"TRANSFER PRICING AND INTANGIBLE ASSETS: PROBLEM AREAS IN ADDRESSING THE TRANSFER OF INTANGIBLE ASSETS"

A RESEARCH REPORT
BY

ROBERT SIDDLE

SDDROB002

IN PARTIAL COMPLETION OF THE REQUIRMENTS TO BE AWARDED A LLM TAX LAW

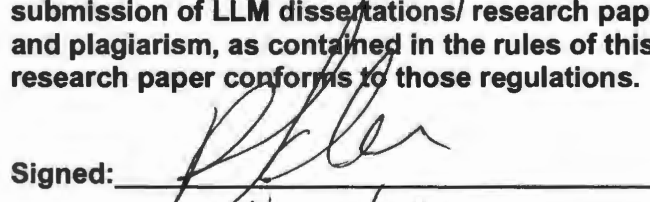
UNIVERSITY OF CAPE TOWN

17 February 2014

Word Count: 15 357

Research dissertation/ research paper presented for the approval of Senate in fulfillment of part of the requirements for the LLM in approved courses and a minor dissertation/ research paper. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of LLM dissertations/ research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation/ research paper conforms to those regulations.



Signed:__________

Date:__________

The copyright of this thesis vests in the author. No quotation from it or information derived from it is to be published without full acknowledgement of the source. The thesis is to be used for private study or non-commercial research purposes only.

Published by the University of Cape Town (UCT) in terms of the non-exclusive license granted to UCT by the author.

University of Cape Town

Contents

Introduction 3
Research Question 5
Transfer Pricing 5
The South African Context: Section 31 6
Transfer pricing methods suitable for intangible assets 13
  The Transactional Profit Split Method 13
  The Strengths and Weakness of the Recognized Methods 14
    The Transaction Profit Split 14
Intangible Assets 15
Identifying intangibles 23
Identification of the parties entitled to intangible related returns 28
Functions, risks and costs related to intangibles 30
Determining Arm's Length Conditions in Cases Involving Intangibles 38
Evaluating the presence of intangibles 49
Difficulties in dealing with intangible assets in transfer pricing 53
Possible solutions to short-comings in transfer pricing of intangible assets 57
Conclusion and Recommendations 63
Bibliography 66

DIGITISED
- 4 DEC 2014

Introduction

Intangibles assets have become considerably more important in business since Chapter VI of the OECD transfer pricing guidelines was first published in 1995. The transfer pricing issues that arise have become more common and can be some of the most difficult to resolve. The revised chapters now refer to valuable, unique contributions and the valuable intangibles which are given a central role in determining the selection of the most appropriate method and comparability analysis.[1]

The differing interpretation in respect of intangible assets has led to a discussion where the more pertinent question has become "What is not an intangible" in an attempt to narrow the definition thereof. The difference in accounting practices and recording of intangibles by corporates has added to the confusion. It would prove difficult to nail down an exact definition of all intangibles and effort spent on setting out the characteristics of intangibles may prove more fruitful.

In the context of transfer pricing the issues of concern regarding intangible assets become magnified as the inherent uncertainty in intangibles make them the perfect vehicle for multinational enterprises to target in transfer pricing schemes.

The global stage in which the practice of transfer pricing is set accompanied by the fact that intangible assets form an essential mechanism in MNE's business structure and as

[1] J. Owens, 'Transfer Pricing Aspects of Intangibles: Scope' PWC.

a stand-alone income generating asset makes the interaction of these two areas of law and accounting of great significance. The mobility of intangibles make them a very attractive assets to repatriate to lower tax jurisdictions.

Section 31[2] makes reference to arm's length prices; however fails to establish how said prices are to be determined. This is a problem that has been grappled with and solved in traditional business models, but which presents a different set of problems when superimposed on transactions involving intangible assets. Transfer pricing is acknowledged as lacking any characteristics of an exact science and exhibiting more similarity to a form of art.

In assessing the problems that arise when the practice of transfer pricing is applied to the transfer of intangible asset transfers there are certain areas and nuances that need to be recognized. These include the distinction between economic and legal ownership and the fact that the two concepts, in certain circumstance, are mutually exclusive. Furthermore, the fact that the traditional methods of transfer pricing may not be able to address the unique nature of certain intangibles and that even the more complex methods involving both parties may fall short in situations where the rights and obligations connected to the intangibles assets are not subject to written agreements or accounting standards and procedures.

In delving into the interaction of these two fields I will first establish the playing field and the rules, being the practice of transfer pricing, both on the international stage and

[2] Income Tax Act, No. 58 of 1962 (amended).

domestic level. Next it will be necessary to understand the nature of intangible assets as viewed internationally. Upon reviewing the status of intangible assets in the context of transfer pricing I hope to locate the shortcomings caused by the unique characteristic of intangibles and hopefully will be able to suggest some viable options and alternatives.

Research Question

An examination of the nature of intangible assets, the difficulties that the presence of intangible assets pose in transfer pricing arrangements, in particular with regard to identification and valuation of intangibles, and possible solutions thereto.

Transfer Pricing

In general terms, transfer pricing is the price at which goods, services or intellectual property are transferred between related parties of a multinational organization or enterprise ("MNE") across international borders typically resulting in the transfer of profits from a high tax jurisdiction to a low tax jurisdiction. Transfer pricing is a technique that is frequently utilized by MNE's to reduce their effective universal tax obligations. In normal, arm's length, transactions prices are normally determined by market factors and the market price is established. However, in transactions between related parties, these market forces are ignored and pre-determined, fixed terms, usually relating to price, but

possibly also to terms relating to credit or guarantees are set that favour the MNE as a whole.[3]

The South African Context: Section 31

Comprehensive transfer pricing legislation was introduced in South Africa in 1995 when the revised S 31 was introduced into the Income Tax Act. Prior to this the methods of attack were limited given the restrictive wording of the previous section.

Since the introduction of the revised S 31, SARS now has the power to adjust the prices of a much wider range of goods or services which are not regarded as being at arm's length.

Section 31 (1) contains the definitions applicable to this section, while Section 31 (2) provides for the transfer pricing adjustment mechanism. Section 31 (2) stipulates that where goods or services are supplied or acquired in terms of an international agreement and the acquirer is a connected person in relation to the supplier, and where the price of the goods or services is not at arm's length, the Commissioner may adjust the price in these situations.[4]

Section 31 acts as an anti-avoidance section and deals specifically with transfer pricing and also thin capitalisation. We are primarily interested in transfer pricing. The section

---

[3] Paragraph 10.1, De Koker, "*Silke on International Tax*", November 2010.
[4] Page 403, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.

enables the Commissioner of SARS to adjust prices payable in respect of a supply of goods or services in terms of international agreements between connected persons. The Commissioner will enact such powers if consideration for goods or services is higher or lower than arm's length price and profits are shifted out of South Africa. This "arm's length" principle is internationally accepted and allows the South African fiscus to ensure it receives its fair share of tax.[5]

The important definitions in S 31 (1) such as 'goods', 'services' and 'international agreements' are defined as follows:

'*Goods*': these are widely defined to include any incorporeal movable thing, fixed property and any real right in any such thing or fixed property.

Consequently, mineral rights, trademarks, real estate and usufructs are examples of goods for purposes of this definition. '*Services*' are widely defined to include anything done or to be done, as well as; the conferring of rights to incorporeal property.[6]

'*Connected Persons*': this definition extends to persons, natural or juristic, including a trust, involved in a transaction, operation, scheme, arrangement or understanding; a beneficiary; connected person to that beneficiary; any member of a partnership; any connected member of that partner; in respect of a company, any other company with a majority share in that company or that that company holds in it; any person, excluding a

[5] Page 422, "*Notes on South African Income Tax*", Huxham and Haupt, 2009.
[6] Page 403, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.

company, that, directly or indirectly holds 20% or more of the of the shares or voting rights; any company if said company is managed or controlled by any person who is a connected person in relation to such company, or any person who is a connected person in relation to that person; in respect of a close corporation, any member, any relative of such member or any trust including any relative of the aforementioned persons.[7]

SARS' Practice Note 7 contains the following definitions:

"*Controlled transaction*": a transaction in terms of which the ownership or control relationship is able to influence the transfer price set. In relation to s 31 a controlled transaction will be any transaction between connected persons as defined.[8]

"*Uncontrolled transaction*": a transaction concluded at arm's length between enterprises which are not connected persons in relation to each other. Uncontrolled transactions form the benchmark against which a MNE's transfer pricing is appraised in determining whether its prices are arm's length.

"*The arm's length pricing method*": This method operates on the basis of taxing each company within MNE group separately as if transactions between them were independent transactions at arm's length. The arm's length method is used by countries which are members of the OECD or non-members who subscribe to the OECD Model

---

[7] Income Tax Act, No. 58 of 1962 (amended).
[8] Page 403, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.

Tax Treaties and Guidelines, such as South Africa. Both S 31 and SARS' Practice Note 7 refer to the arm's length principle, while Practice Note 7 states that the Practice Note is based on OECD Transfer Pricing Guidelines and these guidelines should be followed in the absence of specific provisions in the Practice Note, despite South Africa's non-member status in respect of the OECD. The OECD guidelines follow the arm's length approach and reject the formulary apportionment method. As such, South Africa follows the arm's length method. By utilizing the arm's length method South Africa is effectively conforming to article 9 of the OECD Model Tax Treaty, which determines the profitability of each group company separately on an arm's length basis.[9]

S 31 does not provide any further definition as to what or how an arm's length price is to be determined.

Consequently, SARS has issued detailed guidelines in Practice Note 7 in terms of the adjusting power SARS is entitled to as per S 31. The reference in the practice note to internationally accepted principles, such as comparability, the arm's length principle and acceptable methods for determining arm's length prices elevates the status and authority of this particular practice note as it draws on specific internationally recognized methods and principles.[10]

However persuasive, specifically in the context of practice notes, Practice Note 7 still does not constitute an authoritative source of law, much like the international law that it

---

[9] Page 407, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.
[10] Ibid.

draws on is considered persuasive, however is elevated to a status superior to a normal practice note.[11]

Therefore, as set out in paragraph 3.1 of the note itself, the guide is note prescriptive or exhaustive and it is important that the taxpayer undertakes a comprehensive analysis of relevant business strategies and other commercial factors as well as a comparison of relevant prices in accordance with accepted methodologies to determine the objective arm's length price.[12]

The transfer pricing review process involves the review of the relevant global and local industry and of the business of the related parties. The global structure is analyzed, where after a functional analysis and separate risk analysis is conducted.[13]

Functional analysis is a method of finding and organizing facts about a business' functions, assets, including intangible assets, and risks. The aim of functional analysis is to determine how these are divided between parties.[14]

Thereafter the most appropriate method for determining an arm's length priced is selected, based on specific functions and risks relevant to the circumstances. Screening is then undertaken to determined relevant comparable companies for ongoing analysis, including a determination of the relevant comparable pricing range. The functional

---

[11] Page 407, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.
[12] Page 407, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.
[13] Page 408, ibid
[14] 8.3.5, page 10, "*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.

analysis identifies functions performed by each member of the multinational group and assesses the relative importance of each function to the overall operation of the multinational.[15]

Functional analysis requires an outline of the MNE's operations and group structure as part of the analysis. It is implied that most of the functional analysis needs to be documented by the taxpayer.[16]

The four step approach is follows;

1. Understanding the cross-border dealings between connected parties in the context of the business;
2. Selecting the pricing method or methods;
3. Applying the pricing method or methods; and
4. Arriving at the arm's length amount and introducing processes to support the chosen method.[17]

Practice Note 7 recognizes that neither s 31 nor any tax treaty entered into by South Africa prescribes any particular methodology for the purpose of ascertaining an arm's length consideration. It therefore endorses the use of any of the principle methods referred to by the OECD;

1. The comparable uncontrolled price ("CUP");

---

[15] Page 408, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.
[16] Ibid.
[17] Ibid.

2. The resale price method ("RP");
3. The cost plus method ("CP");
4. The transactional net margin method ("TNM"); or
5. The profit split method.[18]

The most appropriate method to utilize depends on the particular circumstances and the extent of reliable data to enable the proper application of a selected method that ensures a reliable result. As a general rule, the traditional methods are preferred, one such method being the CUP method as it looks directly to the relevant product or service and is relatively insensitive to the specific functions performed by the entities being compared, give that it looks at the product rather than the contributions. This general rule would generally not apply to most transaction involving unique intangibles, given the input by the participants and the service or products unique nature.[19]

In line with the principle of comparability, which is fundamental to the application of the arm's length principle, as it allows for products and/or services in different transactions to be compared when or if the differences between two transactions may be discounted[20], SARS advises the taxpayer to seek the highest practical degree of comparability, while still recognizing the unique situation. Comparability must be judged be by the methodology that requires the fewest and most reliable adjustments.[21]

---

[18] Page 409, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.
[19] Ibid.
[20] Page 9, "*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.
[21] Page 409, "*International Tax: A South African Perspective*", Olivier & Honniball, 2005, 3rd Ed.

Transfer pricing methods suitable for intangible assets

The Transactional Profit Split Method

This method first identifies the combined profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. Sometimes the combined profits will be the total profits from the controlled transactions in question. In other cases, the combined profits will be a residual profit intended to represent the profit that cannot readily be assigned to one of the parties from the application of another transfer pricing method, such as the profit arising from valuable, unique intangibles. The transaction profit split method then splits the combined profits between associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated between enterprises. This split will more often than not be supported by internal data. The types of data will be relevant depending on the facts and circumstances of the case and may include, for example; allocation keys relating to the respective sales; research and development expenses; operating expenses; assets or headcounts of the associated enterprises. The splitting factor should reflect the respective contributions of the parties to the creation of income form the controlled transaction. The split should, to the greatest extent possible, be based on objective data rather than data relating to remuneration between the parties.[22]

[22] Page 8, "*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.

The Strengths and Weakness of the Recognized Methods

The Transaction Profit Split

The main advantage of this method is that it offers a solution for highly integrated operations for which a one-sided method would not be appropriate, such as when an entity within a MNE develops an intangible, sells it to another entity who then licenses it back, all within the same MNE . It may also be highly appropriate in cases where both parties to a transaction make unique and valuable contributions, such as intangibles, to the transaction, because in such cases independent parties might wish to share the profits of the transaction in proportion to their respective contributions and the two-sided method might be more appropriate in these circumstances that the one-sided method.[23]

Furthermore, in the presence of unique and valuable contributions, reliable comparable information might be insufficient to apply another method. Another strength of the transaction profit split method is that it offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm's length approach. Furthermore, this method is less likely to yield a result where either party to the controlled transaction will be left with an extreme and improbably profit result, since both parties to the transaction are evaluated. This aspect may be particularly important when

[23] Page 8, "*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.

analyzing the contributions by parties in respect of the intangible property employed in the controlled transactions.[24]

Intangible Assets

Chapter VI of the OECD Transfer Pricing Guidelines is to provide guidance for instances when transactions occur in respect of the use or transfer of intangible assets and in determining whether said transactions are at arm's length. The key consideration is whether a transaction assigns economic value from one associated enterprise to another, whether that benefit derives from intangible property, services or other items or activities.[25]

An intangible is not a physical assets or financial asset and is capable of being owned or controlled for use in commercial activities. Instead of focusing on legal or accounting definitions the thrust of a transfer pricing analysis in a case involving intangible assets should focus on the conditions that would be agreed upon between unconnected parties for a comparable transaction.[26]

---

[24] Page 12, "*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.
[25] Page 6, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[26] Page 7 ibid. This is in contrast to accounting definitions of intangible assets, such as "assets lacking physical substance", "an amount paid by a company to acquire certain rights that are not represented by the possession of physical assets." and "assets lacking physical substance....include items that involve exclusive rights[.]" pages 16, 218, 412 and 417, "*Financial Reporting and Analysis*", CFA Institute, 2011.

The first step in assessing such transactions, as with other transfer pricing assessments, is comparability analysis, including functional analysis. Said analysis should identify the functions performed, assets used and risks assumed by each relevant party of a MNE group. In the analysis concerning intangible assets it is important to ground the analysis on an understanding of the MNE's global business and how the specific intangibles are used to add or create value.[27]

The process to be followed is:

(a) Identification of the intangible assets;

(b) The identification of the parties who are entitled to retain the return derived from employing the intangible assets;

(c) The nature of the controlled transaction and whether same involves the use of or transfer of intangible assets; and

(d) The remuneration that would have been paid in such a transaction had the parties been unconnected and independent.[28]

Transfers of intangibles are ubiquitous in almost every company's international intercompany transactions. It is therefore important to consider the effects of such transactions in the specific scenario given the unique nature of intangible assets.

---

[27] Page 6, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

[28] Ibid.

The first matter of interest is the definition of intangible property. These includes; patents, trademarks, trade names, designs or models, literary and artistic proprietary rights as well as know-how and trade secrets.

The OECD concentrates on "business rights" that are intangible property associated with commercial activities, including marketing activities. The listing of intangibles is fairly consistent in most countries. It is recognized that business activities may create intangibles even though those intangibles may not be legally protectable property. This is particularly true of marketing intangibles. This complexity makes the analysis of certain intercompany transfers of intangibles challenging. However, a properly conducted functional and industry analysis will identify the intangible that create value in a particular transactions.[29]

In certain circumstances intangible assets are not recognized for accounting purposes, and this requires transfer pricing rules to apply specific consideration thereto. An example is the expensing of research and development ("R & D") used to develop an intangible rather than having same capitalized for accounting purposes. A result thereof is that the intangible asset generated is often not recognized.[30]

[29]Page 16, "*OECD Chapter VI: Special Considerations for Intangible Property Issues and Analysis*", Wright, Charles River Association Inc. Boston.
[30] Page 7, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

The importance is recognizing the economic value of this class of assets. This calls for a varied approach and to not dogmatically apply accounting standards in recognizing intangible assets.[31]

The availability of protection may affect the value of an item and the returns it may generate. The existence of such protection is however not a prerequisite for an item to be categorized as an intangible asset for the purpose of transfer pricing. Similarly, certain assets are capable of transfer separately while other only while bundled with other business assets. Therefore, separate transferability is also not a prerequisite for such an asset to be classified for transfer pricing.[32]

Not all intangibles create an economic benefit. The expenditure on R & D on creating an intangible asset does not *ipso facto* lead to the creation of same. Similarly with marketing spend and the fact that same does not necessarily generate or enhance an intangible.[33]

It is important the when conducting a transfer pricing analysis in respect of intangible assets that the economically signification intangibles are the focus of the analysis, the manner in which they contribute to the creation of value in the transaction under

---

[31] Page 7, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[32] Ibid.
[33] Page 8, ibid.

assessment, and the manner in which the interact with other intangible, with tangible assets and with business operations to create value.[34]

Categorization of intangibles may be necessary in assessing transfer pricing. Some make distinction between "soft" (trademarks, copyright, designing rights, passing off) and "hard" (patents) intangibles, between trade (created by research and development) and marketing (created by sales or marketing activities) intangibles, between routine and non-routine intangibles and between classes and categories of intangibles. The guidelines provided by the OECD do not prescribe to these categories and classification of intangibles.[35]

The OECD transfer pricing guidelines contain an outline of categorization of 'intangible property' and an illustrative list of assets. Since then a number of tax authorities have taken a much broader view of what intangibles may be, or in some cases, a narrow view, more akin to commercial law definitions. Widely differing approaches to the recognition of intangible assets increase the risk of economic double taxation.[36]

Some examples of items often considered in transfer pricing analysis which involve intangible are as follows:

---

[34] Page 8, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[35] Page 8, ibid.
[36] J. Owens, 'Transfer Pricing Aspects of Intangibles: Scope' PWC.

"*Patents*": a legal instrument which grants an exclusive right to its owner to use a given invention for a limited period within a set geographic area. This patent may relate to a physical object, or a process. Patentable inventions are often developed with great risk and investment via costly R & D. In some circumstances relatively small expenditure can lead to very valuable patentable inventions. These costs may be sought to be recovered through the sale or licensing of the patent.[37]

"*Know-how*" and "*trade secrets*": these represent proprietary information or knowledge that assists or improves a commercial activity, but are not registered for protection in the manner of patents or trademarks. Both usually consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience which has practical application in the operation of an enterprise. The value of these intangibles is dependent on the ability to have them remain confidential. This may be protected by some degree by unfair competition or similar laws, via employment contracts which include confidentiality and restraint terms or by economic and technological barrier (i.e. economies of scale).[38]

These forms of intangible property are often remain unreported in the accounting records of the MNE, but form an essential term in contracts assigning rights and obligations. These are significant forms of intangibles, because they are not accorded the same degree of legal protection as patents and trademarks. Economists have, for

[37] Page 9, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[38] Ibid.

years, pointed out that intangibles can have great value without being legally protected.[39]

"*Trademarks*", "*trade names*" and "*brands*": a trademark is a unique name, symbol, logo or picture that an owner may use to distinguish its products or services from other suppliers. These proprietary rights are usually established via a registration system. A registered owner has exclusive rights in respect of the use of the trademark. This protection may be indefinite.[40] A trade name differs as it may not be the name of the enterprise, but may be registered in some specific form. The term "brand" and "trademark" are sometime used interchangeably. In some context a brand is considered a trademark which is imbued with social and cultural significance. It may consist of a bundle of intangibles and these may be impossible to segregate or separately transfer.[41]

"*Licenses*" and similar limited real rights in intangibles; Rights to intangibles are often transferred by means of a license or similar contractual arrangement akin to a lease, either written, orally or implied. These licenses may have limitations imposed with regard to geography, use, term of use and others. These rights, as recorded contractually are themselves intangibles as they may be traded and used as commercially instruments.[42]

---

[39] Page 18, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[40] Ibid.
[41] Page 10, ibid.
[42] Ibid.

"*Goodwill*" and "*ongoing concern value*": Goodwill may have different meanings in different contexts. In some accounting and business valuations contexts, goodwill is the difference between the aggregate value of a going concern and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill may represent the future economic benefits associated with business assets that are not individually identifiable and separately recognized. It is generally recognized that goodwill and ongoing concern value cannot be segregated or transferred separately from the other business assets.[43]

"*Group synergies*": This may contribute to the level of income earned by a MNE group. Examples of group synergies include streamlined management, elimination of costly duplication of effort, integrated systems, purchasing power etc. These elements may have an effect on the determination of arm's length conditions of controlled transactions and should be addressed for transfer pricing purposes as comparability factors. These are not formally considered intangibles as they are not owned or controlled by a single enterprise.[44]

"*Marketing Intangibles*": Marketing intangibles are those created by the marketing or sales activities of a company and generally apply to more than one product offered by the company. An example is "image" advertising which is designed to build recognition of the company's name and will, if successful, impart value to all products sold by the

---

[43] Page 10, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[44] Page 11, ibid.

company. Interesting issues arise regarding which legal entity within the corporate group should earn the income attributable to the marketing activities.[45]

"*Research and Development*" (R & D"): There are three recognized methods by which a MNE may choose to conduct R & D. One legal entity within the MNE may conduct R & D entirely for its own account and, presumably, enter into licensing agreements with any other group companies that use the trade intangibles it creates. The developer could perform R & D on a contract basis for another company or it could participate in a cost-sharing arrangement whereby ownership is shared among the two or more group companies. The OECD has confirmed these three methods of planning the ownership of intellectual property. It clearly shows that the planning of inter-company transactions that are beneficial to the group have been endorsed.[46]

Identifying intangibles

Intangibles may be protected or unprotected. Examples of protection are patents and trademarks. Intangibles may be recorded on a balance sheet or not. Examples of this are acquired or created intangibles and capitalized or created and expensed intangibles. They may be remunerated or used free of charge by other group

---

[45]Page 17, "*OECD Chapter VI: Special Considerations for Intangible Property Issues and Analysis*", Wright, Charles River Association Inc. Boston.
[46] Page 17, ibid.

companies, often in good faith. Where they are not protected and not on the balance sheet, identification and determination of ownership can be difficult.[47]

As mentioned herein above, in order to identify intangibles, a thorough functional analysis must be performed and one cannot rely on an assessment of an entity's balance sheet alone. Furthermore, it is not sufficient to reply on the income statement, as the taxpayer may omit to raise charges in respect of valuable intangibles used by related parties. Risk assessment forms which are filed with tax returns in some countries often prove insufficient in this report.[48]

When selecting an appropriate transfer pricing method, the two groups or options are "one-sided" tests such as cost plus, resale price and transitional NMM and the "two sided" tests such as profit split. In selecting the "tested party" for one sided methods, the less complex party to the transaction is to be tested. In selecting comparable elements the uncontrolled transactions must present no material difference or differences, but may be adjusted in a reasonably accurate manner.[49]

How does one determine ownership of intangibles and how do the various forms of ownership affect the transactions? The substantive different forms of ownership are economic versus legal ownership and centralized versus distributed ownership.[50]

---

[47] Page 7, "Identifying Intangibles; Legal vs. Economic Ownership", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.
[48] Page 8, ibid.
[49] Page 10, ibid.
[50] Page 12, ibid.

Legal ownership refers to who the party is that has registered a legal right to the intangible via the use of tested modes of protection such as registered patents, trademarks and copyright. Economic ownership refers to whom is entitled to benefit from the intangible and who will reap the returns related to the exploitation of that intangible. For transfer pricing purposes, a party that bears the costs and risks of developing an intangible should be entitled to a corresponding beneficial interest, even if it may not be the legal owner of that intangible. So for transfer pricing purpose the pertinent question is: who has legal ownership over the intangible?[51]

The reasons a taxpayer may want to segregate legal and beneficial ownership are either to handle the intangible registration centrally or in respect of a cost contribution arrangement ("CCA") where economic ownership is shared, but legal ownership cannot be under multiple names i.e. in terms of 8.6 of the OECD guidelines. If a CCA is alleged then the taxpayer must be able to furnish the relevant *fiscus* with sufficient documentation to verify this arrangement.[52] *

The OECD transfer pricing guidelines recognize the difference between legal and economic ownership and provide specific comments in this respect in relation to marketing intangibles which encompass marketing activities performed by a party that does not own the trademark to enhance it.[53]

[51] Page 13, "Identifying Intangibles; Legal vs. Economic Ownership", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.
[52] Page 14, ibid.
[53] Page 15, ibid.

In the context of treaty law, there is a useful, although different, notion of beneficial ownership. This states that for the purpose of determining treaty benefits, a conduit company cannot normally be regarded as the beneficial owner, if, even though it is the formal owner, it has, as a practical matter, very narrow powers which render it in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.[54] This logic could be applied to transfer pricing to alleviate the uncertainty regarding legal and economic ownership.

Ownership may be held centrally or be distributed. In a centralized ownership scenario a single company in a group owns the intangibles, both beneficially and legally. It then enters into license agreements with other entities within the group.[55]

When this occurs there is a need to determine what the arm's length price to be charge by unconnected parties. This provides an opportunity to tax planning to avoid negative findings with regard to prices paid. Distributed ownership is where a number of companies would share ownership of intangibles on a pre-determined basis, for example, on the basis of geographic territory or product application. This ownership structure will always involve shared beneficial ownership and usually take the form of a CCA and is driven to a lesser extent for tax planning reasons.[56]

---

[54] Page 16, "*Identifying Intangibles; Legal vs. Economic Ownership*", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.
[55] Page 18, ibid.
[56] Page 18, ibid.

Multinational enterprises have the freedom to fund and organize the development of intangible property, subject to the legal form of the arrangement being consistent with the substance of the transaction and the arrangements. These arrangements are to be viewed in their totality with particular reference to functional analysis. Furthermore, whether the arrangement is consistent with the function analysis, and finally, whether this arrangement achieves an arm's length allocation of risks will determine whether the transactions hold substantive weight.[57] Legal and economic ownership is increasingly disconnected from the location where the R & D is performed. The location of legal and economic ownership of intangibles have huge transfer pricing consequences. This is a policy issue which affects fiscal attractiveness.[58]

The attractiveness of a jurisdiction will be greatly affected by its treatment of transferred assets, intangibles assets and the application of transfer pricing thereto. The decision regarding where to locate R & D activities is usually based mainly on non-tax factors, e.g. the location of skilled personnel, although tax factors such as specific tax credits or exemptions for R & D activities may help.[59]

However, what are the tax factors that need to be taken into account by MNE's when deciding where to locate intangible property ownership? These may include:

1. Depreciation and amortization of acquired or developed intangibles;

---

[57] Page 29, "*Identifying Intangibles; Legal vs. Economic Ownership*", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.
[58] Page 29, ibid.
[59] Page 30, ibid.

2. The deductibility of license fees;
3. The use of the treaty network;
4. The effect of withholding taxes on inbound and outbound royalties;
5. The applicable tax rate on benefits from gains generated from the exploitation of intangibles; Repatriation of earnings to shareholders;
6. The future disposal of intangibles.[60]

Identification of the parties entitled to intangible related returns

It is necessary when undertaking a transfer pricing analysis in respect of intangible assets to identify the member or members of the MNE group that are entitled to intangible related returns in an arm's length transaction. It may be that more than one party is entitled to the returns in respect of the transfer of intangible assets.[61]

To determine which member of the MNE is entitled to the returns the following must be considered;

(a) The terms of the arrangement including registration, license agreements etc;
(b) Whether the functions performed, the assets, the risks assumed and the costs incurred by members of the MNE group in developing, enhancing, maintaining and

[60] Page 31, "*Identifying Intangibles; Legal vs. Economic Ownership*", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.
[61] Page 12, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

protecting the intangible are in alignment with the returns to be expected for intangibles and relevant registrations and contracts;

(c) Whether services rendered by members of the MNE to others entitled to intangible related returns under the registrations and contracts, are compensated at arm's length.[62]

Registration and contractual arrangements are the starting point for determining which members of the MNE group are entitled to intangible related returns. Where no written terms exist, the contractual relationship between the parties must be deduced from their conduct and the economic principles that govern relationships between independent enterprises. Specific rights pertain to certain registered rights such as patents and trademarks as well as licenses discussed above. These entitled the holder of said right to exploit an intangible in a specific area and/or for a specific period. The protection afforded to intangibles varies from country to country. Often an entity which is entitled to the full rights of an intangible will enter into contracts where these rights and use are made available to others. This may include full or partial rights, where restrictions exist. In assessing the respective entitlements of members of the MNE group to intangible related returns, it is important to analyze the specific terms of such agreements and of the restrictions imposed, if any.[63]

[62] Page 12, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[63] Page 13, ibid.

The entity entitled to the use of the intangible and to exclude others from using it is the entity entitled to intangible related returns with respect to that intangible for transfer pricing reasons. In the case of a license or analogous arrangement, the licensee will be the entity entitled to such returns attributable to its license.[64]

In light of the fact that agreements form the starting point in the analysis of intangible assets in transfer pricing it is good practice for associated enterprises to document in writing decisions to allocate significant rights in intangibles. Such safeguards should be undertaken before the development, enhancement, maintenance or protection of intangibles occur. It is akin to building on immovable property with protecting the investment via a lease or sale agreement.[65]

Functions, risks and costs related to intangibles

To determine if a member of a MNE group is entitled to related returns from intangible assets it is important to examine whether the conduct of the parties is aligned with the terms of the registrations and contracts or whether the agreements adhered to merely form and are of no substance. Where conduct and formalities are not aligned it may be appropriate to allocated all or part of the returns to the entity or entities that as a matter of substance, performs functions, bear risks and costs related to development,

[64] Page 12, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[65] Ibid.

enhancement, maintenance and protection of intangibles. The conduct of parties is generally taken as the best evidence concerning the true allocation of entitlements.[66]

Functions such as R & D and sales and marketing leading to development and enhancement of the product will be especially important functions in evaluating which members of the MNE group are entitled to returns. Functions related to preserving the legal protections accorded to intangibles and the defence of intangibles against infringement is similarly important.[67]

It is not essential that a company claiming returns for development of intangible assets performs every function mentioned above. These functions are often outsourced to other entities. It is expected, however where alignments between functions and claims for remuneration in contracts and registrations, that the entity claiming entitlement will physically perform through its own employees the important functions related to the development, enhancement, maintenance and protection of intangibles. The functions would often include *inter alia* design and control of research and marketing programs, management and control of budgets, control over strategic decisions regarding intangible development programs, important decisions regarding defence and protection of intangibles, and the ongoing quality control over functions performed by independent

[66] Page 14, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[67] Ibid.

or associated enterprises that may have a material effect on the value of the intangible.[68]

The allocation of risks is an essential element in determining which party to a transaction involving intangible assets is entitled to intangible related returns. Where the conduct of one party is aligned with registrations and contracts, the member(s) of the MNE group entitled to returns will bear and control the risks associated with development, enhancement, maintenance and protection of intangibles. When such rights encompassing the control etc. of intangible assets are transferred the risks will be borne and controlled by the transferee following the transfer.[69]

Important types of risks in considering the entity/ies entitled to intangible related returns include:

(i) Risks that investment in costly R & D will prove unsuccessful;

(ii) The risk of product obsolescence including the risk that technology developed by competitors will eroded the value of the intangibles;

(iii) Infringement risk including the risk that defence of intangible rights prove to be time consuming and costly; and

(iv) Product liability and similar risks.[70]

---

[68] Page 14, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

[69] Ibid.

[70] Page 15, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

In assessing the use of intangible assets by NME's it is important to assess the risk and whether a bona fide alignment exists between contractual allocations of entitlement to returns among members of the MNE group and the risk(s) borne.

The question as to whether the costs incurred when relevant risks come to fruition are in fact borne by the entity claiming entitlement to intangible related returns answers the query as to whether the correct entity is taxed correctly.

The importance of assessing risk and the degree of alignment between contractual allocations of the entitlement to returns among members of the MNE group conduct in order to determine whether costs incurred when relevant risks come to fruition are in fact borne by the entity claiming entitlement to intangible related returns.

Where disconnect exists between contractually allocated returns and the allocation amongst enterprise of related risk-associated costs, an arrangement will not have the level of alignment between actual conduct and the allocation of returns.[71]

In other words, if the entity within the MNE who receives the returns does not carry the associated risks, the ire of transfer pricing must be invoked.

---

[71] Page 15, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

When assessing arm's length dealing, it is important to consider the amount of compensation paid and the level of activity undertaken. A more elementary approach would be to link effort and return, where effort constitutes input of capital, skill or time.

When assessing arm's length dealing, it is important to consider the amount of compensation paid and the level of activity undertaken. Both factors should be evaluated against comparable uncontrolled entities performing similar functions in assessing whether the compensation provided is in line with the arm's length principle.[72]

Where a distributor actually bears the costs of its marketing activities i.e. when there is no arrangement for the owner to reimburse the expenditures, the issue is the extent to which the distributor is able to share in the potential benefits deriving from its functions, assets, risks and costs currently or in the future.[73]

An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate in order to compensate for its functions, assets, risk and costs.[74] Such a benefit begot via an omission to enforce a charge must then be considered by the taxation authorities in order to enforce the necessary taxation on the true economic value of the transfer and/or benefit.

---

[72] Page 16, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

[73] Ibid.

[74] Ibid.

In summary, for a member of an MNE group to be entitled to intangible returns, it should in substance:

(a) Perform or control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises that are compensated at arm's length;

(b) Bear and control risks and costs related to developing and enhancing the intangible; and

(c) Bear and control risks and costs associated with maintaining and protection its entitlement to intangible related returns.[75]

Where a party is allocated returns under registration or contracts, but fails to perform and control important functions, fails to control related functions by independent or associated enterprises, or fails to bear and control relevant risks and costs, the parties performing and controlling part or all of such functions and bearing or controlling part or all of such risks will be entitled to part or all of the intangible related returns.[76]

Where risks, functions and costs are not in alignment with contractual allocations, part or all of the intangible related returns may be allocated to parties performing such

---

[75] Page 16, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[76] Ibid.

functions and bearing such risks, and transfer pricing adjustments may be appropriate to ensure that each member of the group is properly rewarded for its risks, functions and costs and tax in proportion with that reward.[77]

Intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible.

An example is the patents used to manufacture cars that are then sold to associated distributors. The patent adds value to the product and the distributor does not acquire any right in the patent, but does benefit from it by increasing the value of the car, but patents themselves are not transferred.[78] There is a correlative advantage to having the use of this patent and the associated reward, regardless of the fact that the patent is not owned by the distributor. The distributor, despite not having the risk or bearing the costs of the development of the intangible assets, clearly enjoys a significant benefit. A notional royalty may be implied and the distributor taxed accordingly.

Rights in intangibles themselves may be transferred in controlled transactions. This transactions may encompass all rights in the intangibles or only limited rights (sale of the intangible versus licensing or similar transfer of rights subject to limitations regarding geographic limitations, limited duration etc.). It is of significant importance to identify the nature of a transfer of rights in intangibles to consider whether the transferee receives

[77] Page 17, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[78] Page 18, ibid.

the right to use the transferred intangible for the purpose of further product development. The nature of any limitations on further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancements, can affect the value of the rights transferred and the comparability of the two transactions involving otherwise identical or closely comparable intangibles. The terms of the agreement that establishes the returns and economic benefit in lieu of the intangible, will create substantive differences when comparing the intangible to *prima facie* comparable intangibles. The differences in personal rights will thus have a substantive effect on comparing the intangibles.[79]

Intangibles may be transferred singularly or in bundles of intangibles that operate together, thereby creating more value than were they sold separately. When considering transactions where combinations of intangibles are concerned, two related issues often arise. The first is the consequence of the interaction between different intangibles. Certain intangibles may have enjoy an increased value when paired with certain other intangibles. It is therefore important to examine the nature of the legal and economic interactions between intangibles that are transferred as a composite.[80]

A suitable example for the abstract scenario above is that of a pharmaceutical product which will include several intangibles such as; the active pharmaceutical ingredient which is patented, the governmental approval to produce and distribute the product in a

[79] Page 19, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[80] Ibid.

given area, the marketing of the product to a specific consumer, the trademark of the product and the necessary protections associated therewith, the R & D undertaken to develop the product etc. In combination, these intangibles may be extremely valuable. The interactions between each of these classes of intangibles as well as which parties incurred the risks, costs and performed which functions, are therefore very important in performing a transfer pricing analysis with regard to bundled intangible assets.[81]

A second related issue involves the importance of assuring that all intangibles transferred in a particular transaction have been properly identified, segregated and valued. In some cases intangibles may be so intertwined that is impossible, as a substantive matter, to transfer one without transferring the other. The transfer of one intangible asset will often imply the transfer of the other. In such cases it is important to identify all the intangibles made available to the transferee.[82]

Determining Arm's Length Conditions in Cases Involving Intangibles

In transfer pricing analysis, and specifically when assessing the comparability of transactions, one must consider the options realistically available to each of the parties to the transaction. The perspective of each of the contracting parties must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles. The specific

[81] Page 19, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[82] Ibid.

business circumstances of one of the parties must not be used to dictate an outcome contrary to the realistically available options to the other party. A price offered by transferor to transferee may easily be compared with the realistically available options of each of the parties.[83] It is for this reason that two-sided arm's length tests provide a more realistic view in assessing transactions relating to the transfer of intangible assets.

In most cases the less complex of the two parties being tested is subject to transfer pricing analysis. In most cases the arm's length price or level of profit for the tested party can be determined without reference to the value of intangibles used in connection with the transaction. In some instance the tested party will or does use intangibles and may be entitled to intangible related returns. In this case, it becomes necessary to consider the intangible used by the tested party and by parties to potentially comparable uncontrolled transactions as one comparability factor in the analysis.[84]

An example is a tested party engaged in the marketing and distribution of goods purchased in controlled transactions which may have developed trademarks and related intangibles in a geographic area, including customer lists and customer relationships. Further possible considerations may be in relation to developed advantageous logistical know-how and software. The impact of such intangibles on profitability of the tested party should be considered in conduction comparability analysis.[85]

---

[83] Page 21, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[84] Page 22 ibid.
[85] Ibid.

It may be the case that the intangibles possessed by the tested party are also held by parties to comparable uncontrolled transactions. Where that is the case the level of comparability will be high and may sustain reliance on prices paid or margins earned by the potential comparable as an appropriate measure of arm's length compensation for both functions performed and the intangibles owned by the tested party.[86]

Where similar intangibles are held by the tested party and are comparable, no comparability adjustments will be required. However, in cases where goodwill is transferred, it may be necessary to make the necessary comparability adjustments or revert to alternative transfer pricing methods.[87]

In transactions involved the transfer of intangibles or the rights of intangibles, the comparability of the intangibles themselves must be considered. Intangibles often have the most unique characteristics and, as a result, have the potential for generating returns and creating future benefits that differ vastly. Moreover, grants of rights to use intangibles may have limitations imposed on the usage of those rights which have a direct and important bearing on the price that would be paid for such rights.[88]

Certain features of intangibles may prove important as part of comparability analysis. Exclusivity is such a feature.

---

[86] Page 22, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[87] Page 23, ibid.
[88] Ibid.

The question has to be posed: Are the rights which are subject to the transaction exclusive or non-exclusive? Some intangibles allowed the party entitled to returns related thereto to exclude others from using the intangible. This is achieved by making use of patents that grant exclusive rights for a period. This exclusion will provide a market advantage, a degree of market power and influence. A party with non-exclusive rights won't be able to exclude competitors from the market and will, generally speaking, not have the same market power or influence. This exclusivity issue is an important factor when conducting comparability analysis.[89]

The extent and duration of legal protections associated with some intangibles may prevent competitors from entering a particular market. For other intangibles such as know-how or trade secrets, available legal protection may be of a different nature and may not be as strong or last as long. For intangibles with limited useful lives, the duration of legal protections can be important since the duration of the intangible rights will affect the expectation of the parties to the transaction with regard to the future benefits attributable.[90]

A global grant of rights to intangibles may be more valuable than a grant limited to one or a few countries, depending on the nature of the product, the nature of the intangibles

[89] Page 23, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[90] Page 24 ibid.

and the nature of the markets in question. This issue relate to the geographic scope of the right and related intangible. [91]

Many intangibles have a limited useful life. The nature and duration of legal protection often affects the useful life of some intangibles as well as the rate of technological development in the industry and by development of new and potentially improved products. It may also be that the useful life of intangibles may be extended in some cases.[92]

Intangibles that provide a market advantage for a longer period of time will, generally, be more valuable than similar intangibles providing such advantages for a shorter period of time, other things being equal. The use of the intangible is also an important variable to consider when evaluating the useful life of an intangible.[93]

It is often the case that an intangible is transferred in a controlled transaction at a point in time before it has fully demonstrated that the intangible will support commercially viable products. A common situation is the pharmaceutical industry where a product or compound is patented and the patents transferred in a controlled transaction, we in advance of the time when further R & D and testing demonstrates that the compound constitutes a safe and viable treatment. Generally, intangibles relating to products with established commercial viability will be more valuable than otherwise comparable

[91] Page 24, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[92] Ibid.
[93] Ibid.

intangibles relating to products whose commercial viability is yet to be tested. The establishment of whether further development will lead to commercially significant future benefits is a consideration that is important for such a scenario.[94]

Products protected by intangibles can often become obsolete in a relatively short period of time in the absence of continuing development and enhancement of intangibles. Rights to enhancement, revisions and updates ensure that the useful life of the intangible is extended and maintained. Having access to updates and enhancements can be the difference between deriving short term advantage from intangibles and deriving long term advantage. The inclusion of enhancements and updates is an important consideration when assessing comparability.[95]

Intangibles that provide for a basis for high profit products or services are not likely to be comparable to intangibles that are likely to support products or services with only industry average profits. Any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in the analysis.[96]

In assessing the comparability of transactions the comparison of risk should be assessed and include the following types of risks, amount others:

---

[94] Page 24, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[95] Page 25, ibid.
[96] Ibid.

(1) Risks related to the future development of intangibles;

(2) Risks related to product obsolescence and depreciation;

(3) Risks related to infringement of the intangible rights and;

(4) Product liability and similar risks relating to the future use of intangibles.[97]

In general, when selecting the most appropriate transfer pricing method the following should be considered:

1. The nature of intangibles;
2. The difficulty of identifying comparable uncontrolled transactions for all intangibles; and
3. The difficulty of applying certain transfer pricing methods in cases involving intangibles.[98]

Selecting the appropriate pricing method may require consideration of several issues. It is important to recognize that transactions structure in different ways may have similar economic consequences. Therefore, in selecting the most appropriate transfer pricing method in connection with a transaction involving intangibles, it is important to consider the economic consequences of a transaction, rather than proceeding on the basis of the a formal label.[99]

---

[97] Page 26, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[98] Ibid.
[99] Ibid.

One should be cautious to assume that the appropriate transfer pricing methodology that assumes that all residual profit should necessarily be allocated to the party entitled to the intangible related returns is the appropriate option. The selection of the method should be based on a functional analysis that provides clear understanding of the MNE's global business processes and how intangibles interact with the other functions, assets and risks that compromise the global business. The method should reflect all the relevant factors that materially contribute to the creation of value, not merely reflect intangibles and routine functions.[100]

Financial based valuation techniques are useful in cases where intangible assets are connected to the sale of goods or services. The application of income based techniques, especially methods premised on the discounted cash flow of projected future cash flows, may be particularly useful when properly applied with appropriate assumptions. However, caution should be exercised in adopting valuations performed for accounting purposes as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. This is due to the fact that in some accounting valuation assumptions there may be bias due to inherent conservatism in respect of the particular jurisdiction interpretation of generally accepted accounting practices.[101]

---

[100] Page 27, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[101] Ibid.

Valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return is generally discouraged. Unlike traditional industries, there is little correlation between the cost of developing intangibles and their value or transfer price once developed. Therefore, valuations based the cost of development should be avoided.[102]

Where a reliable comparable exist, one of the five OECD transfer pricing methods may constitute the most appropriate method where the transaction involves the use of intangibles in connection with a controlled sale of goods/services and a reliable comparable is present.[103]

In situations where reliable comparable uncontrolled transactions do not exist, it may be due to the lack of available data regarding comparable transactions involving the use or transfer of intangibles or from other causes.[104]

When information for reliable comparable uncontrolled transactions is not available, the arm's length principle requires another method to determine the prices that uncontrolled parties would have agreed under comparable circumstances. In determining these prices the following needs to be considered;

1. Functions, assets and risks of the respective parties;

---

[102] Page 27, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[103] Page 29, ibid.
[104] Page 30, ibid.

2. The business reasons for engaging in the transaction;
3. The other options realistically available to the participants;
4. Market advantage conferred by the intangible including relative profitability of products and services related to the intangibles;
5. Other important factors regarding location advantage and market difference.[105]

The application of profit split method is suitable when reliable uncontrolled transactions cannot be identified. This may be applicable where both parties to the agreement make unique and valuable contributions.[106]

In applying the profit split method care should be taken to identify the intangibles in question, to evaluate the manner in which those intangibles contribute to the creation of value, and evaluate other income producing function, risks and assets. Vague assertions of the existence and use of unspecified intangibles will not support an application of the profit split method.[107]

In some cases valuation techniques not dependent on the identification of reliable comparable uncontrolled transaction may be utilized to determine arm's length conditions for the sale of goods or services where intangibles are used. The alternative

---

[105] Page 30, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[106] Ibid.
[107] Page 31, ibid.

which is selective should reflect the nature of the goods or services sold and the contribution of intangibles and other relevant factors to value creation.[108]

Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and transaction profit methods.[109] In using the CUP method, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in potentially uncontrolled transactions. In some situations, intangibles acquired by a MNE group from an unrelated party are transferred to a member of the MNE group in a controlled transaction immediately following acquisition. In such a case the price paid for the acquired intangible will usually represent a useful comparable for determining arm's length prices and other conditions for the controlled transactions, even where intangibles are acquired indirectly through an acquisition of share or where the price paid to the third party for share or assets exceeds the book value of the acquired assets.[110]

In some circumstances a transaction profit split method can be applied to determine arm's length conditions for transfer of intangibles or rights to intangibles where it is not possible to identify reliable comparable uncontrolled transactions.[111]

---

[108] Page 31, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[109] Ibid.
[110] Page 32, ibid.
[111] Ibid.

Where limited rights in intangibles are transferred in a license or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method often can be utilized to evaluate the respective contributions of the parties to earning combined income. The profit contribution of the rights in intangibles made available by the licensor or other transferor would, in such a circumstance, be one of the factors contributing to the earning of income following the transfer. Other factors should not be ignored, specifically functions performed and risks assumed by the licensee/transferee should be taken into account. Careful attention should be given to the limitations imposed by the terms of the transfer on the use of the intangibles by the licensee/transferee and on the rights of the licensee/transferee to the use of intangibles for the purposes of ongoing research and development. It should not be assumed the all the residual profits after the functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis relating to a licensing agreement.[112]

Evaluating the presence of intangibles

Deciding whether intangibles form a part of any given intercompany transaction is a challenging process and one which the OECD recognizes. R & D and marketing are inherently risky. There is no guarantee that the R & D department will discover or develop a valuable intangible asset. In addition, marketing expenditure dos not guarantee that the trade mark or other marketing intangible will have value. Some companies commit vast sums of money just to remain in the market without creating

[112] Page 32, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

valuable trademarks. The mere existence of R & D cannot ipso facto be used to determine whether intangibles of value have been created, are utilized or exist.[113]

Marketing activities encompass a wide range of business activities e.g. market research, designing or planning products suitable for market needs, sales strategies, public relations, sales, service and quality control. The OECD states that some marketing expenditure should be expensed and other should be capitalized. Expensed items are those that no impact beyond the year in which they are incurred while capitalized expenditures are those that affect the success of the company beyond the year in which they are incurred.[114]

A common question is: "how do I know whether I have a transfer of intangibles that justifies analysis"?

The process begins by identifying the legally protected intangibles owned by the multinational. This is often easily obtained in most companies. Next one must evaluate which intangibles are valuable. This is done through a thorough functional and industry analysis. The relevant question is: "are there 'extraordinary rates of return' for the product over time?"[115]

---

[113] Page 32, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.
[114] Ibid.
[115] Ibid.

To assess this the ratio of operating profit to assets or nets sale is often used. Compare these ratios to industry averages to determine whether the product in question is likely to be attached to a valuable intangible. It should be apparent that the lack of extraordinary rates of return does not mean that no intangibles are present.[116]

The identification of arrangements made for the transfer of intangible property include, amongst others, sales and licenses. Licenses are most the commonly used method of transferring intangibles within a multinational. The license requires the payment of royalties that are usually a recurrent payment based on the users output, sales, or in some rare circumstances, profits.[117]

The OECD stipulates that the royalty be commensurate with the income generated by an intangible. While must US companies tie royalty rates to sales or output, the relationship between the royalty rate and profits generated from the intangible must also be analyzed. This is not normally considered in terms of the OECD guidelines, not in normal circumstances.[118]

Where a group of intangibles is transferred e.g. patent, trademark, trade secrets and know-how, it may be necessary to desegregate the bundle to determine an appropriate royalty rate per constituent part. This process carries a significant valuation challenge. It

---

[116] Page 32, "*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

[117] Page 22, "*OECD Chapter VI: Special Considerations for Intangible Property Issues and Analysis*", Wright, Charles River Association Inc. Boston.

[118] Page 23, ibid.

may seem appropriate that a royalty is to be determined for each intangible that is transferred.[119]

Generally this can be done, but aggregating these pieces of information may, however, prove difficult. Do the percentages aggregate? Must one proceed to simply bundle the royalty percentage to a single percentage? There are circumstances where the aggregate would be worth more than the sum of the royalties and others where the full bundle or package would be worth less. It is, in other words, not possible to develop a formula that applied universally.[120]

A factor to consider when assessing the royalty paid is the level of technical assistance and training of employees that the developer may provide. This may be fairly easily dealt with by reference to the comparable that is used to set the royalty rate. It is in the licensors bests interest to provide enough support so that the licensee makes the best use of the property as this how the licensor maximizes royalty income. It is fairly commons for a license agreement between unrelated parties to specify the amount of technical assistance and training that is included in the license agreement. Dealing with this issue is relatively straightforward, where the comparable does not include this type of information, the problem can be handled by specifying what is included and then establishing a fee structure for additional assistance.[121]

---

[119] Page 23, "*OECD Chapter VI: Special Considerations for Intangible Property Issues and Analysis*", Wright, Charles River Association Inc. Boston.
[120] Ibid.
[121] Ibid.

Difficulties in dealing with intangible assets in transfer pricing

Transfers of intangible assets raise difficult questions both as to the identification of the assets transferred and as to their valuation. Identification can be difficult because not all valuable intangible assets are legally protected and registered and not all valuable intangibles assets are recorded in the accounts. Relevant intangible assets might potentially include rights to use industrial assets such as patents, trademarks, trade names, designs or models, as well as copy rights of literary, artistic or scientific work (including software) and intellectual property such as know-how and trade secrets. They may also include customer lists, distribution channels, unique names, symbols or pictures.[122]

An essential part of the analysis is to identify the significant intangible assets that were transferred, whether independent parties would have remunerated their transfer, and what their arm's length value is. It will be affected by a number of factors among which are the amount, duration and riskiness of the expected benefits from the exploitation of the intangible property, that nature of the property right and the restrictions that may be attached to it, the extent and remaining duration of its legal protection, and any exclusivity clause that might be attached to the right. Valuation of intangibles may be complex and uncertain.[123]

---

[122] Page 22, "*Report on the transfer pricing aspects of business restructurings; Chapter IX of the Transfer Pricing Guidelines*", OECD, 22 July 2010.
[123] Ibid.

Disposal of intangible rights by a local operation to a central location (foreign associated enterprise) may involve the transfer of intangible assets that were previously owned and managed by one or more local operations to a central location in another tax jurisdiction. The intangible asset transferred may or may not be valuable for the transferor and/or for the MNE group as a whole. In some cases the transferor continues to use the transferred intangible asset, but does so in another legal capacity i.e. as a licensee of the transferee, or through a contract that includes limited rights to the intangible such as a contract manufacturing arrangement using patents that were transferred; or a what is known as a 'stripped' distribution arrangement where only the trademark is used and transferred[124]

MNE groups may have sound business reasons to centralize ownership and management of intangible property. An example in the context of business restructuring is a transfer of intangibles that accompanies the specialization of manufacturing sites within an MNE group. In the case of manufacturing sites that are sold along with their intangible property, when each site has specific intangible property specific to the different geographic regions a consequence of restructuring the MNE group might be that the group proceeds with the transfer of locally owned and managed patents to a central location which will in turn given contractual rights via licenses or manufacturing agreements, to all the group's manufacturing sites to manufacture the products falling in

[124] Page 22, "*Report on the transfer pricing aspects of business restructurings; Chapter IX of the Transfer Pricing Guidelines*", OECD, 22 July 2010.

their new areas of competence using patents initially owned by only one of the entities in the group. [125]

The arm's length principle requires an elevation of the conditions between associated enterprises to the level of each other, i.e. from the perspective of both the transferor and transferee. The fact that centralization of intangible property rights may be motivated by sound commercial reasons at the level of the MNE group does not answer the question whether the disposal is arm's length from both the perspective of the transferor and transferee.[126]

When a local operation disposes of its intangible property rights to a foreign associated enterprise and continues to use the intangibles further to the disposal, but does so in a different legal capacity e.g. as licensee, the conditions of the transfer should be assessed from both the participants perspectives, particularly by examining the pricing at which comparable independent enterprises would be willing to transfer and acquire the property. The determination of arm's length remuneration for ownership, use and exploitation of the transferred asset should take account of the extent of the functions performed, assets used and risks assumed by the parties in relation to the intangibles transferred.[127]

[125] Page 23, "*Report on the transfer pricing aspects of business restructurings; Chapter IX of the Transfer Pricing Guidelines*", OECD, 22 July 2010.
[126] Ibid.
[127] Ibid.

limited risk distributor may require the examination as to whether the distributor has developed local marketing intangibles over the years prior to it being restricted and if so, what the nature and the value of these intangibles are, and whether they were transferred to an associated enterprise. Where local intangibles are in existence and are transferred to a foreign associated enterprise, the arm's length principle should apply to determine whether and if so how to compensate such transfer, based on what would be agreed between independent parties in comparable circumstances.[130]

Contractual rights, encompassing rights to intangible assets, may be valuable intangible assets themselves. Where such contractual rights are transferred between associated enterprises, they should be remunerated at arm's length taking account of the value of the rights transferred and from the perspective of both parties. Instances where local enterprises have cancelled contracts in order for foreign associated enterprise to enter into a similar contract thereby enabling them to benefit from the profit potential attached thereto are also included in this examination.[131]

Possible solutions to short-comings in transfer pricing of intangible assets

German transfer pricing rules introduced a 'hypothetical arm's length method' in 2007. This is concerned with situations where no arm's length values can be found. In the context of highly valuable intangible assets as well as business restructuring which are both important for the tax revenue potential of Germany, it did not come as a surprise

[130] Page 24, "*Report on the transfer pricing aspects of business restructurings; Chapter IX of the Transfer Pricing Guidelines*", OECD, 22 July 2010.
[131] Ibid.

that Germany did not wait until the OECD working group presented its findings on transfer pricing and the application thereof to intangible assets.[132]

The focus of the changes to the arm's length principle in German tax law is on the determination of a hierarchy and the terms of application for individual transfer pricing methods. Consequently for intra-group cross-border business transactions the German foreign tax act requires the transfer price to be determined primarily according to the comparable uncontrolled price method, the resale price method, or the cost plus method.[133]

The condition for this is that arm's length values can be found that, after adjustments appropriate in light of the functions performed, the assets employed and the opportunities and risks assumed are comparable without limitation to those methods. The result is that a range of values are determined and several such values form a range and within this range the suitable transfer price will exist.[134]

If no such arm's length values can be found, the application of a suitable transfer pricing method is to be based on values of limited comparability as appropriately adjusted.[135]

---

[132] Page 3, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax.
[133] Ibid.
[134] Ibid.
[135] Page 4, ibid.

If no third party values of at least limited comparability can be found, the taxpayer is to base his income determination on a hypothetical third-party comparison. For this he or she is to estimate the lowest price for the seller and highest price for the buyer on the basis of a functional analysis and internal planning calculations. This scope for agreement is to follow from the profit expectations of each party and the profit potential. The price to be taken is that most likely to accord with the arm's length principle. If no other value is plausibly put forward, then the mean of the scope of the agreement is to be taken.[136]

Where a function including related opportunities and risks is transferred accompanied by assets and other advantages for which no arm's length value or even limited comparability can be found, the taxpayer shall determine the scope for agreement on the basis of the transfer of the function as a whole. This has to be done on the basis of capitalization at adequate interest rates. The piecemeal determination is to be accepted if it can be show that the sum of the piecemeal values is equivalent to the arm's length price for the transfer package.[137]

In determining the hypothetical arm's length price the starting point is the price that the transferor or transferee would at least require or be prepared to pay at most. The minimum and maximum prices constitute the expected scope for agreement. These, as per German law, are to be determined on the basis of functional analysis and internal

[136] Page 4, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax.
[137] Ibid.
[137] Ibid.

financial planning taking expected profits into account. The relevant transfer price is given by that value within the scope for agreement that is most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is taken.[138]

In order to determine arm's length price based on anticipated benefits it is necessary to determine the values of the relevant profit potentials. In order to do so it is necessary to;

(a) Identify the surplus associated with the transferred asset or package;
(b) Determine the useful life of the corresponding asset; and
(c) Establish the required rate of return for purposes of calculating the net present value of the profit potential associated with the assets transferred.[139]

From a commercial perspective the value of an asset results from the anticipated future benefit which may be derived. In order to value an asset, a key starting point is to identify the specific revenues and expenses associated with using the asset.[140]

With regard to the determination of the relevant cash flows, four different methods may essentially be distinguished:

---

[138] Page 5, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax.
[139] Ibid.
[140] Page 6, ibid.

(i) The 'Direct cash flow forecasting method' identifies the cash flows that may be allotted directly to the asset under consideration;

(ii) The 'License fee analogy method' assesses the value of an asset that is derived from comparable license fee payments saved through acquisition of the asset;

(iii) The 'Residual value method' acknowledges that attributing cash flow is in many cases difficult since corresponding cash flows are typically generated in combination with using other tangible and intangible assets.

Therefore, the residual value method requires identification of the cash flows relating to the relevant 'cash flow generating unit' as a whole and subtracting from these cash flows all expense that are deemed to accrue in relation to the 'supporting assets'.[141]

In terms of the German Chartered Accountants principles the valuation of intangible assets provides for referring to the useful life, in economic terms, or the remaining useful life of the asset to be valued. As, in principle, the use of an intangible asset is of a temporary nature, calculating net present value based on perpetuity is not an option.[142]

In determining the required rate of return the basic interest rate is to be increased by a premium reflecting the risk of the underlying investment. Where the subject of the valuation is activities, such premiums shall be determined by looking at the customary

[141] Page 6, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax.
[142] Page 7, ibid.
[142] Page 4, ibid.

market return which may be earned when carrying out comparable activities. Where capital market data does not exist with respect to the company concerned, the risk premium may, in principle, be derived on the basis of an individual comparable enterprise or a corresponding peer group. In order to determine this range, care should be taken that the operative business and size of these companies correspond as far as possible, whereas financing differences may be corrected.[143]

The scope for agreement is stipulated by minimum to maximum prices that the seller and acquirer wish to achieve or are prepared to pay. If, thereafter, no plausible value is put forward then the mean of the scope for agreement is to be taken.[144]

In looking to the future, the German authorities have suggested that a project on the transfer pricing of intangibles should cover the question as to whether, in the context of intangibles for which a market price does not exist, the OECD supports the determination of transfer prices using the 'hypothetical arm's length test'. Using this method the transfer price is determined by reconstructing the pricing process in the market. This process requires not only the consideration of the value of the asset, but also the minimum and maximum price a transferor and transferee would require or be prepared to pay. It would also be beneficial for the OECD to indicate how the value of an asset are to be determined based on anticipated benefits. These indications would require a concretization by the OECD of how the profit potential, the useful life and the

---

[143] Page 8, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax.
[144] Page 9, ibid.

required rate of return are to be determined. Further considerations relate to changing price effects not present at the time of transfer and the adjusting of prices due to new developments which play a part in the value of intangibles.[145]

Conclusion and Recommendations

In assessing the treatment of intangible assets in the context of transfer pricing I have established that Section 31 doesn't provide the necessary definition of what arm's length prices are or how to calculate same. The relevant practice note provides the example of an uncontrolled transaction between comparable parties and that the prices applicable therein are used as a benchmark to determine market prices.

The nature of intangible assets is that same are often unrecorded, unprotected and unrepresented on the balance sheet.

The traditional methods are not useful for transactions involving intangibles except if there are significantly comparable and this is often not the case as intangibles may be unique or self-generated.

Of the methods, the profit split method proves most useful, as it is two sided and splits the total or residual profit between the parties based on their functions, costs and risks assumed.

[145] Page 11, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Prof. A. Oestreicher, Georg-August University of Gottingen, Institute for Domestic and International Tax..

The transaction profit split method allows for scenarios where both parties make unique and valuable contributions and is less likely to yield a situation where one party will be left with an extreme profit result.

The key consideration in assessing intangibles in a transfer pricing context is to decide whether a transaction assigns economic benefit in respect of intangible property that has been transferred. In assessing economic benefit, one must distinguish economic ownership from legal ownership. The consideration of which party is entitled to economic benefit is to be accompanied by the assessment of factors such as the existence of any protection, the duration of the protection, the location of the protection, whether the intangible includes further developments and advancements, whether the assets is owned or held via a license and established contractually, if it capable of recording or transferring.

A departure point in identifying intangibles is via a functional analysis conducted through interviews, assessing the enterprise historically and perusing financial information.

As stipulated above it is essential to identifying which party is entitled to the returns. The practice is similar the test to determine source, the originating cause test, however, just as determine source can be fraught with complex factual situations, so can the allocation of benefits in respect of intangible asset transfer. In tracing the *causa causans* it is necessary to first look at the contractual arrangements and registration of

rights. Thereafter the substantive actions of the parties, the functions performed, assets held and risk and costs borne.

In the case of intangible assets, information on comparable transactions is often lacking due to a lack of data and the nature of intangibles covered herein above, including the difficult task of identifying intangibles.

A proposed method of determining arm's length prices for transaction concerning intangible assets where comparable data is lacking is via the determination of a range of prices set between the prices that the contracting parties would accept. Thereafter a functional analysis is undertaken to ascertain the arm's length price. If no arm's length price can be determined, the mean price is accepted. This ensures that there is not a gross over statement of profits to one of the participants and the effect of the transfer pricing arrangement is minimized.

Bibliography

Primary Sources

Statutes

Income Tax Act, No. 58 of 1962

Secondary Sources

Books

Huxham, Haupt, "Notes on South African Income Tax", 2009, Hedron Publishing, 28th Ed.

De Koker, "*Silke on International Tax*", November 2010.

Olivier & Honniball, "*International Tax: A South African Perspective*", 2005, 3rd Ed.

Articles

Prof. A. Oestreicher, '*Comments on the scoping of a future project on the Transfer Pricing Aspects on Intangibles: Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines*', Georg-August Univeristy of Gottingen, Institute for Domestic and International Tax.

"*Report on the transfer pricing aspects of business restructurings; Chapter IX of the Transfer Pricing Guidelines*", OECD, 22 July 2010.

Wright, "*OECD Chapter VI: Special Considerations for Intangible Property Issues and Analysis*", Charles River Association Inc. Boston.

"*Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*", 6 June to 14 September 2012, OECD Centre for Tax Policy and Administration.

"Identifying Intangibles; Legal vs. Economic Ownership", Transfer Pricing Workshop (Cairo) 14 – 25 February 2010.

J. Owens, 'Transfer Pricing Aspects of Intangibles: Scope' PWC.

Naomi Klein in "No Logo" London, 2000.

Practice Note

"*Practice Note No. 7, Section 31 of the Income Tax Act, 1962 (the Act): Determination of taxable income of certain persons from international transactions: Transfer Pricing*", SARS, 6 August 1999.