

26. Compare current legal requirements in China.

27. Compare current legal requirements in Algeria.

categories involving intangibles,²⁸ as outlined above. The question as to how valuable the legal claim is from an economic perspective needs to be answered in a valuation.²⁹ There are, however, some constraints: legal ownership cannot be obtained for all types of intangibles, for example, nor for corporate culture, company reputation, best practices, human capital or successful management teams.³⁰ Also, legal norms may vary to some extent by country, with regard to the scope of protection granted for different types of intangibles; for example, software codes will fall under copyright law, but cannot be patented as such.

Contractual ownership (2) is based on a set of obligations between the transaction parties which is established upon, and documented by the conclusion of a contract. In this contract, the parties agree upon certain rights and duties, binding themselves with regard to the relevant intangible(s). Therefore, the contract also constitutes a claim basis which confers specific ownership rights and which is also enforceable in court upon breach of such contract. Consequently, these contracts may be subject to trade between market participants. Moreover, as mentioned, there may be a requirement to register IP contracts with domestic patent or trademark offices, economic authorities or even banks in some countries, as a basis of cross-border royalty payments for the utilization of IP.

Categories (1) and (2) can be summarized under the heading of *legal (or juridical) perspective*. By contrast, the two remaining ownership concepts (3) and (4) are not correspondingly linked to legal or contractual ownership. Moreover, there is no generally accepted definition for these concepts. Rather, different interpretations may be found in literature and/or in common practice. To some extent, these concepts are used interchangeably, which only adds to the ambiguity of their meaning. From the author's perspective, however, it seems possible to summarize concepts (3) and (4) under the term "economic perspective", to differentiate these from legal and contractual ownership.

Economic ownership (3) is linked to the notion of "economic fairness". If one transaction partner provides valuable contributions to a transaction-relevant intangible or IP item (for example by financial funding of activities, risk bearing or the provision of relevant personnel), this transaction party becomes the economic owner (or co-owner) of the intangible.³¹ This is assumed to be the basis for an (at least partial) entitlement to the income earned in the (successful) commercialization of the intangible. However, one needs to consider separately the remuneration for two transactions in those cases. On one hand, it is the remuneration for the utilization of an intangible or IP item to which the legal or contractual owner is entitled (i.e. licence/royalty payment). On the other hand, it is the remuneration for a service which is (potentially) provided by the user of the intangible or IP item for the legal/contractual owner. And for this service provision, an entitle-

ment to an arm's length remuneration would then arise (e.g. contract research). This ownership concept is outlined, for example, in the context of paragraphs 6.36 to 6.39 of the current OECD Guidelines, which refer to "marketing activities undertaken by enterprises not owning trademarks or trade names". Furthermore, the Australian Taxation Office (ATO) has published six examples, in which the understanding and interpretation of the ATO with regard to economic ownership and the potential necessity for tax adjustments of the income of local taxpayers under comparable circumstances³² is further elaborated upon.

Finally, the concept of *beneficial ownership* (4) is oftentimes also interpreted in a way that the beneficial owner may be bearing the costs and economic risks of certain intangibles or IP, for example, by financing respective development or maintenance expenses. This interpretation is very similar, if not identical, to the concept of economic ownership as discussed above. Another interpretation, which does not originally arise from a transfer pricing context, may be derived from the discussion of articles 10, 11 and 12 of the OECD Model.³³ In this case, it is assumed that the legal owner of an intangible asset (a brand, for example) is acting according to instructions received from an undisclosed "true" owner, i.e. the beneficial owner. Consequently, the beneficial owner can be characterized as the party having the exclusive unrestricted right to use, enjoy the benefits or dispose of the intangible asset – in other words "[...] essentially legal ownership without the relevant registration".³⁴

Apart from the fact that one would encounter *prima facie* legal ownership (1) under these circumstances, it may be assumed that independent parties would wish to conclude a contract in this case which would govern the framework conditions for giving and acting upon instructions and the economic consequences linked to such conduct. However, this would then lead back again to contractual ownership (2), as already outlined above.

It is obvious that in a transfer pricing context, and from a legal and economic perspective, different ownership concepts are being considered which are, unfortunately, not always unambiguously defined. The discussion is then triggered by the question regarding to whom which

32. Compare: ATO, *International Transfer Pricing: Marketing Intangibles* (no year provided), available at <https://www.ato.gov.au/General/International-tax/In-detail/Transfer-pricing/International-transfer-pricing---marketing-intangibles>, accessed 18 June 2014.

33. Compare e.g. T. Stradinger, *Classification of Cost Allocation Agreements*, 41 Intertax 12 (2013), at 672; X. Ditz & M. Puls, *OECD Invitation to Comment Transfer Pricing Issues on Intangibles*, letter to the OECD dated 9 Sept. 2010, sec. 2.6, at 7-9, available at <http://www.oecd.org/tax/transfer-pricing/46018603.pdf>, accessed 23 June 2014; M.L.L. van Bladel, *Beneficial Ownership in the OECD Model Tax Treaty*, Commentary on: OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in articles 10, 11 and 12, mailing to the OECD dated 30 Jan. 2013, available at http://www.oecd.org/ctp/treaties/BENOWNMLL_vanBladel.pdf, accessed 23 June 2014; M. Wall, *Re: Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, issued on 30 July 2013, letter to the OECD, dated 9 Sept. 2013, at 3-4, available at <http://www.oecd.org/ctp/transfer-pricing/mdw.pdf>, accessed 23 June 2014.

34. J. Henshall, *OECD Meeting with Business Representatives on the Transfer Pricing Aspects of Intangibles*, Session 4: Ownership Issues, Paris, 7-9 Nov. 2011, slide 3, available at <http://www.oecd.org/ctp/transfer-pricing/49014409.pdf>, accessed 18 June 2014.

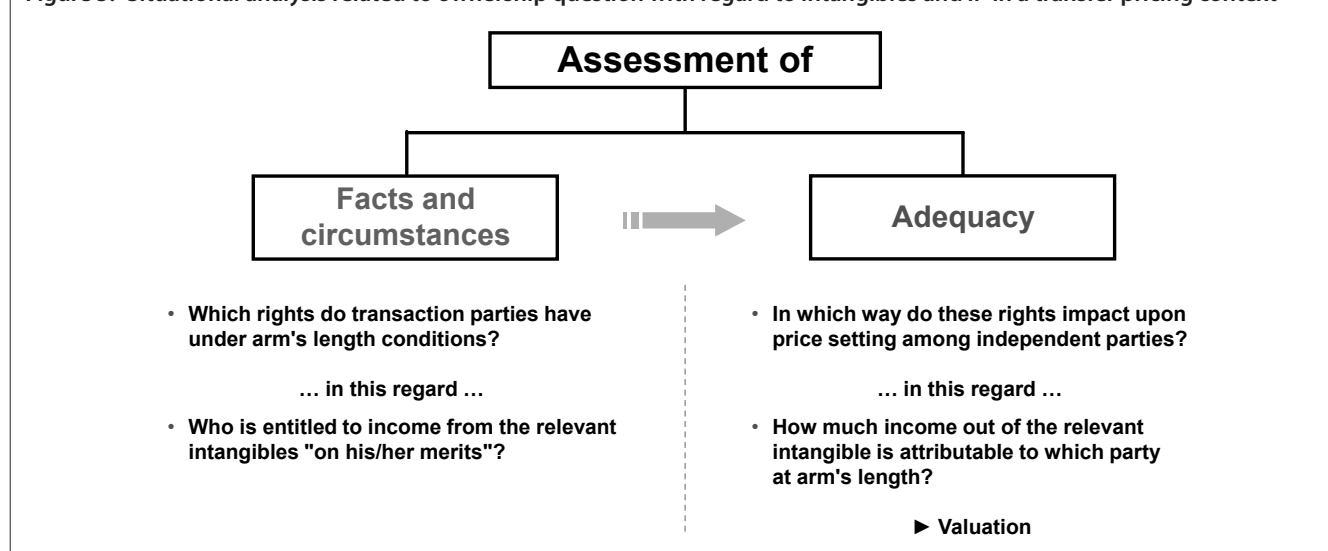
28. I.e. acquisition/sale, licensing and R&D cost sharing.

29. Compare sec. 5.

30. Compare sec. 3. and Figure 2.

31. Compare e.g. Henshall (2013), *supra* n. 7, secs. 6.62 et seq., at 92 et seq.

Figure 5: Situational analysis related to ownership question with regard to intangibles and IP in a transfer pricing context



(taxable) income share from the (successful) commercialization of intangibles may be attributed under arm's length conditions. This necessitates a closer situational analysis, as shown in Figure 5.

This is normally part of a comparability analysis under chapter III of the OECD Guidelines (2010), which entails a review of existing rights and/or contractual agreements between transaction parties, their actual conduct and function and risk profiles, as well as their contribution of resources with regard to the relevant intangibles. Moreover, legal practice in different countries (e.g. India, the United Kingdom and the United States) has established bright-line tests on the basis of the situational factors mentioned.³⁵ These tests should serve as benchmarks for arm's length behaviour, for example with regard to the remuneration of "local marketing intangibles".³⁶

In summary, a transparent bundling of legal (and/or contractual) and economic (and/or beneficial) ownership in intangibles and IP within one company may be advantageous to avoid or limit disputes with tax authorities in different countries, to the extent that these countries are involved in, or affected by relevant cross-border transactions between affiliated companies. On this basis, the arm's length remuneration for legal or contractual ownership in the intangibles may then be established in a valuation, and also for potentially supporting services provided in connection with these assets. But there is no need to refer to rather fuzzy ownership concepts such as (3) or (4) in this context. The Henkel Group has been following this stra-

tegic approach for years, for example, by way of contract R&D agreements concluded with affiliated companies.

5. What Is It Worth?

The valuation of intangible assets is a complex, but nevertheless well established topic, in theory and practice. This statement is valid not only for transfer pricing specialists, but also other stakeholders such as advisors (e.g. valuers in corporate finance, accounting experts and public financial auditors).³⁷ Unfortunately, it is rather easy to get lost in a host of technical details or to simply reduce the determination of arm's length prices first and foremost to the application of sophisticated valuation methods. Instead, it is crucial to remind oneself, at times, that a meaningful valuation for transfer pricing purposes must be built upon answers to the questions dealt with in the two preceding sections, namely:

- What is the subject of the discussion, i.e. which intangibles are relevant to the transaction under consideration? This refers to identification of intangibles.
- Who owns the intangibles in question? Who is entitled to remuneration based on facts and circumstances, i.e. on a legal or contractual basis, or, alternatively, based on relevant (service) contributions with regard to the intangibles?³⁸ This refers to ownership clarification.

Only then is the next step to resolve the "adequacy question" as outlined in Figure 5, namely the determination of an arm's length value or price attributable to the intangibles and/or (potentially) supporting services under consideration within the framework of the relevant intercompany transaction(s).

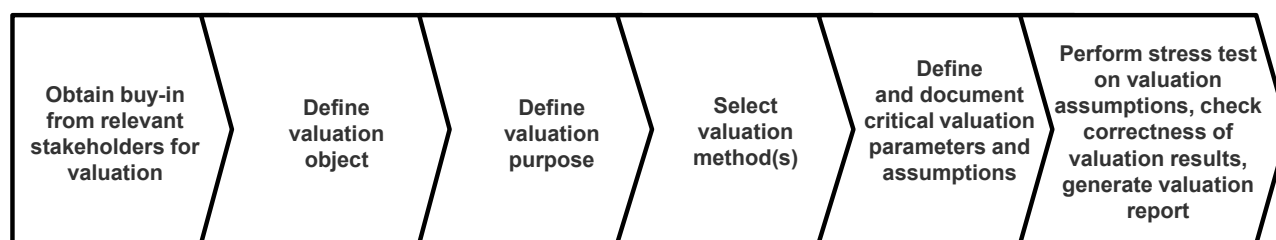
35. Compare e.g. United Nations, *UN Practical Manual on Transfer Pricing for Developing Countries* (2013), at 401.

36. Compare e.g. the *Maruti/Suzuki* (IN: HC Delhi, 1 July 2010, "*Maruti*" *Suzuki India Ltd v. ACIT*; IN: SC, 1 Oct. 2010, "*Maruti*" *Suzuki India Ltd v. ACIT*; IN: HC Delhi, 31 Jan. 2013, *Maruti Suzuki India Ltd v. ACIT*; IN: ITAT, 2 Aug. 2013, *Maruti Suzuki India Ltd v. ACIT*, Tax Treaty Case Law IBFD) and *LG Electronics* (IN: ITAT, 17 May 2013, *LG Electronics India Pvt. Ltd. v. ACIT*, Tax Treaty Case Law IBFD) cases in India, *DHL v. Commissioner* (US: TC, 30 Dec. 1998, *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*; US: CA, 11 Apr. 2002, *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, Tax Treaty Case Law IBFD) in the United States (and the discussion of economic ownership (3), above).

37. See sec. 2.1.

38. And in which form does the remuneration occur?

Figure 6: Valuation process



5.1. Starting point

Valuation is a process, as shown in Figure 6. It is not merely the calculation of one or more numerical results out of an array of data, based on a more or less sophisticated algorithm in an Excel spreadsheet. Rather, the transparent conduct and documentation of the entire process and valuation assumptions strengthen not only the acceptance of the results thereof among stakeholders inside the company, but also their consistent validation in a tax audit.

The valuation process is always a subjective exercise, because the main determinants of the value of economic goods are their desirability and utility.³⁹ These subjective factors may suggest a two-sided valuation, in order to capture (potentially different) ideas of transaction parties⁴⁰ about an adequate value of the object of the valuation. This is in line with the arm's length principle. And under article 1(3) of the German Foreign Tax Code (*Aussensteuergesetz*), this two-sided valuation is to be established by reference to the hypothetical arm's length test, if necessary.⁴¹ Moreover, valuation standards provide general orientation with regard to a proper conduct of the valuation process and also with regard to the valuation of selected intangible assets.⁴²

Different value concepts may underlie a valuation, such as fair market value, a liquidation value in bankruptcy cases, a negotiation value in market transactions or an infringement value in IP litigation cases.⁴³ Value concepts refer to different situations and define certain framework conditions for the valuation process. They also reflect the general purposefulness of valuations.

Moreover, different valuer roles⁴⁴ adopted by certain stakeholders involved will have an impact on the valuation process. Finally, valuation must be distinguished from measurement. Even though the value of an intangible asset or other goods may be given (colloquially, mea-

sured) in monetary units, measurement refers to directly or indirectly observable factors, which are not measurable on a monetary scale, such as the measurement of purchase probability of test customers in a buyer-intention survey, or the establishment of a utility function in a joint measurement framework.

Costs, value and price are three terms which are often used in a valuation context. Costs are considered to be a poor indicator only of the value of intangibles. An obvious example is funds spent on R&D projects, which will not always automatically turn into commercial success stories that create value for the company. And at the same time, the increased knowledge derived from failed projects is unfortunately difficult to measure. However, costs will be reflected in the price of goods, for example, as distinct price elements or as a minimum price threshold from a seller's perspective, between independent as well as affiliated parties. Consequently, costs will definitely be an important decision criterion in pricing, especially with regard to the timing of the valuation of intangibles for transfer pricing purposes.⁴⁵ Value can be reflected in a certain price, but not necessarily in a "linear relation fashion". This is because price will also be affected by market- or transaction-related aspects, such as relative scarcity, demand and subjective need fulfilment or economies of scale in production, which may be directly or indirectly linked to the intangible(s) relevant to the transaction under consideration.

5.2. Input factors

In preparation for a valuation process, it is necessary to clarify which quantitative and qualitative data and information are available, and whether it would be required to obtain missing or incomplete information, at what cost and how long this would take.⁴⁶ It may be better to proceed with a set of reasonable assumptions or alternative "work-arounds", rather than to insist on the accuracy or completeness of certain sets of data going into the valuation. Therefore, information availability will also have an impact on the choice of the applicable valuation methods.

Through the range of data and information used for valuation purposes and also via applicable valuation methods, several significant influencing factors can be built into the valuation process, for example, the (remaining) useful life

39. Compare D. Andriessen, *Making Sense of Intellectual Capital* (Elsevier Butterworth-Heinemann 2004), at 11-12.

40. I.e. buyer and seller, licensor and licensee or current and potential R&D pool members, in line with the main transaction categories discussed in sec. 2.2.

41. I.e. if no comparable or adequately adjustable arm's length data are available.

42. Compare e.g. IVSC GN04 (guidance note 4 on the valuation of intangible assets), ISO 10668 (on brand valuation), IDW S5 (on the valuation of intangible assets, including brands and customer-related intangibles), DIN PAS 1070: 2007-02 (on patent valuation); DIN 77100 (on patent valuation).

43. M. Lagarden (2011), *supra* n. 6, at 23-24.

44. E.g. expert witness, public financial auditor, arbitrator or advisor.

45. Compare e.g. Henshall (2013), *supra* n. 7, secs. 6.92-6.93, at 100 et seq.

46. See also OECD (2010), *supra* n. 12., chap. V, paras. 5.6-5.7.

Figure 7: Approaches to valuation of intangibles and IP in a transfer pricing context

Cost-based	Market-based	Income-based	Other approaches
<ul style="list-style-type: none"> Cost-plus method¹ Historic (creation or reproduction) cost method¹ Replacement cost method¹ Return on R&D method¹ 	<ul style="list-style-type: none"> Comparable uncontrolled price/ transaction method (as internal or external CUP/CUT) Adjusted CUP/CUT method (e.g. as benchmark study for royalty rates) Resale-minus method¹ 	<ul style="list-style-type: none"> Discounted cash flow method(s)¹ (DCF/applied here as direct cash flow method; and also ...) ... applied as: Relief from royalty method¹ Incremental cash flow method¹ Profit or income split method (here: DCF-based) Price or volume premium method¹ Multi-period excess earnings method¹ 	<ul style="list-style-type: none"> Profit split method; encountered in different variations, e.g. residual profit, (total) profits available, differential profit analysis Decapitalization method¹ Transactional net margin method^{1,2} and comparable profits method^{1,2} Combination methods (e.g. interbrand)¹ Real options method¹ Industry sector comparables (e.g. tabulated royalty ranges or industry norms) Goldscheider's rule,³ Knoppe formula,³ 5% margin rule³ Other⁴

1 One-sided method

2 Based on database-founded benchmark studies

3 Rules of thumb

4 E.g. empirically derived calculation formulae; valuation on the basis of capital market data (e.g. share prices)

of the intangible subject to valuation; uncertainty and risk; inflation; tax rates; the company's capital structure; and the time value of money of expected cash flows. A double counting of relevant factors⁴⁷ or their inconsistent consideration⁴⁸ may be deemed avoidable technical pitfalls in the valuation process. The transformation of qualitative information, which has potentially been established in a comparability analysis, into quantitative data is another challenge, for example, the function and risk profile of transaction parties involved, contractual conditions⁴⁹ or the scope of protection assigned to certain intangibles from a timing (duration), geographical and content perspective. In order to make such information and data available to monetary valuation, assumptions will have to be made and, again, this reflects the subjective character of valuations.

Last but not least, the point in time when a valuation is conducted is a decisive factor. This is valid with regard to the question as to the stage in the life cycle of an intangible at which valuation and pricing are actually performed. And it has a relevant impact on the value and/or the amount of an arm's length price, as the development of a patent or brand will give rise to costs right from the start, while profits (or profit potential) may materialize (or not) only at a later point in the lifecycle of the intangibles. In this context, cost-oriented valuation methods may deliver more reasonable indications of the value of an intangible

at an earlier point in its lifecycle, in comparison to highly sophisticated discounted cash flow methods, which may become more reliable and relevant for valuation purposes at a later point in time, when certain turnover linked to the intangible subject to valuation has already been realized, or can be expected with higher likelihood.⁵⁰

5.3. Methods available

In addition to the well-known transfer pricing methods described in detail in chapter II of the OECD Guidelines, a broad spectrum of methods for the valuation of intangibles is available in literature and business practice.⁵¹ Although these methods were most likely not developed for transfer pricing purposes, they may well be applicable from a mere "technical perspective" while duly taking into account certain transfer pricing-relevant framework conditions, such as the requirement for two-sided valuations or an adequate reflection of specific information obtained in a comparability analysis. As there is no one-size-fits-all method available for all cases of valuation of intangibles in a transfer pricing context, it does not seem reasonable at this point to provide prescriptive recommendations for or against certain valuation methods a priori.

Rather, the selection of a valuation method in a given case will depend on the type of intangible or IP that is subject

47. E.g. project-specific risk built into project cash flows and into the discount rate.

48. E.g. cash flow consideration on an *after-tax* basis, while a *pre-tax* discount rate is employed.

49. E.g. a licence agreement with(out) an option to extend its duration.

50. See also Henshall (2013), *supra* n. 7, secs. 6.92-6.93, at 100 et seq.

51. See e.g. Australian government, *IP Australia: Valuing Your IP assets* (no year specified), available at <http://www.ipaustralia.gov.au/manage-your-ip/review-your-ip/>, accessed 24 May 2014; World Intellectual Property Organization, *List of Documents on IP Valuation* (no year specified), available at <http://www.wipo.int/sme/en/documents/valuationdocs/index.htm>, accessed 24 May 2014.

to valuation; the respective data and information available; the valuation purpose and timing relative to the intangible's lifecycle; and the application and acceptance of the method in common business practice and/or in court. In other words, the choice will depend on the given situational framework conditions. The method chosen is then applied several times in the process, to adequately reflect a two-sided valuation. It also makes sense to apply more than one valuation method in order to do plausibility checks of the valuation results obtained. Figure 7 provides an overview over various transfer pricing-relevant valuation methods, which may themselves be categorized into fewer general approaches⁵² to valuation.

It is, however, not always possible to unambiguously categorize the methods listed here. Examples are the transactional net margin method (TNMM), comparable profits method or the relief from royalty method, which may also be summed up under the heading of "market-based approaches", as they rely on market comparables (i.e. profit margins or royalty rates). Moreover, variants of one "base method" could potentially be attributed to different categories, depending on how the calculation method has been established in detail.⁵³

The valuation of intangibles and IP is important for Henkel, particularly with regard to the determination and documentation of arm's length royalty rates charged to affiliated companies for their utilization of corporate intangibles and IP. This is effected on the basis of the residual profit split method, as described in the OECD Guidelines. Additionally, external and internal CUP data are available in this regard for plausibility and consistency checks, as well as for transfer pricing documentation purposes. In individual cases, valuations of self-created or acquired intangibles will be conducted in the case of cross-border IP transfers, which can support the consolidation of the IP ownership structure inside a multinational group. As an example, in these cases the relief from royalty method is often applied. Whether the valuation is conducted internally by finance professionals or is supported by external valuation specialists also, will depend on the value and strategic relevance of the transaction in question. And purchase price allocations which can, at the very least, be considered indicative for the value and valuation of intangibles, are rather only seldom available.

After having considered the ownership question (see section 4.), the preceding discussion is meant to provide a practical framework for the determination of an arm's length value (and price) for relevant intangibles in inter-company transactions. The discussion below addresses (i) current developments at the OECD and UN level, with regard to transfer pricing aspects of intangibles and (ii) the

most significant consequences that these developments might entail for companies (in the author's opinion).

6. Current Trends

In January 2011, OECD Working Party No. 6 began its focus on transfer pricing aspects of intangibles, which targets the new formulation of chapter VI of the OECD Guidelines. This initiative had been prepared and has been conducted with broad involvement of all interested stakeholder groups.⁵⁴ The revision of chapter VI (currently still in its version published in 1995) has become urgently required in order to take account of the increased importance of intangibles from both a business and tax planning perspective, and also because of the parallel evolution of cross-border transactions between affiliated companies. In this regard, the OECD project work needs to be considered in connection with chapter IX, Transfer Pricing Aspects of Business Restructurings, which was added to the OECD Guidelines in July 2010. Consequently, the two chapter VI discussion drafts which were published in the summer of 2012 and 2013 establish several links to statements in chapter IX, especially with regard to the concepts of risk and control and their importance in relation to intangibles in a transfer pricing context. Finally, the publication of the final version of chapter VI by the OECD (planned in September 2014) may also be eagerly awaited against the background of the BEPS discussion and the future implementation of respective (counter-)measures.

Similarly, the UN has been actively dealing with transfer pricing over the last couple of years. As a focal point of these efforts, the *Practical Manual on Transfer Pricing for Developing Countries* was published in mid-2013. As the title already implies, the UN is explicitly representing the interests of the developing economies, among them the so-called BRICS countries.⁵⁵ By contrast, the OECD is representing the interests of the historically already established national economies in North America, Europe and Asia. To a large extent, the UN Practical Manual is in broad agreement with the contents of the OECD Guidelines.⁵⁶ In chapter 10, however, the tax authorities of Brazil, China, India and South Africa have had the opportunity to present their national perspectives with regard to current transfer pricing challenges in a comprehensive manner. Consequently, these positions neither reflect a consensus among the UN – nor the transfer pricing subcommittee members who were in charge of creating the UN Practical Manual.⁵⁷ They also, to some extent, deviate from OECD considerations on the practical design and interpretation of the arm's length principle, as laid down comprehensively in the OECD Guidelines. Especially with regard to China and India, interested readers have the opportu-

52. I.e. cost-based, market-based, income-based and other valuation approaches.

53. For example, with regard to profit split methods. The methods listed under the category "Other approaches" in Figure 7 may also be regarded as income-based, at least in part, even though they may not always refer to discounted cash flow algorithms, which have been chosen to "lead" the income-based approaches here.

54. See Figure 1, sec. 2.1.

55. BRICS: Brazil, Russia, India, China and South Africa.

56. Compare e.g. A. Eigelshoven & A. Ebering, *Das Fremdvergleichsprinzip neu interpretiert: Das „Practical Manual on Transfer Pricing for Developing Countries“ der Vereinten Nationen*, 23 Internationales Steuerrecht (IStR) 1 (2 Jan. 2014), at 16-21.

57. UN (2013), *Practical Manual on Transfer Pricing for Developing Countries*, ST/ESA/347, at viii and 357, available at http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf, accessed 23 June 2014.

nity to learn more about the understanding and expectations of the tax authorities of those countries with regard to their approach to intangibles in cross-border transactions between affiliated companies, to the extent that (at least) one of the transaction parties would be subject to taxation in the countries mentioned.

Therefore, the following discussion deals on the one hand with the most current chapter VI of the Revised Discussion Draft of the OECD Guidelines (as of 30 July 2013)⁵⁸ and, on the other, specifically with the Chinese and Indian statements on intangibles in sections 10.3 and 10.4 of the UN Practical Manual.

6.1. OECD: Transfer pricing aspects of intangibles

With regard to the identification of intangibles, the Revised Discussion Draft provides a very broad and rather general definition: “[...] something which is not a physical asset or a financial asset, [...] capable of being owned or controlled for use in commercial activities, [...] whose use or transfer would be compensated [...] in transactions between independent parties [...]”.⁵⁹ This listing includes similar (but not all) elements compared to the tentative definition given in section 2. of this article. Moreover, the Revised Discussion Draft offers a range of exemplary categories of intangibles,⁶⁰ such as company names⁶¹ and “goodwill and ongoing concern value”. Separate transferability is not regarded as a necessary condition characterizing an intangible from the perspective of the Revised Discussion Draft.⁶² However, certain features – such as “location savings and other local market features”, “assembled workforce” and “MNE Group Synergies” – are not regarded as intangibles, but relevant factors in a comparability analysis.⁶³ This is a significant difference in comparison to the position of the Chinese and Indian tax authorities in chapter 10 of the UN Transfer Pricing Manual. However, it is consistent with the tentative definition of intangibles provided in section 2., as these factors, as such, may not be actively controlled or transferred by a company.

The OECD itself concedes that:

... not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances. [...] [N]ot all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible [...].⁶⁴

Even though there is no “quasi automatic” relation between intangibles and their value,⁶⁵ it is obvious that the definition for intangibles suggested by OECD Working Party No. 6⁶⁶ is designed to broaden the general content basis to which taxation of respective transactions between affiliated companies may be tied, depending on facts and cir-

cumstances (see Figure 5). Against this background, corporate taxpayers should have lesser opportunities to assert either that “there are no intangibles” or that these are “irrelevant to cross-border transactions” within a multinational group.⁶⁷ However, the downside is that both aspects are also prone to support the diffuse notion that “[...] there must be something of value”.⁶⁸ Although this “something” is difficult to define, it should readily serve as an explanation for “excess profits” in certain affiliated companies participating in the transactions under consideration. And it is these actual or assumed profits which tax authorities would then seek to tax to the affiliated company taxpayers in their jurisdiction.

With regard to the question of ownership in intangibles and the investigation into whether (or not) a certain share of remuneration may be derived therefrom, it is the position of the OECD that legal ownership can be regarded as a reference point.⁶⁹ However, the Revised Discussion Draft explicitly states that “[...] for transfer pricing purposes, legal ownership [...], by itself, does not confer any right ultimately to retain any return [...] as a result of [...] [a] legal or contractual right to exploit the intangible [...]”.⁷⁰ Again, on the one hand, this wording is geared towards a limitation of advantageous tax design alternatives for companies and, on the other, towards broadening the basis of potentially taxable transactions in this context. Legal (or contractual) ownership is not regarded as necessary under arm’s length conditions, in order to be entitled to a (partial) remuneration from earnings which arise in transactions between independent companies, involving the contribution of relevant intangibles. It remains doubtful to the author, however, how this could be derived from observable transactions between independent third parties.

Rather, in its Revised Discussion Draft, the OECD places more emphasis on a comprehensive comparability analysis and respective documentation in order to ascertain to whom which shares of remuneration related to intangibles may be attributable under arm’s length conditions.⁷¹ Figure 8 provides an overview of the relevant factors in this regard.

The general framework is set by the definition and description of identifiable transactions and related contractual arrangements between parties involved. This includes the actual conduct of the transaction parties, with regard to the basic principle of substance over form,⁷² as well as other potentially relevant comparability factors, such as “location savings and other local market features”, which need to be adequately covered in the analysis. The core portion then consists of four segments (see sections 1. through 4.):

- identification of intangibles involved;
- clarification of the ownership question with regard to these intangibles;

58. See OECD (2013), *supra* n. 17.

59. Compare OECD (2013), *supra* n. 17, sec. 40.

60. Compare OECD (2013), *supra* n. 17, secs. 52-61.

61. Compare also OECD (2013), *supra* n. 17, secs. 99-103.

62. Compare OECD (2013), *supra* n. 17, sec. 42.

63. Compare OECD (2013), *supra* n. 17, secs. 1-33 and 63-64.

64. Compare OECD (2013), *supra* n. 17, secs. 44-45.

65. See also table 1 in sec. 3.

66. See OECD (2013), *supra* n. 17, sec. 40.

67. Indeed, both aspects are addressed in sec. 39 of the *Revised Discussion Draft*, see OECD (2013), *supra* n. 17 accordingly.

68. Compare e.g. Henshall (2010), *supra* n. 13.

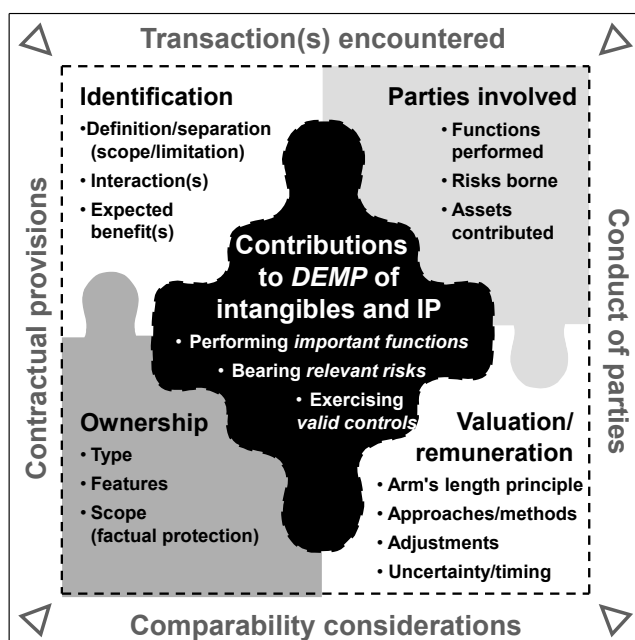
69. Compare OECD (2013), *supra* n. 7, secs. 67 and 73.

70. Compare OECD (2013), *supra* n. 17, secs. 73-74 and 89.

71. Compare OECD (2013), *supra* n. 17, secs. 36-38, 66, 73-88 and 157.

72. See OECD (2010) *supra* n. 12, chap. I, paras. 1.48 and 1.65.

Figure 8: Relevant comparability analysis factors with regard to intangibles and IP in a transfer pricing context



DEMP: development, enhancement, maintenance and protection; IP: intellectual property

- valuation and remuneration of the intangibles; and
- functions performed, risks borne and (other) assets contributed by transaction parties involved.

More important, however, is the fifth segment in the centre of Figure 5. A response needs to be provided to the question concerning the way in which – and the extent to which – the parties involved have contributed to the development, maintenance, enhancement and protection of the relevant intangibles.⁷³ This should serve as a yardstick for an attribution of certain shares of remuneration to parties as part of their transactions involving the relevant intangibles. In this regard, important functions are listed in the Revised Discussion Draft, which include, but may *not* be limited to:

- (1) design and control of research and marketing programmes
- (2) management and control of budgets
- (3) control over strategic decisions regarding intangible development programmes
- (4) control over important decisions regarding defence and protection of intangibles
- (5) ongoing quality control over functions performed by independent or associated enterprises.⁷⁴

Moreover, it is stated that these (especially) significant functions will generally be performed by the own employees of the legal owner, if this owner claims an entitlement to (at least partial) remuneration from the intangibles in question.⁷⁵ However, it is also stated that the legal owner does not need to perform virtually “each and every” function with regard to the development, maintenance,

enhancement and protection of relevant intangibles with its own employees. An outsourcing of (lesser important) functions is considered feasible under the control retained by the legal owner.⁷⁶

Relevant risks to be borne by a transaction party entitled to a respective share of remuneration from the intangibles are summarized in the Revised Discussion Draft in sections 87 and 146 as follows:

- development risks (general uncertainty of R&D with regard to its (commercial) success);
- obsolescence risks (regarding development of demand and technological progress);
- infringement risks (regarding defence and legal claim enforcement in the protection of intangibles); and
- product liability and other product- and service-related safety risks.

At this point, a direct link is established to chapter IX of the OECD Guidelines, with regard to the consideration, the way and extent to which a transaction partner exercises valid control over the relevant risks and important functions mentioned.⁷⁷ In this context and in alignment with the approach provided in chapter IX,⁷⁸ valid control entails:

- the capacity to decide whether to take on a certain risk, to pass it on to another party or to avoid it;
- the power of decision regarding how to manage the risk, for example, by:
 - allocation of decision-making authority to other parties performing certain risk management functions;

73. Compare OECD (2013), *supra* n. 17, secs. 75-76.

74. I.e. requiring certain expertise and capacity on the part of the legal owner or principal to be able to exercise this important function and valid control. Compare OECD (2013), *supra* n. 17, sec. 79.

75. Compare OECD (2013), *supra* n. 17, sec. 80.

76. Compare OECD (2013), *supra* n. 17, sec. 76 and compare the subsequent discussion under *control* in the main text.

77. Compare OECD (2013), *supra* n. 17, secs. 76 and 84-85.

78. Compare OECD (2010), *supra* n. 12, chap. IX, paras. 9.23-9.32.

- assigning objectives to these managing parties;
- the scope of financial resources invested (handed over to the managing parties);
- regular reporting by the managing parties to the ultimately responsible principal; and
- the ability on the part of the principal to assess the results contributed by the managing parties; and
- actual financial capacity to bear risk.

These broad and general substance requirements become relevant, for example, with regard to the practical layout of (future) contract research transactions within a multinational group. From the OECD's perspective, the mere financing of activities and projects by an IP holding or a parent company, related to the development, maintenance, enhancement or protection of intangible assets, does not convey any more or less entitlement to remuneration than a risk-adequate return on capital to a financial investor (e.g. a bank).⁷⁹

The valuation of intangibles for transfer pricing purposes by employing various methods is also covered in the Revised Discussion Draft in some detail. In this context, the OECD considers the application of one-sided methods, such as resale minus, TNMM and cost-based methods (see Figure 7) as (rather) not suitable for the valuation of intangibles – or suitable under only very limited conditions.⁸⁰ The OECD also argues against recourse to rules of thumb for valuation purposes.⁸¹ Instead, the CUP and profit split methods are favoured.⁸² Moreover, income-based valuation methods are outlined in particular,⁸³ as well as some detailed considerations with regard to significant valuation input parameters for discounted cash flow methods.⁸⁴

Additionally, many (and, to some extent, comprehensive) examples are provided in various sections of the Revised Discussion Draft. They should facilitate a better understanding and interpretation of the OECD approach to transfer pricing aspects of intangibles.⁸⁵ Interestingly enough, the OECD also defines a “law of value conservation”: “It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring”.⁸⁶ Although it may be conceded that this statement was not made with the same claim to absoluteness that can be attributed to conservation laws in physics⁸⁷, business practice unfortunately provides many examples to prove the correctness of the contrary. And this is independent of any sophisticated tax planning ideas, even despite best intentions and highest efforts of all parties involved in a company to avoid failure.

6.2. UN: Selected country perspectives on intangibles and transfer pricing

6.2.1. China

From the perspective of the Chinese tax authorities (SAT), the main challenges with regard to intangibles which often “remain unanswered by the OECD Guidelines”, are the “quantification and allocation of location specific advantages”, which are assumed to be oftentimes closely linked to marketing intangibles, and also the identification and valuation of intangibles.⁸⁸ Several location-specific advantages which are considered as comparability factors but not intangibles in the Revised Discussion Draft⁸⁹, are outlined in section 10.3.3.1 in more detail. In the view of the SAT, these are more often encountered in China than in developed OECD economies. Hence, they give rise to higher profits, which should then be rightfully earned by Chinese taxpayers. In this context, the automotive industry is presented as a valid example in more detail in sections 10.3.3.6 and 10.3.3.7.

Also, with regard to contract R&D it is suggested in a sample calculation that a cost-plus percentage rate considering the comparables of developed countries, needs to be substantially increased by an additional factor, taking into account the net cost savings between the lower Chinese R&D cost base and the higher average cost base in the developed countries. Moreover, the issue of the status as a new high-technology enterprise (providing an attractive corporate income tax reduction) is considered irreconcilable with the claim of mere contract R&D undertakings. Rather, in the opinion of the SAT, this status would call for an application of the profit split method for local R&D activities.⁹⁰

With regard to intangibles, only a few examples are given in section 10.3.4.2 (“intangibles may take various forms, such as a global brand name, technical know-how or business processes”), and it is also stated that Chinese affiliates acquire expertise and skills over time which enable them to contribute to the improvement of the original intangibles initially provided by a foreign parent company. Therefore, the Chinese tax authorities claim that local affiliates should be entitled to earn additional profits, for example, potentially by paying lesser royalties for the initial intangibles provided (cf. section 10.3.4.3). Similarly, the creation of substantial local marketing intangibles should be remunerated at arm's length by an application of the profit split method (cf. section 10.3.5.11).

In summary, the general position of the SAT is that relevant intangibles are created in China to a large extent, taking advantage of a host of favourable market factors and peculiarities⁹¹ – and without pondering too much the subtleties of the definition of intangibles. Consequently,

79. Compare OECD (2013), *supra* n. 17, secs. 82-84.

80. Compare OECD (2013), *supra* n. 17, secs. 159-161.

81. Compare OECD (2013), *supra* n. 17, sec. 162.

82. Compare OECD (2013), *supra* n. 17, secs. 164-170.

83. Compare OECD (2013), *supra* n. 17, secs. 171-175 and Figure 7.

84. Compare OECD (2013), *supra* n. 17, secs. 176-196.

85. Compare OECD (2013), *supra* n. 17, secs. 24-33, 94-103 and 224-329.

86. Compare OECD (2013), *supra* n. 17, sec. 292.

87. Which apply under a set of well-defined framework conditions.

88. UN (2013), *supra* n. 57, sec. 10.3.1.2 and 10.3.4.1.; SAT: State Administration of Taxation, People's Republic of China.

89. Compare OECD (2013), *supra* n. 17, chap. I, D.6, secs. 1-34.

90. See UN (2013), *supra* n. 57, secs. 10.3.3.8, 10.3.3.9, and also 10.3.5.1 and 10.3.5.4.

91. Compare UN (2013), *supra* n. 57, secs. 10.3.3.1-10.3.3.3, 10.3.3.6, 10.3.5.1, 10.3.8.2

these intangibles should be adequately remunerated by applying a (residual) profit split which takes into account the role, contribution and risks assumed by local affiliates, or even “a global formulary approach should be a realistic and appropriate option” (cf. sections 10.3.6.3 and 10.3.6.4). Obviously, there are several points where the SAT disagrees with OECD positions. And the general target of broadening the taxable income base and increasing local tax revenues in China is evident.⁹²

6.2.2. India

While the ultimate target of the Indian tax authorities (Income Tax Department) with regard to the taxable income base and related revenues is identical to the SAT position described in section 6.2.1., the line of argumentation is slightly different. The Indian tax authorities stress the importance of risk bearing, in relation to functions performed and assets employed (cf. section 10.4.4). In this context, they go into some detail on contract R&D and respective control over risks, which is somewhat similar to the OECD approach in the Revised Discussion Draft as outlined in section 6.1. However, the Indian tax authorities have a much broader – and, to an extent, also different – understanding of what constitutes strategic operational decision making and corresponding control over risk.⁹³ Likewise, location savings are considered to constitute a unique value proposition of the Indian market, thus leading to the conclusion that the profit split method should be the method of choice for adequately remunerating respective advantages at arm’s length.⁹⁴

Key issues surrounding intangibles include the determination of arm’s length royalty rates; allocation of new market and brand development cost; remuneration for marketing development; R&D intangibles and their use; and transfer pricing of co-branding.⁹⁵ R&D activities and marketing intangibles are then considered in more detail in sections 10.4.8.8 through 10.4.8.18. And again, certain arguments asserted by the Indian tax authorities⁹⁶ are similar to the OECD’s with regard to the centrepiece shown in Figure 8 (i.e. performance of important functions, bearing relevant risks, exercising valid control), although the conclusions drawn with regard to contributions specifically rendered by Indian affiliates in this context are rather different from the OECD positions in the Revised Discussion Draft.⁹⁷

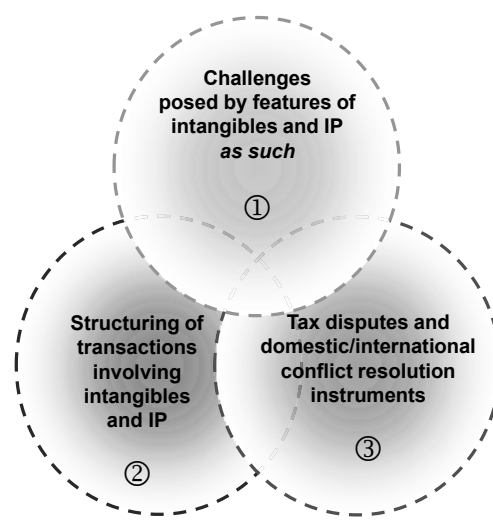
The OECD approach outlined above (to the extent that its contents are ultimately published in the final new version

of chapter VI in the OECD Guidelines in 2014) and also the rationale of the non-OECD UN member countries China and India, in their individual interpretation of the arm’s length principle,⁹⁸ entail significant consequences for cross-border transactions between affiliated companies involving intangibles.

7. Where Does the Road Lead?

Three focus areas can be identified against the background outlined above. They will be of prime importance with regard to intangible-related cross-border transactions within multinational enterprises. The areas shown in Figure 9 are likewise relevant for corporate taxpayers and tax authorities in the countries affected.

Figure 9: Focus areas for companies in their dealings in intangibles and IP in a transfer pricing context



The first area is linked to challenges posed by certain features of intangibles and IP such as (1), which remain unchanged.⁹⁹ This specifically refers to the identification, different ownership concepts and the valuation of transaction-relevant intangibles under arm’s length conditions. Providing more refined definitions and methodological advice is clearly helpful, but it does not simply make those inherent challenges linked to intangibility and the uncertainty in forecasting future business development disappear. And in this regard, there is a different understanding on the side of taxpayers and tax authorities as to what might constitute arm’s length measures to deal with these challenges. A less broad and less general definition of intangibles in the new chapter VI would be helpful for all stakeholders, as it could support the separation of intangibles against rather diffuse “value notions”.¹⁰⁰ However, this may not necessarily be in the best interest of tax authorities, potentially tapping into a broader domestic taxable income basis in future.¹⁰¹ It may therefore be advisable for multinational companies, in this context, to combine their

92. G. DeSouza, *What the UN Manual Really Means for China?*, 41 Intertax 5 (2013), at 331; A. Eigelshoven & A. Ebering, *supra* n. 56, at 18-20.

93. See UN (2013), *supra* n. 57, sec. 10.4.4.5; also A. Ebering & J. Simonovic, *Auftragsforschung im Fokus der indischen Finanzverwaltung: bemerkenswerte Verwaltungsanweisungen des indischen Finanzministeriums*, 1 Verrechnungspreise direkt digital 1 (21 Jan. 2014), NWB Verlag GmbH & Co. KG, Herne, at 2-4; A. Chakravarty & S. Ray, *Circulars on Transfer Pricing of Contract R&D Centres: The Road Ahead*, 20 Intl. Transfer Pricing J. 6 (2013), at 404, Journals IBFD.

94. See UN (2013), *supra* n. 57, sec. 10.4.7; A. Eigelshoven & A. Ebering, *supra* n. 56, at 20-21.

95. Compare UN (2013), *supra* n. 57, sec. 10.4.8.

96. Compare UN (2013), *supra* n. 57, sec. 10.4.8.8.

97. Compare UN (2013), *supra* n. 57 secs. 10.4.8.10/11, 10.4.8.12/13 and 10.4.8.16-10.4.8.18.

98. See A. Eigelshoven & A. Ebering, *supra* n. 56, at 18-21.

99. See secs. 3. through 5.

100. See Henshall (2013), *supra* n. 7, sec. 6.19, at 81; Henshall (2010), *supra* n. 13, at 10 et seq.

101. See sec. 6.1.

legal and economic ownership of intangibles and IP in one location or one company. This can support a more consistent structuring, documentation and successful argumentation of, for example, contract research set-ups or cross-border licensing of intangibles and IP to affiliated companies in a multinational group versus tax authorities in different countries.

The second field is linked to the future structuring of transactions (2) between affiliated companies, in which intangibles play a relevant role cross-border. In view of the discussion in section 6, it may well be expected that transparency requirements with regard to tax planning initiatives involving intangibles will increase. On the one hand, this relates to substance and sustainability of underlying business purposes and, on the other, to comprehensive documentation of transactions in and by the companies involved. As a consequence, different value contributions of affiliated companies (if any) with regard to a performance of important functions, relevant risk bearing and valid control of those elements in the development, maintenance, enhancement and protection of relevant intangibles will need to be transparently documented in more comprehensive comparability analyses.

Unfortunately, this may not necessarily reconcile different approaches to the arm's length principle upheld by various tax authorities.¹⁰² However, in future, more emphasis needs to be placed on internal comparables in a multinational group, to the extent that these become available. For example, this may relate to the arm's length pricing of licences for the utilization of corporate intangibles and IP by affiliates. Also, case law precedents will serve as important reference points for arm's length conditions (from a legal perspective) – even more so as intangibles are considered “unique by definition” and therefore hardly comparable with external comparables.

Viewed from another angle, focus area (2) can also be described as follows: Regular information exchange and cooperation between tax authorities in different countries presently remain in an emerging stage. In 10 to 15 years, however, the situation may have changed to a more cooperative approach – provided that underlying tax competition, national sovereignty and/or economically protectionist interests, as well as intercultural, administrative and language barriers can be managed more effectively and efficiently in future. This will definitely require more political will and active efforts on the side of fiscal stakeholders involved.¹⁰³ Multinational corporate taxpayers can be proactive in this regard, for example by establishing open and constructive long-term working relations with tax authorities in countries in which they are doing business. Henkel Group also adheres to this “beyond minimum compliance” approach, which is internationally encouraged by various tax authorities as well.

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102. See secs. 6.1. and 6.2.

103. See sec. 2.1.

The third and final focus area, according to Figure 9, is addressing tax disputes that may arise despite (or even because of) the new OECD Guidelines in chapter VI, as well as against the background of the current BEPS action plan, and corresponding domestic and international instruments to resolve these (3). In this context, one must consider potential conflicts between corporate taxpayers and domestic tax authorities on the one hand, but also disputes between tax authorities in different countries on the other, resulting from competition for taxable income and independence in establishing a national tax law framework, as well as from a different interpretation of the arm's length principle by OECD members (partly among themselves) and the non-OECD BRICS states, for example.¹⁰⁴

There are, of course, established tax dispute resolution instruments available (e.g. advance pricing agreements, mutual agreement procedures and joint tax audits) to avoid double taxation and to safeguard adequate taxation in line with article 9 of the OECD and UN Model Conventions. However, based on common experience, these procedures take a rather long time in practice, which is not merely due to difficulties in the clarification of facts and circumstances in any given case, but also due, for example, to inefficient processes and the refusal to address (or to agree on) contentious points. Different interpretations of the arm's length principle only serve to highlight this aspect.¹⁰⁵ Moreover, tax authorities in most countries are not always adequately equipped to cope with an increasing number of cases.

Also, income tax treaties and/or arbitration conventions and clauses binding upon tax authorities are available only in a rather limited number of cases, to ultimately remove double taxation. And in the current BEPS discussion framework, the focus seems to have shifted somewhat from the issue of avoiding double taxation towards capturing large income amounts which reportedly have remained untaxed so far. However, this development is only rational, as it makes more sense in economic terms to focus scarce resources on gaining access to currently untapped, potentially taxable income, as opposed to the reallocation of profits that have already been taxed somewhere, thus ultimately leaving one side with a final result which is less advantageous than its starting position. In this regard, there is a clear need for further international joint action on a political and economic level, also with regard to a more cooperative approach among different tax authorities.

Therefore, no crystal ball is needed to finally conclude that intangibles in a transfer pricing context will remain a hot topic for different stakeholders¹⁰⁶ and because of different reasons in future.

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104. See UN (2013), *supra* n. 57, chap. 10.

105. See secs. 6.1 and 6.2.

106. See sec. 2.1.