Transfer Pricing of Intangibles

Australian guidance on marketing intangibles

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Background

• ATO booklet published in 2005
• Not a formal Ruling, but is binding on Commissioner and no adjustment if guidance is followed
• 6 examples show how ATO will determine an appropriate reward for marketing activities performed by an (Australian) enterprise using trade marks or trade names it doesn’t own
• Examples are based on paragraphs 6.36-6.39 OECD TPG
• Based on unfinished/abandoned work of a sub-group of OECD WP6 members to develop OECD examples illustrating TPG paragraphs 6.36-6.39
The ATO approach

The 4 key matters that determine the ATO approach:

- the contractual arrangements between the trade name owner and marketer, in particular the duration of the agreement, the nature of the rights obtained by the marketer in respect of the trade name, and who bears the costs and risks of the marketing activities
- whether the level of marketing activities performed by the marketer exceeds that performed by comparable independent enterprises
- the extent to which the marketing activities would be expected to benefit the owner of the trade name and/or the marketer, and
- whether the marketer is properly compensated for its marketing activities by a normal return on those activities or should share in an additional return on the trade name

The ATO approach

- Legal ownership is respected in allocating profits from exploitation of intangibles
- No reliance on concept of economic ownership in allocating profits from exploitation of intangibles
- A marketer does not acquire economic ownership of intangibles it does not legally own, no matter how much marketing activity it performs or value it adds to those intangibles
- It is not necessary to recognise economic ownership in order to arrive at an arm’s length outcome between marketer and intangible owner
The ATO approach

• Economic ownership has appropriately limited recognition for transfer pricing purposes
  – Recognised in an Article 9 context for Cost Contribution Arrangements under Chapter VIII OECD TPG
  – Not explicitly recognised in Chapter VI OECD TPG outside a CCA context
  – Recognised in an Article 7 context for PE profit attribution under OECD AOA

• Broader recognition of economic ownership carries dangers
  – Can inappropriately devalue status of and reward to legal ownership
  – Can inappropriately disregard contractual allocation of ownership risks
  – Can blur distinction between separate legal entity and PE context (inappropriately extending OECD AOA under Article 7 into Article 9)

• Is recognising economic ownership consistent with arm’s length principle?
  – If marketer were independent, could it acquire an ownership interest in an intangible that it does not legally own by performing marketing activity in respect of the intangible?

The ATO approach

• Question: How is the marketer that performs marketing activity in respect of a marketing intangible that it doesn’t own to be rewarded?
• Answer: In the same way as an independent enterprise in comparable circumstances would expect to be rewarded

• Possibilities:
  – The marketer is adequately rewarded through a normal return on its marketing activities (no other compensation from intangible owner)
  – The marketer is rewarded as a service provider by the intangible owner
  – The marketer is entitled to a return on the marketing intangibles above a normal return on its marketing activities
The ATO approach

• Implies a need to characterise the marketer and the capacity in which it performs its marketing activity
  – For whose expected benefit are the marketing activities performed, the marketer, the intangible owner, (or both)?

• Potential ATO adjustments:
  – Reduction in price of branded products purchased from intangible owner
  – Reduction in royalties payable to intangible owner
  – Imputing of a service fee receivable from intangible owner

• Ultimately, available comparables data will determine nature of adjustment in a particular case

Example 1

Marketer with a long-term marketing and distribution agreement that does not bear costs and risks of developing market

• Company A = registered owner of trade name and product manufacturer
• Company B = Australian marketer/distributor subsidiary of Company A
• B is contractually required to develop Australian market for branded product, with A required to reimburse B for marketing costs (via a fee with appropriate profit element)
• Findings/assumptions:
  – Prices paid for B’s product purchases from A are arm’s length (give an arm’s length return for B’s distribution activity)
  – Marketing services fee is arm’s length (benchmarked using marketing agent comparables)

• ATO conclusion: compensation of B for marketing activities is arm’s length => no adjustment
Example 2

Marketer with a **long-term** marketing and distribution agreement that **bears** costs and risks of developing market

- Company A = registered owner of trade name and product manufacturer
- Company B = Australian marketer/distributor subsidiary of Company A
- B is contractually required to develop Australian market for branded product at its own cost and risk, with its expected reward solely from product sales

- **Findings/assumptions:**
  - Long term contract (5 years + option to renew) means B has opportunity to benefit from its marketing (eg. by increasing market share)
  - B’s marketing activities, as illustrated by its marketing costs, are not abnormal
  - B’s profits are similar to comparable independent marketer/distributors

- ATO conclusion: B is fully compensated for its marketing activities from its product sales and market share benefits, and is not entitled to share in any additional return on the trade name => no adjustment

Example 3

Marketer with a **long-term** marketing and distribution agreement that bears costs & risks of developing market and **bears marketing expenses far exceeding those of comparable independent enterprises**

- Company A = registered owner of trade name and product manufacturer
- Company B = Australian marketer/distributor subsidiary of Company A
- B is contractually required to develop Australian market for branded product at its own cost and risk, with its expected reward solely from product sales

- Findings/assumptions:
  - Long term contract means B has opportunity to benefit from its marketing (eg. by increasing market share)
  - Prices paid for B’s product purchases from A are arm’s length (give an arm’s length return for B’s distribution activity)
  - B’s profits are lower than comparable independent distributor/marketers
  - In incurring extraordinary marketing expenditure, B has acted to increase value of the intangible owned by A (ie. for benefit of A) and should be compensated by A

- ATO conclusion: Adjustment proposed, either by reducing prices of product purchases (eg. by reference to profits made by comparable independent marketer/distributors) or by imputing fee based on excess marketing expenditure plus a profit element
Example 4

Marketer with a short-term marketing and distribution agreement that bears costs and risks of developing market

• Company A = registered owner of trade name and product manufacturer
• Company B = Australian marketer/distributor subsidiary of Company A
• B is contractually required to develop Australian market for branded product at its own cost and risk, with its expected reward solely from product sales
• Findings/assumptions:
  ‒ Short term contract (3 years, no option to renew) means B has no opportunity to benefit from its marketing
  ‒ B’s level of marketing activities and costs exceeds that of independents with similar short-term contracts
  ‒ B’s profits are lower than comparable independent distributor/marketers with similar short-term contracts
  ‒ In incurring extraordinary marketing expenditure, B has acted to increase value of the intangible owned by A (i.e. for benefit of A) and should be compensated by A

• ATO conclusion: Adjustment proposed, either by reducing prices of product purchases (eg. by reference to profits made by comparable independent marketer/distributors) or by imputing fee based on excess marketing expenditure plus a profit element

In conclusion

• Can or should OECD develop similar examples for inclusion in TPG?
  • Australian examples are based on unfinished/abandoned work of a sub-group of OECD WP6 members
  • Difficult to get OECD consensus on examples that illustrate real life scenarios and have real practical value?
  • OECD concerns that examples may be misinterpreted or inappropriately exploited
  • Price of achieving consensus tends to be oversimplification?
  • Do the ATO examples have real practical value, or are they based on unrealistic assumptions (eg. that the return for marketing activity of a marketer/distributor can be identified and benchmarked separately from the return on its distribution activity)