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**Transfer Pricing in the Pharmaceutical Industry:  
The Remuneration of Marketing Intangibles**

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## INTRODUCTION<sup>1</sup>

Marketing intangibles have been the subject of heated debates in the transfer pricing (TP) arena for a number of years. The particular situation where a local distributor contributes by his marketing activities to the value of a marketing intangible (MI) he does not own has still recently been hailed as a “main [TP] issue” for the coming years.<sup>2</sup> The unique nature of the pharmaceutical industry<sup>3</sup> introduces further complexity to this issue, partly because the contractual relationships involved in the distribution of pharmaceutical drugs are often tripartite: (1) the manufacturer of active pharmaceutical ingredients (APIs), (2) the owner of patents and trademarks and (3) the distributor. Moreover, the marketing function is typically shared between the distributor and the MI owner or the multinational enterprise’s (MNE’s) head office.

In this paper, we address the following case scenario. A pharmaceutical distributor buys an API from a related party for resale to independent wholesalers after transformation into consumable form (known as secondary manufacturing activities). Other related parties legally own the pharmaceutical drug’s patent and MI rights, which are licensed to the distributor (in the case of MIs, often without a specific royalty).<sup>4</sup> More importantly, it is found that this distributor assumes a higher level of expenses, risks or responsibilities with respect to its marketing activities than what can be found in arm’s length (AL) transactions.

This scenario has proven difficult to solve within the boundaries of the arm’s-length principle (ALP), either because of the positioning of the hypothetical transaction (related distributors incurring a greater level of expenses, risks, responsibilities or any other measure of their involvement in marketing than what can be found in AL transactions) or because it involves unique intangibles (as one author notes, “there has been a growing realization that where intangible assets are concerned, there are grave problems in determining even a comparative

analysis”).<sup>5</sup> In addition, while the development of a patent’s value occurs through research and development (R & D) activities which are performed *before* licensing and can be attributed to one or several parties with relative clarity (either to the parties performing the activities or to the ones contracting them out to other parties while bearing all the risks involved), the development of an MI’s value often occurs *after* licensing and cannot as easily be attributed to one or several parties. Over the years, TP regulations and guidelines around the globe have introduced at least three distinct approaches to determine an AL remuneration for the marketing activities and intangibles involved in this type of situation, all of which have been highly criticized. We group these three approaches under the heading “MI concept”.

Certain authors suggest that the ALP has reached its limits and that formulary apportionment methods should accordingly be developed.<sup>6</sup> However, TP is not an exact science<sup>7</sup> and the development of the MI concept has also given rise to a number of theoretical contributions and proposed solutions designed to solve such cases within the boundaries of the ALP. A first group of authors works within the “traditional” approaches to the ALP and notably discusses the relative importance of various comparability factors. A second group of authors, mainly European, closely examines MNEs’ modes of functioning and decision-making and, in light of the perceived shortcomings of traditional approaches, seeks to expand the ALP through the development of value chain analyses.

After reviewing the historical development of the MI concept, this paper analyzes a portion of the prolific literature on the subject and presents various authors’ points of view, along with their underlying rationale. Author’s contributions bearing on distributors and on licensees are both reviewed where they appear relevant to our case scenario. Finally, this paper examines the potential usefulness of the principal TP methods in the determination of an AL remuneration for the local distributor described above.

# 1 CONCEPT OF MARKETING INTANGIBLES

## 1.1 Definitions and Characteristics of Intangibles

The very notion of intangible has not given rise to a complete consensus among the TP community. While most “definitions” in governmental documents or in the Guidelines consist of lists of examples, certain authors argue that the notion of intangible in a TP context should remain as close as possible to that of legally protected intellectual property (IP).<sup>8</sup> There is however much support for a broader view of what constitutes an intangible.

The Guidelines’ chapter on intangible property classifies commercial intangibles in two distinct categories: trade and marketing.<sup>9</sup> The latter includes notably trademarks, trade names, distribution channels,<sup>10</sup> some business rights,<sup>11</sup> and certain types of know-how.<sup>12</sup> Paragraph 2.25 of the Guidelines adds ‘marketing organization’ to this partial list. The Guidelines also refer to a number of marketing *activities* which may, in some cases, result in the creation of intangible property: market research, designing or planning products suitable to market needs, sales strategies, public relations, sales, service, and quality control.<sup>13</sup> Proposed paragraph 2.90 of the Guidelines explicitly holds that “not all valuable intangible assets are legally protected and registered and not all valuable are recorded in the accounts.”<sup>14</sup>

Under the current Internal Revenue Code regulations,<sup>15</sup> an intangible asset must derive *substantial value* from its intellectual content, independent of the services of any individual.<sup>16</sup>

Aside from this precision, the IRC regulations allow for a wide variety of legally unprotected intangibles, even providing for identification of their ownership through the “practical control” standard.<sup>17</sup>

Among the authors, few propositions have been found for a working *definition* of intangible property. Jean-Pierre Vidal has offered the following, in which *value* and *exclusivity* play an important part:

[U]n bien incorporel est constitué par un ensemble d'informations qui a la particularité de changer le niveau de profit d'une entreprise en déplaçant sa courbe d'offre ou de demande, sans que soient déplacées d'une manière équivalente les courbes d'offres ou de demande des autres entreprises en concurrence directe ou indirecte avec elle.<sup>18</sup>

Other authors prolong the lists contained in official documents with items that widen the scope of the notion, such as: human capital skills and organizational knowledge;<sup>19</sup> market information including information on cost-effective promotion, marketing plans and promotional materials;<sup>20</sup> customer lists and knowledge of distribution channels;<sup>21</sup> and goodwill, which embodies the value of an established work force, infrastructure and reputation for reliability.<sup>22</sup> Embracing one of the largest conceptions of what constitutes intangible property and referring largely to Baruch Lev's book entitled *Intangibles: Management, Measurement, and Reporting*,<sup>23</sup> Martin Przysuski, Srinilal Lalapet and Henri Swaneveld identify the "three major generators of intangibles" as: discovery, organizational practices, and human resources.<sup>24</sup> These authors are also of the view that most MIS are unprotected.<sup>25</sup>

Several authors argue that intangibles for TP purposes should be limited as much as possible to legally protected ones.<sup>26</sup> Monique van Hersken, Marc Levey, and Richard Fletcher notably warn against the "slippery slope of considering any potentially contributing aspects an intangible",<sup>27</sup> arguing that only in situations where a process adds "abnormal and excess value", leading to an "obvious and clear out-performance", does the reference to MIS make "economic" sense.<sup>28</sup>

## **1.2 Origins and Development of the Concept**

Several versions of the TP concept of MI have been developed over the years, with the United States at the forefront of most developments in this area.<sup>29</sup> We will briefly review this history.

The 1968 IRC regulations initially introduced what is commonly known as the “developer-assister” rules,<sup>30</sup> which operated through a partial economic ownership attribution of legally protected MIS, such as a trademark within a specific geographic location. Hailed as disrespectful of legal ownership by the greater part of the TP community, these rules were presumably introduced as an anti-avoidance measure unsuccessfully aimed at US-based MNEs relocating IP ownership to tax haven affiliates,<sup>31</sup> and later on at foreign-owned MNEs operating distribution activities in the lucrative US market through subsidiaries.<sup>32</sup>

The 1994 IRC regulations<sup>33</sup> added the notion of “routine expenditures”, namely the level of expenditures independent enterprises would be expected to incur,<sup>34</sup> and presented a since-famous series of examples, the “Fromage Frere” examples.<sup>35</sup> Under these revised rules, related distributors incurring a “routine” level of expenditures were no longer viewed as “developer-assisters” of the foreign-owned MI.<sup>36</sup> Moreover, related distributors incurring a “significantly larger” level of expenditures were now viewed as service providers deserving additional remuneration as such, rather than as partial owners of foreign-owned MIS,<sup>37</sup> unless they benefited from exclusive, long-term agreements.<sup>38</sup>

In 1995, a distinct section headed: “Marketing activities undertaken by enterprises not owning trademarks or tradenames” was introduced in chapter 6 of the Guidelines.<sup>39</sup> The OECD’s approach hinges on the concept of “extraordinary marketing expenditures”, a variation on the notion of “significantly larger” level of expenditures found in the 1994 IRC regulations. In accordance with the Guidelines, a related distributor who “bear[s] extraordinary marketing expenditures beyond what an independent distributor with similar [contractual] rights might incur for the benefit of its own distribution activities ... might obtain an additional return from the owner of the trademark” under the ALP.<sup>40</sup> The Guidelines therefore do not conceptually rely on partial ownership attribution of foreign-owned MIS to conclude that a related distributor should in these

circumstances be remunerated above the normal return on its marketing activities. As two authors rightly note, while the IRC regulations place some emphasis on ownership of intangibles in their framework to resolve our basic scenario, the OECD guidelines do not.<sup>41</sup>

Noteworthy of mention, the Australian Taxation Office (ATO) issued specific guidance in 2005 on the issue of what constitutes an “appropriate reward for marketing activities performed by an enterprise using trademarks or tradenames it doesn’t own”.<sup>42</sup> The ATO does not explicitly adhere to the 1994 IRC regulations’ view on economic ownership of legally-protected MIs. Under the ATO’s guide, the basis for an additional return to the distributor incurring marketing expenses “far beyond those of comparable independent enterprises” with similar rights is either its relative contribution to the value of the foreign-owned MI or direct compensation for the excess expenditures (presumably as a service fee).<sup>43</sup> The distinguishing factor between these two bases is not offered. One interesting feature of the ATO’s guide resides in the alternative indicators suggested to measure the “level of risks assumed by a marketer” for the purposes of the comparability analysis: aside from, or in conjunction with the cost-based approach (measuring the level of marketing expenditures), the ATO proposes other indicators such as market share, sales growth, and surveys of advertising effectiveness.<sup>44</sup>

On 31 July 2006, the United States adopted new and temporary regulations, slightly modifying those initially proposed in 2003.<sup>45</sup> The 2006 IRC regulations completely evacuate explicit references to partial economic ownership of legally protected intangibles.<sup>46</sup> They provide for two different ways to ensure that a related distributor receive an AL remuneration for its marketing activities.<sup>47</sup> First, the regulations elevate the *license* of intangible property to the level of an intangible in itself, deserving part of the profits attributable to the underlying intangible.<sup>48</sup> Second, the regulations provide that a distributor’s relative contribution to the development or enhancement of the value of a foreign-owned MI should be considered in a comparability analysis

and compensated.<sup>49</sup> In this regard, the notion of “significantly larger” level of expenditures is replaced with the notion of “incremental marketing activities”.<sup>50</sup> Referring to activities that are “quantitatively greater (in terms of volume, expense, etc.) than the activities undertaken by comparable uncontrolled parties”,<sup>51</sup> this replaced notion appears to have a lower threshold than the previous one. Where the incremental marketing activities are contemporaneously documented with regards to the parties’ respective contributions to the MI’s value, the US distributor can still be compensated as a service provider. If not, alternative arrangements may be imputed by the commissioner based on the economic substance of the transaction.<sup>52</sup> Partly for that reason, the new regulations are generally seen as strengthening “the [US] principle that the economic reality of a relationship takes precedence over a written contract”.<sup>53</sup>

Aside from the classification of contractual rights as a separate intangible owned by a distributor that is found in the 2006 IRC regulations, the reviewed guidance and regulations do not explicitly refer to the broader views, referred to in section 1.1 above, of what constitutes an intangible. Nonetheless, several authors have alluded to the fact that tax authorities draw from these broader views in their assessment work, arguing for instance that marketing activities create “atypical intangibles as they requir[e] a specialized and highly-skilled work force that ha[s] intimate knowledge and working relationships with health professionals”.<sup>54</sup> In this text, we will refer to this particular angle of the concept of MI as the “atypical intangible approach”, as opposed to the “partial economic ownership” and “incremental marketing activities” approaches.

### **1.3 Is the Marketing Intangibles Concept Reconcilable with the Arm’s Length Principle?**

The MI concept has been criticized, regardless of the specific approach, as inconsistent with the ALP.<sup>55</sup> Steve Allen, Rahul Tomar and Deloris R. Wright state in that respect that AL parties contributing to the value of an MI are generally allowed low, stable returns.<sup>56</sup> The authors, who

recognize that “virtually every subsidiary of a multinational corporation incurs marketing expenses in excess of those borne by independent distributors”,<sup>57</sup> agree that an additional return with regards to incremental marketing activities would be warranted in a situation where a subsidiary incurred losses continually for six years.<sup>58</sup> They argue however that it would not be AL where the subsidiary was profitable after all costs, since “virtually all *related-party* resellers incur incremental marketing expenses” and “[t]hese expenses are typically covered in the transfer price” between AL parties.<sup>59</sup> We understand their argument as supporting the view that, as long as the incremental expenses are indirectly reimbursed to the local distributor through a transfer price designed to ensure a “routine” return, no additional return should accrue to the related distributor. This view which is shared by several authors is examined further below.<sup>60</sup>

In an article entitled “Marketing Intangibles in Canada: Myth or Reality?”,<sup>61</sup> François Vincent first addresses the MI concept with the help of established notions of property, arguing that MIS cannot exist in Canada since they are not protected under Canadian intellectual property law<sup>62</sup> and no value can be attributed to them.<sup>63</sup> He also argues that there is no legal basis for the MI concept unless specific national legislation exists, as with the IRC regulations.<sup>64</sup> This argument of course leads to the inherent danger of economic double taxation by different states, as Vincent himself recognizes.<sup>65</sup> While he does not conclude on the validity of the economic rationale of the MI concept,<sup>66</sup> Vincent finally argues that it is incompatible with the ALP<sup>67</sup> since, “regardless of the level of marketing expenditures incurred”, AL distributors are not entitled to share in the profits attributable to trademarks.<sup>68</sup> In our view, this last argument fails to address the fundamental concern underlying the development of the MI concept, especially from the early 90s on, which proceeded from tax authorities’ perceptions of a greater involvement on the part of related distributors when compared to independent ones. In other words, the very roots of this concept

arise from the acknowledgement that a functionally similar situation cannot be found in AL transactions.

In response to this concern, Vincent proposes that the proper tax solution in this situation should either be to disallow the excess expenses, or to remunerate the distributor with a mark-up on these expenses as a service provider.<sup>69</sup> We note however that he partly criticizes the concept of MI on the basis that it is quite difficult to identify such an amount of excess marketing expenses.<sup>70</sup>

## **2 OWNERSHIP OF MARKETING INTANGIBLES**

The partial economic ownership and atypical intangible approaches to the MI concept are asset-based. Not surprisingly, placing emphasis on ownership is one of the ways in which some authors have responded, through time, to the development of the concept. One author thus writes that identification of the intangible owner is the “first essential step to setting arm’s length prices”.<sup>71</sup> While some authors argue that legal ownership should be respected, others apparently accept the notion of economic ownership as a reality.

### **2.1 LEGAL OWNERSHIP**

Several authors see legal title as determinative of bargaining power and therefore of entitlement to the related income under the ALP.<sup>72</sup> Most of these authors however provide for some possible exceptions to this basic rule.

For instance, Gregory J. Ossi recognizes that, where “one prospective licensee offers some unique advantage that would add value to the combined enterprise”, the owner may not find equal alternatives and would therefore offer more generous contractual terms.<sup>73</sup> The owner of an intangible would certainly be willing to pay a premium in order to achieve increased results (in terms of both price and volume of sales) earlier in time.

J. Roger Mentz and Linda E. Carlisle also consider that “some intangible value could accrue to the [AL] distributor” holding a long-term, non-cancellable license or distribution agreement, by reason of the significant capital investment it typically incurs.<sup>74</sup> In their view, “the interest of a long-term licensee or distributor in intangible property may well result in significant intangible rights (but not ownership)” for TP purposes.<sup>75</sup> They even suggest that this exception could apply where a short-term agreement “may be considered to be the equivalent of a long-term agreement”.<sup>76</sup>

Mentz and Carlisle’s view somewhat contradicts the frequent observation that an AL distributor will generally accept a lower level of remuneration in exchange for long-term access to the distribution rights. Indeed, it is widely acknowledged among the authors, as well as by tax authorities, that long-term exclusive licensees might not receive as high a level of remuneration as short term or non-exclusive licensees would, since the former are expected to fully benefit from their costly initial efforts in future years.<sup>77</sup>

On that subject, we express some doubt on what may be a tendency to assume that intra-MNE arrangements are by nature long-term ones. As recognized by the OECD, it appears to us on the contrary that an MNE’s head office has all the latitude needed to modify its internal arrangements at any time, including making the decision to outsource some of its activities in given locations:

Associated enterprises are able to make a much greater variety of contracts and arrangements than can unrelated enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between unrelated parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. *Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively.* In such instances tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm’s length principle.<sup>78</sup>

In addition, the long or short-term nature of an agreement entered into between related parties may have to be examined in combination with the fixed or varying nature of the price. Looking at

license arrangements, Brian Becker argues that it is the *lack of updating* of the intercompany royalty rate over a long period of time (ultimately, over the life of the licensed intangible property), that creates additional risk for the licensee, thereby justifying a (projected) higher profit margin than otherwise.<sup>79</sup> Of course, the underlying risk must be real to begin with. As Andrea and Alberto Musselli remark, “to assess arm’s length conditions, one must determine when and if a real risk is faced by the aggregate firm, i.e. the multinational entity which performs the integrated activity of producing and distributing goods”.<sup>80</sup> In light of the above, for high-risk products, long-term arrangements with a fixed price would justify a higher profit margin for the distributor/licensee, while for low-risk products, such arrangements would justify a lower level of remuneration.

Tenants of legal ownership theories naturally walk hand in hand with tenants of the argument that the definition of intangibles for TP purposes should remain as much as possible within the realm of IP, thereby limiting the notion to its barest expression. As Przysuski, Lalapet and Swaneveld put it, “[l]egal ownership, as the name implies, requires the existence of legal title and legal protection of any intangible property.”<sup>81</sup>

## **2.2 ECONOMIC OWNERSHIP**

### **2.2.1 LEGALLY PROTECTED INTANGIBLES**

Other authors place as much importance on identifying an intangible’s owner as the tenants of legal ownership do, while accepting the notion of economic ownership. As Ossi remarks, under the generally applicable economic substance doctrine in US tax law, the ownership and taxability of intangible property is determined with the help of the “all substantial rights” test, which is based on “the possession of the requisite intellectual property law [and contractual] *rights*, not the expenditure of funds to create or enhance intangible value”.<sup>82</sup> In the TP context however, the

economic owner of an intangible asset is generally understood as the party “that bears the greatest economic burden (economic costs and risks) of developing the intangible.”<sup>83</sup>

Several authors have reviewed the extent to which tax authorities accept the transfer pricing concept of economic ownership. Nigel Dolman remarks that it is recognized by several tax authorities, including those of the United Kingdom and Germany,<sup>84</sup> while Przynski, Lalapet and Swaneveld argue that it is emphasized by the Canadian “regulations”.<sup>85</sup> These authors add that the concept of economic ownership is either “acknowledge[d]”<sup>86</sup> or “emphasize[d]”<sup>87</sup> in the Guidelines, mostly in situations similar to our case scenario.<sup>88</sup> Contrary to Przynski, Lalapet and Swaneveld’s view on the strength of the TP notion of economic ownership in Canada, we suspect that this issue, as yet unaddressed by Canadian courts, could encounter certain difficulties in light of the general precedence of legal relationships over economic substance in Canadian tax law, as decided by the Supreme Court of Canada in *Shell Canada*.<sup>89</sup>

Where “legal rights and economic ownership [of legally protected intangibles] are divorced”,<sup>90</sup> the core issue is often defined as how to allocate IP income between the legal and economic owners.<sup>91</sup> Authors of several articles founded in part on economic evidence underlining the importance of *incremental innovation* to the modern industry,<sup>92</sup> Przynski, Lalapet and Swaneveld note that the notion of economic ownership is particularly invoked in the context of licensing transactions, where the licensor transfers the risks and benefits of ownership to the licensee while retaining legal ownership.<sup>93</sup>

Understandably, the extent to which a trademark is already known in a territory is seen as a key factor in allocating IP income between legal and economic owners. One author thus believes that when a trademark has no value in a given territory at the time of licensing, an AL party “that has to pay all of the related development costs for its market itself” will normally stipulate in the agreement that it becomes the beneficial owner of the licensed trademark in its territory.<sup>94</sup> De

Hosson adds that a trademark can also have value without being known in a territory, for example where it has proven elsewhere “that it fulfils a valuable communication and identification function.”<sup>95</sup>

The degree of centralization or decentralization of the decision-making process within an MNE is seen as another important factor when allocating IP income between its legal and economic owners. In an article discussing the potential impact of different business strategies on transfer prices, Przysuski, Lalapet and Swaneveld examine strategies based on the level of global integration of the MNE’s activities, namely, the level of centralization or decentralization of the decision-making process.<sup>96</sup> They argue that where an MNE pursues a global strategy of centralized decisions in a highly integrated environment, the parent may have both legal and economic ownership of local MIs as a result of the high level of coordination between parent and local subsidiaries. A local affiliate could however be considered as having some economic ownership in this situation if expenses and risks assumed “can be proven to be in excess” of what a typical AL party would have borne.<sup>97</sup> In another article, they advise MNEs to “quantify this additional ‘extraordinary’ contribution and compensate the subsidiary” who enhances the value of a trade name or brand in its local market beyond what an AL distributor would normally do, in order to avoid a transfer of economic ownership of the legally protected MI.<sup>98</sup>

### **2.2.2 ATYPICAL INTANGIBLES**

In their article bearing on business strategies, Przysuski, Lalapet and Swaneveld directly link the successful use of certain business strategy models, such as market share enhancement or market penetration, to the creation of MIs:

When MNEs pursue a multidomestic strategy<sup>99</sup>, autonomous subsidiaries that help develop a new market from scratch or that significantly improve market share in an existing market may be considered to have economic ownership of the resulting MI because they bear the burden of the costs and the risks of developing the new market or enhancing the market share.<sup>100</sup>

The extent of the pharmaceutical industry's marketing activities may place it among the best candidates for the argument in favor of the atypical intangible approach. Sophisticated and intensive worldwide marketing, infused with knowledge of specific national markets, is considered a necessity by industry players.<sup>101</sup> Much of the industry's marketing efforts require "very labour intensive" individual communications from scientifically trained staff,<sup>102</sup> including detailing (visits of sales representatives to physicians),<sup>103</sup> medical journal advertisement and conference sponsoring.<sup>104</sup>

However, as with the partial economic ownership approach of legally protected intangibles, an adoption of the atypical intangible approach still begs the question of remuneration. Firstly, in determining remuneration, should legally unprotected MIS be considered routine or exceptional? Indeed, "the return allocable to routine intangibles is deemed included in all activities along the supply chain and can be remunerated by applying normal simple benchmark analyses, as the comparables are deemed to possess the same or similar routine intangibles".<sup>105</sup> Moreover, in the words of two authors, "any company successful at selling finished pharmaceutical products must have knowledge of and contacts on the local market".<sup>106</sup> If the atypical intangible perspective is adopted, what would differentiate a related distributor from an independent one? Should the former's MIS attract a different level of remuneration? And if so, how would the TP analyst account for such?

With regards to accounting for the value addition of unprotected, often overlooked MIS, Przysuski, Lalapet and Swaneveld consider that it is a "rather challenging" endeavor.<sup>107</sup> They nonetheless disagree with the widely-held view that these intangibles may be of limited value:

Many taxpayers and quite a number of transfer pricing practitioners and tax authorities assume that intangibles associated with the day-to-day functioning of a firm may not be valuable since other firms in the industry are also presumed to be performing similar functions. This conclusion

would imply, however, that no *distinctive* advantages are created for a firm that engages in ongoing activity ... that ... enhance[s] the effectiveness of its sales/marketing organization.<sup>108</sup>

Recognizing that not all attempts to create an intangible result in a valuable one,<sup>109</sup> they argue that the “only measure of an intangible’s importance to the firm is its ability to improve and sustain a firm’s competitive advantage”.<sup>110</sup> They also argue that incremental innovation is “one of the principal means available by which a firm can add continuous value to its products and process technology”.<sup>111</sup>

Their argument is set from the point of view of proper TP planning. A determination of the benefits that should accrue to each MNE unit involved in the innovation process requires an understanding of that process from an economic point of view,<sup>112</sup> as well as an understanding of the relative contributions of the MNE units to that process.<sup>113</sup> With this last point, the authors add their voices to the mainly European proponents of value chain analyses<sup>114</sup> although, as tenants of economic ownership principles, they view the MNES’ value drivers mainly from the perspective of intangible *property* or *assets* rather than that of *activity* or *contribution* of the group’s entities.

### **3 COMPARABILITY IN THE PHARMACEUTICAL INDUSTRY**

Comparability is at the heart of traditional approaches to the ALP: the fundamental assumption here is that sufficiently comparable transactions do occur in the open marketplace.<sup>115</sup> The Guidelines identify five principal comparability factors or “economically relevant characteristics”<sup>116</sup>: (1) characteristics of property or services,<sup>117</sup> (2) functions, including assets used and risks assumed,<sup>118</sup> (3) contractual terms, which define the division of responsibilities, risks and benefits,<sup>119</sup> (4) economic circumstances including different markets,<sup>120</sup> and (5) business strategies bearing on the daily conduct of business.<sup>121</sup> The following discussion concentrates on a few factors that can markedly impact comparability in the pharmaceutical industry. Before analyzing two fundamentally different interpretations of the notion of risk from a TP perspective

as well as existing differences in geographical markets and various business strategies linked with the pharmaceutical patents' life cycle, we will first briefly examine the nature of competition in the pharmaceutical industry.

### **3.1 COMPETITION IN THE PHARMACEUTICAL INDUSTRY**

The pharmaceutical industry is increasingly global,<sup>122</sup> allowing firms to benefit from economies of scale. It is also characterized by important barriers to entry, due mainly to both ownership of intangible property and the ability to differentiate products with the help of significant marketing resources.<sup>123</sup> Furthermore, when divided into therapeutic classes, the pharmaceutical market becomes quite concentrated.<sup>124</sup> The industry is thus largely viewed as operating in a situation of imperfect competition although, considering competition from me-toos<sup>125</sup> and other non-drug forms of therapies, not of pure monopoly.<sup>126</sup>

Barriers to entry are generally seen as giving rise to an economic profit, which is viewed as the additional return one makes because of the situation of imperfect competition.<sup>127</sup> Accounting profit is therefore composed of the normal return one would make in a situation of perfect competition, plus the economic profit. This additional, premium or excess return, also referred to as *economic rent*,<sup>128</sup> can result from volume increase or premium price.<sup>129</sup>

Becker remarks that intangible property can have an effect on both volume of sales and profit margins, in the latter case either through increased prices or cost-reduction.<sup>130</sup> He further suggests that patents generally offer more of a profit margin effect through increased prices, while brand names generally offer more of a volume effect.<sup>131</sup> Building on this view, Wright opines that “[m]arketer/distributors that add value to trademarks they do not own should be remunerated [solely] through increased volumes of products sold”, but only where the contract is of long

duration or where all selling, general and administrative expenses are “covered” by the transfer price.<sup>132</sup>

### **3.2 NOTIONS OF RISK APPLIED TO THE PHARMACEUTICAL INDUSTRY**

The risk factor is often viewed as quite important for TP purposes, as “a shift in risk [can] account for a large shift in profit streams”.<sup>133</sup> Although all agree that risk-bearing can attract higher profits as well as greater losses, the abundant TP literature suggests differing interpretations of the notion of risk. Certain TP authors writing about the pharmaceutical industry compare the risk level of various *activities* or *functions* performed by a pharmaceutical MNE’s entities as a potential measure of their relative *value* to the MNE as a whole (or even to the industry). In our case scenario, this first interpretation is generally used to compare the relative values of R & D and marketing activities. A second, more widespread interpretation examines the notion of risks from a transactional perspective, attributing the risks associated with a single function either to the party responsible for its costs or to the party who exercises control over it.

#### **3.2.1 NOTION OF RISK COMPARING DIFFERENT FUNCTIONS**

Authors who apply the first interpretation of the notion of risk to the pharmaceutical industry usually favor R & D over marketing as the riskiest and therefore most valuable function.<sup>134</sup> Jamal Hejazi argues in *Structural shift in risk*<sup>135</sup> that the recent erosion of patent protection in the United States, designed to ease generic entry,<sup>136</sup> along with pricing and other regulations affecting the marketing function in Canada have modified the assignment of risks among related parties within North America. Noting that the R & D function is often performed in the United States while the Canadian pharmaceutical entities’ role is often focused on the marketing function, he concludes that “more risks [are] being downloaded from marketing and being distributed to the R & D area”.<sup>137</sup> His rationale is two-fold: erosion of patent protection increases

the level of risk bearing on the R & D function, and government regulations, especially those stripping the marketing function from its potential to affect price (or price controls), render the marketing function “less relevant”.<sup>138</sup>

A study performed after the adoption of the *Hatch Waxman Act* has indeed shown that the erosion of patent protection and the corresponding increase in generic competition can reduce the overall returns from innovation.<sup>139</sup> In concluding that this phenomenon increases the level of risk bearing on the R & D function, Hejazi may be interpreting the notion of risk as “potential for cost recuperation”. However, patent erosion produces measurable effects on the marketing function as well: as generics are allowed earlier entry into the market, the need to maximize profits through skillful, efficient, and earlier marketing efforts greatly increases.<sup>140</sup>

When concluding that price regulations diminish the relevance of the marketing function, Hejazi may be overlooking the effects of marketing on sales volume: due to unusually low marginal production costs,<sup>141</sup> sales volume holds a particular importance in the pharmaceutical industry’s returns. Volume-increasing strategies are implemented through promotional activities,<sup>142</sup> which are recognized to exert a large influence in most countries.<sup>143</sup> A recent OECD study offering a clear and objective overview of the pharmaceutical industry describes the industry’s attempts to maximize profits in the following terms:

Since unit production costs can be considered independent of the level of production, maximizing profits translates into maximizing positive cash flows during the life of a product, and particularly during the period in which the product benefits from market exclusivity. In order to meet this objective, a pharmaceutical manufacturer will launch as quickly as possible in the markets with the highest sales potential (in terms of volume and prices), will price its products as high as possible according to market conditions and regulatory constraints, will try to extend period of market exclusivity, engage in promotional activities to capture as large a piece of the market as possible and aim to expand potential market for its products.<sup>144</sup>

Evidence pertaining to competition among branded drugs also shows that advertising is key in the competition for market share.<sup>145</sup> Two observers of the pharmaceutical industry, commenting on the fact that blockbusters launched between 1998 and 2003 reached 2 billion US dollars in sales

within 3.5 years or twice as fast as before, attributed this success in part to “high compression marketing” aimed at creating a rapid take-off curve with higher peak year sales earlier in a product’s life cycle.<sup>146</sup>

Similar to Hejazi’s argument regarding the effects of price control regulations on marketing activities, it was believed during the 1990s that influential efforts to keep prescribing costs down for drug buyers would lower the magnitude of marketing activities in the pharmaceutical industry.<sup>147</sup> On the contrary, MNEs who continued to increase their sales force size during that period “found that it paid off handsomely”.<sup>148</sup>

Unlike the transactional notion of risk examined in the following section, the notion of risk which compares various activities or functions does not appear to link the risks of an activity to its corresponding level of costs, but rather with its potential for success or failure.<sup>149</sup> It is interesting to note however that while the costs of R & D have increased over time,<sup>150</sup> especially as a result of accrued controls on clinical trials,<sup>151</sup> economists have observed as early as 1998 that the failure rate of drugs that go into clinical trials has been curtailed by technological advancement, notably with the development of computer programs that help predict whether the trials are likely to work.<sup>152</sup> Still, it is hardly debatable that the ethical pharmaceutical industry is risky due to its intensive R & D activities and that it cannot, by definition, survive without the R & D function: it is widely recognized that the key to long-term success in this industry is a lively and constantly replenished pipeline of patented products.<sup>153</sup> The question we ask is the following: is the risk factor, understood as potential for success or failure, sufficient to explain the relative value of R & D and marketing?

In our view, the risk-level of an activity constitutes only one factor explaining the market value of the resulting intangible or of the activity itself. Consider for instance the case of “me-too” drugs.<sup>154</sup> In a descriptive review of the ethical pharmaceutical industry’s development, two

authors observe that beginning in the 1960s, “[i]mitating a known drug reduced R & D risk considerably, while the marketplace was open to products offering minor advantages [...] but with much the same therapeutic outcome.”<sup>155</sup> They explain that “[i]t proved relatively easy to identify flaws in the first drug and deliver a follow-up positioned as ‘best-in-class’”.<sup>156</sup> If we were to interpret the notion of risks as potential for success or failure and equate it with value, the market value of a breakthrough drug’s patent should therefore be higher than a me-too drug’s patent. However, me-too drugs clearly have the potential to overtake the market developed by a breakthrough drug,<sup>157</sup> and a study has shown that me-too drugs’ US market prices tend to increase much more rapidly than their more innovative competitors’ drug prices, even where the me-too drug was introduced at roughly the same price as their closest competitors.<sup>158</sup> Holland and Batiz-Lazo’s observations may even lend support to an argument that in some cases, the potential for success or failure of a drug rests heavily on the marketing function. In light of the above, we believe that an interpretation of the notion of risk that automatically equates the comparative risk-level of activities performed with their market value is ultimately incomplete.

### **3.2.2 TRANSACTIONAL NOTION OF RISKS**

The notion of risk is interpreted more frequently from a transactional perspective and is mainly used in the comparability analysis.<sup>159</sup> The TP analyst who adopts this interpretation examines how the risks arising *within* a particular transaction are allocated between the parties. These types of risks “that must be borne by one party or the other, or shared between the two”,<sup>160</sup> are referred to by Anthony J. Barbera as “undiversifiable risk” or “business risk”: “the sort of risk that arises as a result of the general rise and decline in the economy or in the market in which an enterprise operates”.<sup>161</sup>

For most authors, transactional risks lie with the party bearing the ultimate responsibility for costs.<sup>162</sup> Both the Guidelines<sup>163</sup> and the ATO's Guide<sup>164</sup> also emphasize a direct link between cost and risk bearing.

It has been argued that the pricing structure adopted by related parties determines the actual risk allocation among the parties. For instance, Barbera distinguishes between two broad types of trademark license agreements according to the risk level born by the licensee: low or high-risk.<sup>165</sup> The risk taker is identified as the party who bears the burden of advertising and marketing *investment*, and therefore of the overall fluctuations in profitability,<sup>166</sup> while the low risk party is recognized by its priority claim on profits.<sup>167</sup> Barbera argues that this priority claim on profits is mainly a result of the transaction's pricing structure,<sup>168</sup> which he considers as "the key method for the allocation of risk between entities".<sup>169</sup> When a pricing structure delivers a low-risk arrangement for one party, he should be appropriately compensated with only a low, stable level of return.<sup>170</sup>

In our view, this conclusion must be approached with caution. Paragraph 45 of the OECD's *Discussion Draft of Transfer Pricing Aspects of Business Restructuring* states that

[w]hile the terms on which a party to a transaction is compensated cannot be ignored in evaluating the risk borne by that party, it is worth remembering that it is the low risk nature of a business that should dictate the choice of a given transfer pricing method, and not the contrary.<sup>171</sup>

As Andrea and Alberto Musselli remark, "it is not the low remuneration ... that creates a non-risky business", unless it is also "coupled with low volatility".<sup>172</sup> In addition, to conclude that the party whose remuneration is fixed in advance at a low level incurs a low level of risks, the contract must guarantee such remuneration in *every possible circumstance*.<sup>173</sup>

Opinions have also been expressed that transactional risks primarily lie with the party exercising control over the function. With respect to marketing, Lewis and Wright distinguish between strategic (or decision-making) and tactical (or implementation) marketing, and attribute control

over the function to the entity developing marketing strategy.<sup>174</sup> Similarly, Chaïd Dali-Ali remarks that “[p]rofits would arise largely based on strategy, and not exclusively on the nature of assets, functions and risks”.<sup>175</sup> With this approach, cost-bearing becomes a secondary attribute that should normally follow control, rather than a primary indicator of risk-taking.

Finally, it has been suggested that it is the party responsible for the decision to pursue marketing investments or not who ultimately assumes the marketing risks: “the distributor agent must be considered a service provider in all cases where the principal manufacturer has the power to continue or stop marketing investments which are actually made by the distributor.”<sup>176</sup>

### 3.3 GEOGRAPHICAL MARKETS

Economic circumstances as a comparability factor occupy but one paragraph in the Guidelines and generally refer to market differences.<sup>177</sup> In the TP literature bearing on the pharmaceutical industry, geographic location is an often addressed market difference.

Geographic location can give rise to an economic profit.<sup>178</sup> Indeed, geographical markets differ widely with respect to both size and economic strength, which can have an important effect on volume of sales. Should the additional profit due to a specific market’s size or strength accrue to the local distributor or to the intangible owner? This question is rarely mentioned in the literature, although it is indirectly addressed in paragraph 6.4 of the Guidelines which states that the value of MIs is influenced by “the *value* of the market to which the marketing intangibles will provide access”.<sup>179</sup>

Wündisch remarks that pharmaceutical MNEs will generally maintain a presence in countries where business is substantial:

When a multinational group’s sales in a particular country are substantial, it would be *normal* for the sales to be made through a national marketing, sales and distributing subsidiary, rather than through an independent distributor.<sup>180</sup>

In other countries, MNEs may choose an external structure such as a license to a third party, allowing the latter to import or manufacture patented drugs, or a sale agreement with an independent distributor. The decision to retain an external structure may depend on a variety of factors among which: “expertise and connections of independent national firms” to open up a new market; legal or policy requirements as to ownership of locally-operating firms; and restrictions on out-of-country dividends and/or royalties.<sup>181</sup> According to Wündisch, external structures are more commonly put in place outside OECD countries.<sup>182</sup> This is easily understood when one considers the fact that as of 2007, nine OECD countries accounted for 81 percent of world-wide pharmaceutical sales.<sup>183</sup> Could this also be viewed as an indication that the choice to establish an external structure in a sizeable or powerful market entails some degree of sharing of the related economic profit with the local AL distributor? There certainly exists much support for that proposition.<sup>184</sup>

In the pharmaceutical industry, geographical markets also differ with respect to the varying levels of government intervention through patent, pricing and marketing laws and regulations, potentially affecting levels of marketing expenses, customer end-prices, and overall profits.<sup>185</sup> On that subject, paragraphs 1.55 and 1.56 of the Guidelines dictate that government intervention should be treated as market conditions and taken into account in evaluating a transfer price, considering how independent enterprises would have dealt with the situation.

With regards to the relative importance of geographical markets and other comparability factors, opinions vary. Despite the insistence of the ATO on selecting comparable transactions locally, Australian authors Philip Anderson and Melissa Heath favor the consideration at the net margin level of comparable transactions from other geographic locations but within the same industry and bearing on the same product, over the use of “functional” comparables.<sup>186</sup> Lyndon James, Mark Kenny and Nick Houseman similarly note that, although it “has ... been the practice of the

ATO to use comparables in different industries”, internal comparables are “likely to carry more weight in an Australian Court of law”.<sup>187</sup> Russo and Boykin also report that the OECD’s Working Party No. 6 (OECD WP6) expressed a general preference for internal comparables since in their view, such transactions are likely to have a more direct and closer relationship to the transaction under review and specific transactional information is likely to be more available and more reliable, for example because of the use of the same accounting standards.<sup>188</sup> An argument that is raised by Russo and Boykin in favor of the use of internal comparables from other jurisdictions is that business models do not generally differ depending on the market of destination and that often, no material differences would justify deviating from a uniform approach across countries.<sup>189</sup> Their argument may indeed be applicable to some pharmaceutical MNEs.<sup>190</sup>

Several authors argue however that important geographical differences affecting the pharmaceutical industry prevent the TP analyst from effectively using data pertaining to transactions occurring in neighboring countries, although they do not all agree as to what indicator of the transfer prices (actual prices or royalties, gross margins, or operating margins) may thus be affected. While there is considerable support for the proposition that important geographical market differences militate in favor of in-country comparables, where available, the opinion that such geographical differences have a greater impact than product differences on gross profit margins,<sup>191</sup> notably held by Rozek and Korenzo,<sup>192</sup> is a contentious one.<sup>193</sup> In an article entitled “Using In-Country Comparables To Measure the Returns Due to Pharmaceutical Marketing and Distribution Affiliates”,<sup>194</sup> Rozek and Korenzo compare the gross margins of pharmaceutical marketing and distribution entities in five European countries: France, Germany, Italy, Spain and the United Kingdom. The average gross margins obtained in respect of each country vary between 48 and 71 percent. The largest difference observed between the studied countries’ average gross margins is thus of 23 percentage points, with France at the low end and

the United Kingdom at the high end. The authors attribute this wide range to differences in regulatory regimes, types of purchasers, degrees of buying power, forms of financing, levels of sales volume and geographical preferences for products.<sup>195</sup>

However, it is of note that the gross margins examined by the authors *within* a single country also vary by as much as 23 percentage points (Italy) and 16 percentage points (United Kingdom). Although these internal variations might be explained by regional differences,<sup>196</sup> they could in our view more readily be explained by differences in product characteristics and other comparability factors. For instance, several of the examined entities appear to have been selling much more than ethical pharmaceutical products: at the time of writing this paper, Nutricia Ltd. in the United Kingdom sold nutritional products such as baby formulas;<sup>197</sup> Saada-Arzneimittel Aktiengesellschaft in Germany sold generic drugs and personal care products;<sup>198</sup> DSM Capua in Italy included nutritional products and animal feed in their list of products;<sup>199</sup> Gifrer Barbezat in France sold cosmetics and vitamins<sup>200</sup> and Omega Pharma in France also sold cosmetic products.<sup>201</sup> Moreover, some of the entities examined by Rozek and Korenzo were, at the time of writing this paper, part of fully integrated MNEs: Celltech Pharma<sup>202</sup>, DSM Capua<sup>203</sup>, and Ferring Laboratories Ltd.,<sup>204</sup> the last two entities displaying the most extreme gross margins observed by the authors: 82 percent and 40 percent, respectively. These extreme figures suggest that the gross margins of entities that are part of a group might be a reflection of the particular MNE's TP policies. In all events, they certainly do not meet the conditions of the ALP, that is, data obtained from transactions concluded between unrelated parties. Finally, the authors mention that no adjustments were made to the gross margins, suggesting that differing accounting standards were not taken into account.<sup>205</sup> For example, were free samples costs netted against income, included in cost of goods sold, or treated as an operating expense?

As illustrated by the decision of the Tax Court of Canada in *Glaxo Canada*, there is one geographical difference that can effectively rule out the use of internal comparable transactions from certain European countries at the gross margin level: the gross margins in these countries can be underestimated as a result of the fact that, in order to obtain a higher resale price from government regulators, some pharmaceutical enterprises inflate the (apparent) API price, later reducing it by, for example, deposits in resellers' bank accounts.<sup>206</sup> To maintain secrecy on real API prices from government regulators, these subsequent "rebates" are surely not taken into account at the apparent gross margin level but rather netted from operating expenses or otherwise taken into account at the operating margin level.

This particular obstacle to the application of gross margin methods using internal comparables from other jurisdictions is ultimately under the control of the MNE to which the tested party belongs, as it is directly tied to data available to one of its entities. Access to information on foreign affiliates is incidentally considered essential to TP examinations.<sup>207</sup> For OECD WP6, it is "a key issue in the application and review of all transfer pricing methods".<sup>208</sup> The issue was notably discussed by members of the business community while commenting on the OECD's Discussion Drafts on comparability and on profit methods.<sup>209</sup> Certain members apparently argued that access to some foreign information by tax authorities could undermine the application of the ALP since information asymmetry forms the basis of bargaining power differentials in typical market situations.<sup>210</sup> This argument appears erroneous, as foreign information could only help better define the bargaining position of each contracting party. In all events, the argument does not apply to the situation we just described, where tax authorities are not looking for information on the price-setting process but on prices set in potentially comparable transactions.

The context of accrued transparency required by tax administration, exemplified in Canada by the increasing use of requests for information by the Canada Revenue Agency (CRA) and the

consequent explosion of Canadian Court cases bearing on such requests,<sup>211</sup> underlines the importance of obtaining complete information from taxpayers in order to determine the proper taxation of income, at both the administrative and court levels. TP is no exception in this regards, as eloquently demonstrated in the *Glaxo Canada* case.

### **3.4 BUSINESS STRATEGIES AND PATENT LIFE CYCLE**

From a business management perspective, market maintenance, market expansion and market penetration constitute three categories of market share improving strategies.<sup>212</sup> Noting that the Guidelines explicitly recognize only market penetration strategies,<sup>213</sup> Przysuski, Lalapet and Swaneveld argue that “[b]oth reducing prices and increasing expenses are considered legitimate ways to execute” all three types of strategies.<sup>214</sup>

In an article entirely devoted to intangible life cycle’s implications on AL pricing, Nigel Dolman describes a typical intangible’s life cycle as comprising four stages, namely: market introduction, growth, maturity and decline.<sup>215</sup> Michael Stirling suggests that the downward plunge of Glaxo shares’ stock market value as the Zantac patent reached its “expiration date” illustrates the importance of a pharmaceutical patent’s position in its life cycle at the time of valuation.<sup>216</sup> Embracing the concept of economic ownership of IP, Dolman goes even further and argues that the evolution of an intangible’s life cycle should lead to modifications in the division of profits between legal and economic owners.<sup>217</sup> The ALP would therefore require “ongoing monitoring and testing of transfer prices during the IP life cycle”.<sup>218</sup> It is interesting to note that Dolman’s view in this regard is opposed to Wündisch’s observation that “uncontrolled parties would generally not accept any renegotiation of their agreed upon transfer conditions”.<sup>219</sup> The Advance Pricing Agreement negotiated between the IRS and SmithKline in 1992 and 1993 also provided for a single gross margin to be applied throughout the life of the Tagamet patent.<sup>220</sup>

In the pharmaceutical industry, marketing efforts are closely tied to a patent's life cycle. When Holland and Bätiz-Lazo observe that sales and marketing have become an increasingly important source of competitive advantage in this industry, they also report that beginning in the late 1990's, strategic marketers started to seek earlier and higher sales peak and to attempt to extend a product life cycle.<sup>221</sup> As a result, the profit margins of a local distributor will normally be affected by patent life cycle strategies where, as mentioned earlier in the discussion bearing on the transactional notion of risks, it bears responsibility for costs or exercises a degree of control over strategic or investment decisions, while bearing responsibility for costs.

#### **4 VALUE CHAIN ANALYSES**

Several difficulties are encountered when attempting to reconcile the business practices of MNES with the ALP. For instance, certain types of intra-MNE transactions, such as the provision of a group name by the parent company, are unheard of in the marketplace. In such a case, does the absence of comparable AL transactions justify a complete absence of remuneration for the parent company? Fred C. de Hosson argues as follows: to automatically consider that this type of transaction requires no payment from the subsidiary to the parent would disregard the fact that the ALP "is not an objective in itself, but a tool to realize a reasonable international allocation of the group profit".<sup>222</sup> Although generally critical of the concept of economic ownership when applied to our case scenario, de Hosson favors the "payment of a fee by a group company for the costs involved in the development and maintenance of the group name", which is especially valuable in the pharmaceutical industry.<sup>223</sup> But how would one establish an AL value for such a fee? It is of note in this regard that, since the turn of the millennium, almost 70 percent of international trade occurs *within* MNES.<sup>224</sup> The difficulties encountered in determining AL prices in

our case scenario tend to show that the MI concept arose from the objective of ensuring the proper remuneration of an MNE specific type of dealings.

Value chain analyses for TP purposes were initially developed by Pim Fris<sup>225</sup> and have received support from other authors as well.<sup>226</sup> In an article published in November 2003, Fris argued that TP practice has moved too far away from the economic field's insights<sup>227</sup> and qualifies the functional analysis approach as a static, historical approach to the ALP, "incorrect in its just stapling different functions".<sup>228</sup>

Often seen as the cornerstone of traditional TP reviews, functional analysis actually derives from the OECD Guidelines' second comparability factor, *functions*, "taking into account *assets* used and *risks* assumed".<sup>229</sup> It involves "the identification and evaluation of the functions performed, assets used and risks and responsibilities assumed by the controlled and uncontrolled parties in the transactions under review", and seeks to "determine whether the economically significant activities of controlled and uncontrolled transactions are sufficiently similar".<sup>230</sup> Carried to its extreme, a cloistered approach to functional analyses may lead to the remuneration of each function separately. This approach was notably suggested by Wright in support of the Commissioner's position in *Roche Australia*<sup>231</sup> but was ultimately rejected by the Tribunal.<sup>232</sup>

Remarking that the use of traditional transaction methods<sup>233</sup> can be fruitful as long as unrelated transactions do occur as a representative phenomenon in an industry,<sup>234</sup> Fris insists that in the absence of transactional comparables, the most important comparability factor lies in the *circumstances* under which parties operate, that is, "their commercial and financial relations" as a whole, rather than per transaction.<sup>235</sup> He thus aims to bring together functions, assets and risks in a coherent model, mainly with the help of the cooperative game theory,<sup>236</sup> ultimately laying the foundation for a renewed use of the profit split methods<sup>237</sup> which he clearly prefers to the transactional net margin method (TNMM) or comparable profits method (CPM).<sup>238</sup>

Fris explains that MNEs exist as a result of a fundamentally different reaction to market challenges than stand-alone enterprises: they replace negotiated prices with hierarchical structures, presumably where transactional costs in the market are found to be higher than internal costs.<sup>239</sup> Observing that since the '90s, business parties often “form part of integrated processes and of value-creating chains” both within an industry and within an MNE,<sup>240</sup> Fris argues that unrelated parties’ alliances and networks offer a new field of references for comparisons, characterized by sustained relationships and extensive sharing of information.<sup>241</sup>

Wündisch cites several examples of strategic alliances in the pharmaceutical industry that fall short of a merger, including co-marketing (non-exclusive licenses allowing the licensee to market the product under a different brand name),<sup>242</sup> co-promotion (where both the licensor and licensee promote the product under the same brand name), and joint ventures.<sup>243</sup> He adds that these arrangements may be adopted to enter important markets such as North America or Japan and that certain types of alliances may be seen more frequently in specific countries (for example, joint ventures are often used for penetration in the Japanese and Chinese markets).<sup>244</sup> Although exceptional in his view as of 2003, “keen competition” forming the industry’s “basic picture” (as evidenced by high marketing expenditures), Wündisch observes that these arrangements are becoming more common especially for the development and launch of new products.<sup>245</sup> Against that backdrop, Fris and Gonnet’s suggested expansion of otherwise shrinking comparable pools, potentially including pharmaceutical co-marketing or co-promotion agreements as comparable transactions and also involving new tools to identify comparability criteria,<sup>246</sup> may offer an interesting avenue even though it would undoubtedly raise questions as to the necessary adjustments required.

In a follow-up article published jointly with Sébastien Gonnet in June 2006, Fris expands on the above theory by proposing ReAL (Relational Arm’s Length) TP, a four phase analytical approach

“in line with the OECD Guidelines” which leaves “more room for economic analysis”.<sup>247</sup> This analysis is based notably on the determination of an industry’s value drivers or critical success factors and a detailed value chain analysis of the tested MNE, which would replace the traditional functional analysis.<sup>248</sup>

Markus Brem and Thomas Tucha share common ground with Fris and Gonnet in some respect and differ in others. Brem and Tucha refer to actual TP analyses based on external comparisons as an “old model of transfer pricing”, fit at best for the business world as it was up until the early ‘90s.<sup>249</sup> They observe that MNEs have changed their way of doing business, from parent-run to more global organizations, and argue that TP analyses “will have to resort to internal information if the ALP is intended to remain viable”.<sup>250</sup> By “internal information”, they refer firstly to the governance patterns of related-party transactions, noting that such transactions are governed by information and incentive structures that generally differ from the ones governing independent transactions.<sup>251</sup> Secondly, they refer to the type of information that can only be obtained through multilateral and multifunctional value chain analyses.<sup>252</sup> On that subject, Brem and Tucha demonstrate that MNEs are organized around business lines and value chains that are irrespective of national borders and “legal corporate labels”.<sup>253</sup> As the legal structure reveals itself to be of minor importance to business line coordination and value generation, important value drivers such as intellectual capital should not be solely allocated to a particular entity within the group.<sup>254</sup> Their proposition therefore allows for an accounting of shared functions and assets, much like the partial economic ownership approach to the MI concept.

To replace “a narrow ALP concept”, Brem and Tucha advocate that fundamental insights from economic theories of organization and governance contribute to the “next generation of transfer pricing”.<sup>255</sup> More specifically, they suggest incorporating insights from transaction-cost economics (TCE) in TP analyses,<sup>256</sup> to help identify entrepreneurial activity within the MNE with

respect to *coordination efforts* and *governance structure*,<sup>257</sup> which they consider as “key features of value processes”.<sup>258</sup> TCE would also help determine the “relative functional value generated by the transaction” through an identification of the attributes that explain an MNE’s choice to transact at a specific point in the continuum of contractual distance,<sup>259</sup> notably by comparing the transaction cost<sup>260</sup> efficiency involved in each form of governance structure.<sup>261</sup>

The current Guidelines already acknowledge that the relative value of activities or assets can properly inform TP analyses.<sup>262</sup> Value chain economic analyses may thus offer a new and interesting avenue worth exploring and would definitely imply a shift in TP towards greater reliance on economic theory.

#### **4.1 VALUE DRIVERS OF THE PHARMACEUTICAL INDUSTRY**

The economic analyses suggested by Fris and Gonnet that were reviewed above include an examination of the industry’s value drivers or critical success factors and a detailed value chain analysis of the tested MNE. There is no indication that such analyses would elicit less debate between tax authorities and taxpayers: for instance, debates could bear on any number of differentiating (comparability) factors such as product characteristics, geographical location, etc.<sup>263</sup> In their discussion bearing on the analyses of an industry’s value drivers, Fris and Gonnet cite marketing as an example of an increasingly important success factor in the pharmaceutical industry. Compared to the ‘80s, where R & D “in conjunction with manufacturing and traditional promotion were the major success drivers of big pharmaceutical companies”,<sup>264</sup> they attribute the increase in marketing efforts by pharmaceutical MNEs and the corresponding shift in the industry’s value drivers to the emergence of a few major players and the high degree of competition in the sector.<sup>265</sup>

Their comments on the pharmaceutical industry's value drivers find an echo in several studies that can be interpreted as generally supporting at least some aspects of the MI concept. For instance, a recent OECD study on the pharmaceutical industry links the large amount of resources directed at promotion with the importance of these activities on sales.<sup>266</sup> Most studies show that the industry routinely spends more on marketing than on R & D,<sup>267</sup> even though the former only implies expenses on patented or approved drugs, while the latter includes unsuccessful R & D expenses as well as varying levels of government subsidies.<sup>268</sup> According to Wündisch, “[t]he experience of the industry has been that R & D costs represent, very roughly, between 10 percent and 25 percent of the annual gross turnover of the top 10 research-oriented pharmaceutical multinational groups”,<sup>269</sup> while marketing spending represents “approximately 26 percent of [pharmaceutical enterprises’] annual turnover”, with a broad range going from 15 percent to 35 percent.<sup>270</sup> For Ernst R. Berndt, Linda Bui, David R. Reiley and Glen L. Urban, the fact that marketing to sales ratios are quite high in this industry comes as no surprise: since marginal production costs are small, “enhancing revenues is essentially the same as increasing profits”.<sup>271</sup> Authors from the economic and management fields generally agree that marketing is paramount in this highly competitive industry and that it represents another important barrier to entry besides R & D or patents. They even note that there can be no blockbuster drug without adequate marketing support. A pharmaceutical marketing executive “summed up the challenge of would-be players in the high-potential pharmaceuticals’ game” with these words: “Blockbusters are not discovered, they are built!”<sup>272</sup> In the opinion of two authors from the management field, R & D groups alone no longer drive the value of new pharmaceutical products, and marketing and sales organizations can add or subtract billions of dollars in the lifetime value of high-potential drugs.<sup>273</sup>

Authors who explicitly tackle the subject of patents versus marketing's relative importance in creating value for the pharmaceutical industry usually favor the former.<sup>274</sup> For Wündisch, it is recognized that marketing activities, broadly defined so as to include market research (investigation of the need and demand for a product), “is the next most important functional activity within the business after R & D”.<sup>275</sup> Similarly, the managerial case study performed by Holland and Bátiz-Lazo concludes that “[u]ltimately, meaningful innovation is what matters most” to success and growth in the industry.<sup>276</sup> Without questioning these broad statements, we disagree with the argument that dramatic drops in sales following patent expiry suggest that the large profits of a patented drug must be solely attributed to patents.<sup>277</sup> Patents and marketing are clearly interdependent in creating value in the pharmaceutical industry. We argue that the following statement holds true for pharmaceutical patents: “a particular asset may have considerably less value when considered apart from the group of assets of a going concern”.<sup>278</sup> As Holland and Bátiz-Lazo noted, the key rationale for mergers and acquisitions in the late '90s and early 2000s was combining strong pipeline with strong marketing, the acquirer being the party holding either one.<sup>279</sup> Moreover, the speed at which volume of sales is on the rise after a patent is granted is critically dependent on marketing: according to Wündisch, experience has shown that without a vigorous marketing campaign, the introduction and acceptance of new products can be “extremely slow”.<sup>280</sup> Similarly, John E. Calfee remarks that “[s]uccessful advertising and promotion increase the returns from past pharmaceutical R&D beyond what they would otherwise have been”,<sup>281</sup> and Sir Paul Girolami, former Glaxo UK CEO, is quoted as stating that pharmaceutical drugs, however good they are, won't sell unless “you ... sell it hard”.<sup>282</sup>

## 4.2 VALUE CHAIN ANALYSIS OF THE TESTED MNE

Fris and Gonnet see their proposed value chain analyses as particularly relevant and useful for pricing the types of situations that are at the root of the MI concept.<sup>283</sup> They suggest that the creation of value within a group often follows strategic and financial responsibility for marketing decisions,<sup>284</sup> thereby covering all angles discussed above on the transactional notion of risks.<sup>285</sup>

Although such determinations must be case-specific, several comments support the MI concept's fundamental assumption that local pharmaceutical distributors may in some circumstances bear a sizeable responsibility with regards to marketing strategy or costs. Wündisch mentions that while legal ownership of trademarks and other MIs generally resides with the "multinational group centre", more than one company usually contributes to their creation.<sup>286</sup> Furthermore, although he attributes the financial responsibility related to the development of marketing strategy and planning to the group centre, Wündisch adds that these costs are "well outweighed" by the marketing costs supported by local group companies.<sup>287</sup> Likewise, from several brand managers' points of view, the most critical element of a new product's launch uptake is sales force support (whose responsibility normally rests in the hands of local entities): the lack thereof is even viewed as the "Achilles heel of failed launches".<sup>288</sup>

The *Glaxo Canada* case also gave us some insights on the subject. During the course of the litigation process, Glaxo UK CEO Sir Paul Girolami made the following statements, suggesting that Glaxo distributors bore an important share of strategic responsibilities: "The fact of the matter is that the centre – the centre of profit – the centre of market penetration – lies in the local market. It does not lie at Headquarters."<sup>289</sup> More specifically, Sir Girolami stated that he considered Glaxo Canada a "powerful independent company", under group control but with little need for management assistance by the head office, and expected all local companies "to have an acute awareness of the local marketplace".<sup>290</sup>

## **5 TRANSFER PRICING METHODS: THE REMUNERATION OF MARKETING INTANGIBLES**

Under the *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines*,<sup>291</sup> the OECD's Committee on Fiscal Affairs proposes the adoption of the "most appropriate" standard of method selection to replace the existing hierarchy that favors the traditional transaction methods over the transactional profit methods.<sup>292</sup> This recent development reflects the steady pace at which the Guidelines have evolved since their first adoption in 1979, when they only recommended the three methods known today as the traditional transaction methods, namely: Comparable Uncontrolled Price (CUP), Cost Plus (C+) and Resale Price (RP).<sup>293</sup> The transactional profit methods (Profit Split (PS) and Transactional Net Margin Method (TNMM)) were then introduced in the Guidelines in 1995.<sup>294</sup> This section of the paper examines to what extent each of these methods may assist in the determination of an AL remuneration for a local pharmaceutical distributor fitting our case scenario's description.

### **5.1 TRADITIONAL TRANSACTION METHODS**

Russo and Boykin's comment that "particular relevance should be given to the availability of data" when selecting the appropriate TP method<sup>295</sup> holds particularly true for traditional transaction methods. Despite the fact that "[a]ny investigation of the practical application of ... traditional methods to intangible property transactions reveals that a lack of comparable transactions is the rule, rather than the exception",<sup>296</sup> Wright has noted that the "Tax Court strongly prefers transaction-based methods, even if such methods are not perfect".<sup>297</sup> Similarly, representatives of the pharmaceutical industry generally advocate using the RP method when pricing the sale of an API to a related distributor.<sup>298</sup>

### 5.1.1 COMPARABLE UNCONTROLLED PRICE (CUP)

The Guidelines mention that the CUP method can be difficult to apply to controlled transactions involving IP because of the latter's often unique character,<sup>299</sup> but do not rule out its potential use in situations involving the sale of goods that incorporate marketing or trade intangibles.<sup>300</sup> Under the CUP method, the focus in our case scenario is often placed on the API price, thus effectively side-stepping in such cases the issue of marketing intangibles or activities.

Where the subject transaction merely involves the supply of tangible property, namely an API, transactions involving generic versions of the same API in the same jurisdiction could be seen as offering an appropriate pool of comparables. For some authors, generic API prices can in some circumstances be comparable to branded API prices, but only after a number of important and potentially difficult adjustments.<sup>301</sup> Accordingly, when the Tax Court of Canada accepted the CRA's CUP on generics analysis after performing only a minor adjustment in the *Glaxo Canada* case, it attracted severe criticism from a sizeable number of authors,<sup>302</sup> notably with regards to the fact that its decision had the surprising result of attributing most of the intangible or economic return to the local distributor.<sup>303</sup> In our view, two missing pieces of evidence explain the judge's adoption of the CRA's approach and rejection of Glaxo's analysis founded on the CUP and RP methods using internal comparables. Firstly and most importantly, the absence of reliable evidence concerning the actual API prices paid by the third party distributors offered as comparables by Glaxo,<sup>304</sup> and secondly, the absence of evidence with respect to an AL royalty rate for the intangibles that were otherwise transferred to Glaxo Canada. Indeed, Glaxo argued that as long as the combined return provided by the API price and the royalty could be considered arm's length, the Glaxo group did not mind whether that remuneration came from one or the other.<sup>305</sup> Even though the concept of embedded intangibles is recognized both by the OECD and the CRA,<sup>306</sup> transfer pricing does not operate in isolation but within the wider context of tax law

and the judge, who could not have been left with the task of deciding what constituted an AL royalty rate without the benefit of expertise evidence on the subject, was therefore concerned with the differing tax treatments of royalties versus purchase price with regards to withholding tax.<sup>307</sup>

### **5.1.2 COST PLUS (C+)**

Where an atypical intangible approach to the MI concept is adopted, the C+ method would not be an appropriate base for calculating the return on intangibles since, with respect to both R & D and marketing activities, expenses bear no direct relation to the production of an intangible.<sup>308</sup>

However, certain authors support its use as a *supplemental* method when looking at our case scenario from an incremental marketing activities approach. Notably, Vincent proposed its use on additional or excess marketing expenses, viewed as a service rendered to the trademark owner.<sup>309</sup>

Similarly, current paragraph 2.24 of the Guidelines provides for the C+ method supplementing the RP method where “the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product”,<sup>310</sup> and the ATO contemplates the possibility of direct compensation for excess expenditures incurred by a marketer/distributor.<sup>311</sup>

Obviously, this alternate perspective does not alleviate the C+ method’s difficulties of application in our case scenario. As Wündisch notably remarks, cost-based approaches can be difficult to apply from an accounting point of view since both R & D and marketing costs cannot be calculated and attributed to any one pharmaceutical product with precision.<sup>312</sup> Many commentators, even if they admit that related distributors often spend more on marketing than AL distributors, also view the determination of routine versus extraordinary marketing expenditures as problematic.<sup>313</sup> Vincent raises valid points on that subject, including differences in accounting

practices and business strategy,<sup>314</sup> to which others add availability of data<sup>315</sup> and variations in marketing expenses from MNE to MNE and from country to country.<sup>316</sup>

In our case scenario, going beyond marketing cost differential between the tested party and comparable distributors implies an identification of “the extent to which the tested party is advertising or promoting more intensively than others in the market”. While an IRS representative recognizes that this is “a tough point”, he also points out that such an analysis is “generally going to be a material factor”.<sup>317</sup> In the context of the pharmaceutical industry where a great amount of marketing expenditures is spent globally by MNEs, one possible tool for such determination could involve a comparative inquiry into the level of *assistance* provided by the parent company or MI owner to related versus AL distributors, for example in the form of free goods or free samples.<sup>318</sup>

### **5.1.3 RESALE PRICE (RP)**

Aside from all considerations pertaining to MIs including any approach to our case scenario, RP stands out as a proper TP method to price the transfer of APIs for a number of reasons: it is less sensitive to product differences<sup>319</sup> and “probably most useful where it is applied to marketing operations”.<sup>320</sup> While it is most reliable in cases where the reseller does not add substantially to the *value* of a product,<sup>321</sup> there is widespread agreement that the secondary manufacturing activities typically performed by pharmaceutical distributors does not add substantial value to the API, as it does not alter the product’s chemical structure.<sup>322</sup> Moreover, the RP method is apparently widely used in the pharmaceutical industry in order to establish the sale prices of APIs, either internally or to third parties.<sup>323</sup> Recent evidence to that effect was rendered public through the *Glaxo Canada* case.<sup>324</sup> As understandably argued by many,<sup>325</sup> should it for that reason be favored as the proper TP method in our case scenario?

Wündisch, a proponent of that position, argues that “the resale minus method is ... the method of choice in cases of the valuation of transfers of goods with or without related *services* between group companies”,<sup>326</sup> although he considers that this method is generally not appropriate in cases involving the license of intangible *property*.<sup>327</sup> Whether we approach the issue posed by our case scenario from an asset-based or activity-based perspective can therefore make a difference in the appropriateness of the method.

Comparability within the RP method is affected however by differences in functions.<sup>328</sup> Accordingly, valid arguments support the view that without adjustments, its application is not likely to achieve an AL result in our case scenario. In other words, where third-party transactions used as comparables are inherently flawed due to differences in the intensity level of marketing activities, applying the RP method will under-remunerate the related distributor performing additional marketing activities.

#### *5.1.3.1 Does an Ex-Ante RP Structure Provide an Indirect Reimbursement of Marketing Expenses?*

A number of authors argue that, since pricing structures based on RP gross margins are designed to ensure that the costs of the buyer are recovered and to provide an appropriate profit margin,<sup>329</sup> they are equivalent to an indirect reimbursement of expenses incurred at the net margin level.<sup>330</sup> In the view of Mentz and Carlisle, a related distributor that is “permitted to earn a very substantial gross profit margin ... should be regarded as having been indirectly reimbursed” even for extraordinary marketing expenses.<sup>331</sup>

In our view, this argument somewhat stretches the actual effects of a pricing structure based on the RP method. As ex-ante pricing based on gross margins is necessarily based on forecasts, the argument takes for granted the commercial success of the product in the local market. Although it

may hold merit in certain circumstances, this argument would have limited application in our case scenario. Using projections to price an API at the gross margin level still leaves a degree of risk to the marketer since, in the highly risky pharmaceutical industry, there exists multiple reasons for actual sales to deviate from forecasts,<sup>332</sup> while marketing expenditures are quite important early on during the first years of market penetration strategies. As expected sales may not materialize and accordingly, critical mass may not be attained, such an ex-ante pricing structure cannot guarantee a low and stable level of remuneration.

Where it is additionally argued that transfer prices set using the RP method are subject to periodic adjustments,<sup>333</sup> one would have to consider the frequency, the underlying rationale and the ex-ante or ex-post nature of such price adjustments before concluding that the structure provides an indirect reimbursement of marketing expenses and therefore low-risk arrangement for the marketer. In our view, only a net margin pricing structure, ex post by nature,<sup>334</sup> could clearly be relied upon as equivalent to an indirect reimbursement of expenses. It is interesting to note in this regard that Barbera, whose approach to the notion of risk rests primarily on the way pricing is structured, argues that if the price of a product sold by a manufacturer is set using an *operating* margin, “then the manufacturer effectively bears all market risk”.<sup>335</sup>

## **5.2 TRANSACTIONAL PROFIT METHODS**

Profit-based TP methods were introduced in 1988 as the US Treasury’s first interpretation of the “commensurate-with-income” standard.<sup>336</sup> They were officially introduced in the IRC regulations in 1994.<sup>337</sup> Added in the TP Guidelines in 1995 as recommended methods,<sup>338</sup> the profit split (PS) and the transactional net margin method (TNMM) are both ex-post pricing methods,<sup>339</sup> implicitly calling for year-end adjustment mechanisms.<sup>340</sup>

Several observers in the TP community have noted their wide-spread use in an increasing number of countries by MNEs<sup>341</sup> and by revenue authorities, with the United States and Australia as initial promoters of the methods.<sup>342</sup> The OECD WP6, who revised these methods in order to introduce more technical guidance in the Guidelines, attributes the general trend to use them in part to the fact that there is generally more public data available at the profit-margin level.<sup>343</sup>

The Proposed Revision,<sup>344</sup> rendered public on September 9, 2009, goes beyond a simple elimination of the existing hierarchy of methods to recognize that profit-based TP methods may be more appropriate than traditional ones in certain circumstances.<sup>345</sup> This may well be true in our case scenario: transactional profit methods can be particularly useful where a party offers “unique contributions”, or “non-benchmarkable functions, assets or risks for which no sufficiently reliable comparable data are available”.<sup>346</sup>

### **5.2.1 PROFIT SPLIT**

The PS method is defined by Allen, Tomar, and Wright as a “method [which] allows evaluation of the combined operating profit or loss in one or more controlled transactions by reference to the relative value of each controlled taxpayer’s contribution to the combined profit or loss”.<sup>347</sup> Under this method, profits are split “on an economically valid basis”.<sup>348</sup> The choice to split gross or net profits will depend on the comparability analysis:<sup>349</sup> splitting gross profits may pose consistency issues due to differences in expenses allocation, while operating or net profits are generally defined in a more consistent manner.<sup>350</sup>

The PS method is presented by the OECD as appropriate for “highly integrated operations”,<sup>351</sup> notably where both parties to the transactions own intangible assets<sup>352</sup> but also in cases where the parties engage in “highly integrated *activities*”.<sup>353</sup> For instance, OECD WP6 notes that a party who does not use significant intangibles may nevertheless be entitled to profits that fall outside a

typical range of net margins because of unique contributions other than intangible assets, leading to the application of a PS method.<sup>354</sup> Example 12 of the 2006 IRC regulations section 1.482-8 also suggests that residual PS<sup>355</sup> may be the best method to determine a distributor's AL remuneration in situations where both the manufacturer and the distributor make "valuable, non-routine contributions to the marketing and promotional activities" in the local jurisdiction.<sup>356</sup> OECD WP6 sees the method as potentially most reliable where both parties to a transaction co-develop and co-exploit the same intangible<sup>357</sup> and where each party owns or *uses* different intangibles of significant value.<sup>358</sup>

For our purposes, there are two basic ways of splitting combined profits, regardless of the specific PS method utilized (residual,<sup>359</sup> contribution,<sup>360</sup> any other type of PS method or any combination thereof<sup>361</sup>): by reference to comparable AL transactions or mainly to "internal data".<sup>362</sup>

#### 5.2.1.1 *Expansion of the Comparables Pool*

We observe that the Proposed Revision of the Guidelines incorporates several suggestions made by value chain analyses proponents, notably with respects to the expansion of comparables pools. The entirely new proposed paragraph 2.94 of the Guidelines explicitly prescribes that joint venture arrangements and "pharmaceutical collaboration, co-marketing or co-promotion agreements" constitute "possible sources of comparable uncontrolled transactions that might usefully assist in the determination of criteria to split the profits".<sup>363</sup> This development may eventually raise another question: would the use of alternatively structured transactions to determine the profit split level between related parties constitute *recharacterization* of the tested transaction? If proposed paragraph 2.94 is adopted, this question will be particularly relevant in

the Canadian context, where the recharacterization provision in income tax legislation<sup>364</sup> requires the fulfillment of an additional legal test normally used in anti-avoidance provisions.<sup>365</sup>

The better view in our case scenario is that the use of such comparables to analyze the relative value of each participant's contribution with the help of the profit split method should not be perceived as recharacterization, as in this context the exercise proceeds from a search for *data* obtained from what are considered, albeit indirectly, as comparable transactions, rather than from an inquiry into what type of *transaction* would independent parties have entered into. The fact that the OECD's proposed paragraph 2.94 is contained within the discussion on the PS method, entirely apart from the limited discussion on the subject of recharacterization found in the Guidelines,<sup>366</sup> tends to support this view. Moreover, current paragraph 1.41 (renumbered 1.68 in the Proposed Revision) illustrates the difference between restructuring a controlled transaction and using alternatively structured transactions as comparables, as would be the case here.

#### 5.2.1.2 Allocation Keys

Where the TP analyst cannot derive a split of combined profits from comparable data, the need arises for an "economically valid basis" to approximate the division of profits that would be found in AL agreements.<sup>367</sup> The fundamental assumption is that independent parties would have split the combined profit *in proportion to the value of their respective contributions* to the generation of profit in the transaction.<sup>368</sup> The allocation key should therefore reflect the main value drivers of the transaction in the creation of combined profit.<sup>369</sup> Authors from the economic field agree that good economic reasoning is needed to derive an appropriate allocation key for a particular transaction.<sup>370</sup>

### *Cost-Based Allocation Keys*

Cautioning against the risk to become formulaic, OECD WP6 sees as undesirable the establishment of a prescriptive list of allocation keys.<sup>371</sup> It is suggested that costs could provide an appropriate basis where there is a strong correlation between expenses incurred and value added, for example where marketing expenses generate material MIS.<sup>372</sup> OECD WP6 notes that allocations made without external market data are often designed to reflect each party's investment in the development of intangible property.

We agree with several authors however that allocation keys based on the costs of development of MIS can be arbitrary. As panelists Tracy Gomes and Shiraj Keshnavi pointed out during a TP session of the American Bar Association, marketing costs do not always equal value<sup>373</sup> and “[t]he presence of high expenditures does not necessarily mean that we’re efficient”.<sup>374</sup> The same reasoning can be applied to R & D expenses: with respect to the costs of development of ranitidine hydrochloride by the Glaxo Group, two authors remark that “[w]hat is truly relevant is not the exact amount of [R & D] expenses”, but rather the fact that these expenses are not always linked with the tremendous value of the research output.<sup>375</sup> As Wündisch remarks, even market prices of pharmaceutical products in finished form are largely unrelated to costs, being mainly based on prices of competing products and on an assessment of customers' perceptions of the drug's therapeutic value when compared with alternative treatments.<sup>376</sup>

### *Value-Chain Informed Allocation Keys*

Brem and Tucha deplore the lack of a model to derive allocation keys which, they argue, should depend on the valuation of the functions performed.<sup>377</sup> Value chain analyses aim to provide such an economically rational model,<sup>378</sup> hopefully bringing the PS analysis beyond what was characterized by OECD WP6 as a “subjective analysis, using text or charts to show relative

contributions made by the parties”.<sup>379</sup> While the Proposed Revision incorporates in our view several insights from Fris’ written contributions, there is ample room for the OECD to develop additional guidance in this respect.<sup>380</sup> Without further guidance, PS analyses that do not refer to comparable transactions can be endlessly arguable, partially explaining the position of industry specialists like Wündisch and Alfons R. Schmid, who are against its use.<sup>381</sup> A high-profile example of the PS methods’ difficulties of application due to lack of sufficient guidance is found in the *Glaxo US* case, where negotiations undertaken between the competent authorities of the United States and the United Kingdom failed after four years of negotiations.<sup>382</sup> Nevertheless, proponents of value chain analyses are not alone in holding the PS method as the TP method of the future, especially for transactions involving marketing and other high-value intangibles.<sup>383</sup>

However, the PS method is not, and is not represented to be, an easy solution to the TP problems encountered in relation to the MI concept. As Fris and Gonnet recognize when discussing the settlement of the *Glaxo US* case, “differences in interpretation and perceptions of what creates value within a group [“and more generally in the industry”] may be at the origin of severe conflicts between the taxpayer and the tax administration”.<sup>384</sup> Their proposition therefore entails an increased reliance on additional and “more sophisticated economic valuations and related analysis”.<sup>385</sup> To use the words of Llinares: “[t]he greater the economic robustness of the principle for the allocation, the greater the explanatory power of the method”.<sup>386</sup>

Game theory,<sup>387</sup> on which Fris’ initial proposition for value chain analyses is based,

teaches us that for an analysis of the behaviour of parties in a relationship, we have to identify the total performance of the parties together (the size of the pie), as well as the added value of each of the parties individually, because that decides ultimately which part of the pie each will get.<sup>388</sup>

Similarly, Brem and Tucha note that in the future, “the ‘sales’ factor” may be considered an increasingly important allocation key because without sales there can be “no revenues and consequently no chance for profits which can be allocated”.<sup>389</sup> In our case scenario, value-chain

analyses and allocation keys based on sales could indeed provide useful, commercially rational tools to determine an AL remuneration for all the parties involved. As Gomes commented during the American Bar Association's TP session, when analyzing cases including our case scenario, there is probably a need to "expand the objective evidence" and "get more into the brand or marketing manager's parlance", thus examining "what marketers look at to measure the effects of their campaigns".<sup>390</sup>

### **5.2.2 TNMM/CPM**

The TNMM, measuring the net profit margin relative to costs, sales or assets,<sup>391</sup> results from a compromise between OECD countries following the adoption of the CPM in the United States.<sup>392</sup> Its main difference with CPM rests on the emphasis put on transactional rather than company-wide data.<sup>393</sup> The application of both methods relies heavily on external comparables.<sup>394</sup>

As opposed to the PS method where both parties' profits are examined, the TNMM is applied to only one party of the controlled transaction, usually the one performing the simplest functions, bearing the lower level of risk and not owning valuable intangibles.<sup>395</sup> This description of the tested party highlights a potential difficulty of application of the TNMM in our case scenario, where it is found that the local distributor bears a sizeable level of risk with respect to marketing investment or strategy while another party to the transaction owns a valuable patent.

The business community in general is an ardent defender of the TNMM which it considers most appropriate and practicable in most circumstances.<sup>396</sup> Applied with the use of company-wide data (rather than purely transactional data, as normally required by the Guidelines), a TP analysis performed with this method is often relatively low-cost from a tax compliance perspective,<sup>397</sup> due to accessibility of data and simplicity of application (similar in this regard to traditional methods). The TNMM/CPM have nonetheless been the object of much criticism, notably as

stepping away from the ALP due to “the vagueness of defined notions of comparability”.<sup>398</sup> The Australian Administrative Appeals Tribunal also criticized the application of TNMM when based on functional comparables<sup>399</sup> and expressed concerns over the fact that the method “inevitably attributes any loss to the pricing”.<sup>400</sup> Finally, an author questions whether the TNMM can be “consistent with the economic profiles of MNEs” in light of the fact that, without adjusting for economies (or diseconomies) of integration, it can result in under (or over) remunerating the tested party, unlike PS methods.<sup>401</sup>

#### 5.2.2.1 Profit Level Indicator

There are several possible measures of net profit that can be used when applying the TNMM, including “return on assets” and “operating income to sales”.<sup>402</sup> Brian Becker notes that “[t]he choice of a profit level indicator can have a significant impact on the resulting transfer prices”.<sup>403</sup> Remarking that an increase in volume of sales will necessarily increase the routine profit *levels* of an entity but not its profit *margins* (unless, of course, per item costs are diminished as a result of the increased volume, which is normally the case but to a limited extent), he demonstrates that the choice of operating margin (OM) as profit level indicator (PLI) tends to leave the licensee of a (predominantly) volume-increasing intangible with most of that intangible’s profit.<sup>404</sup> On the other hand, Becker demonstrates that the choice of return on equity as PLI tends to allocate the same intangible’s profits to the licensor, assuming that the intangible’s ownership rests entirely with the licensor.<sup>405</sup>

OECD WP6 indicated that the choice of a PLI should be based notably on the value drivers of a transaction and, of course, on the availability of information.<sup>406</sup> In OECD WP6’s view, selling activities should be remunerated based on a sales-related indicator although sometimes a combination of cost-based and sales-based indicators might be acceptable, “for instance where

the sales operation incurs significant promotional expenditures as a service performed for the principal in addition to its selling activities”.<sup>407</sup> They refer in this regard to paragraph 2.24 of the Guidelines in relation to the RP method.<sup>408</sup>

#### *5.2.2.2 TNMM versus RP in our Case Scenario*

Appendix B of this paper compares the application of the RP method and the TNMM in the situation where a related pharmaceutical distributor paid a higher price for the API than the price paid by a hypothetical AL distributor, and also incurred incremental marketing expenses which were assumed by the manufacturer in the AL transaction. The results quite expectedly demonstrate that the RP method applied without adjustments in this case scenario will correct the API price but will not adequately remunerate the incremental marketing activities. Similarly, OECD WP6 finds that a net profit margin analysis can be more reliable than a gross margin analysis where “there are material differences in [the intensity of] functions between the tested and the uncontrolled transaction which are reflected only in operating expenses below the gross margin level.”<sup>409</sup> Certain differences in accounting classification that would affect a gross margin analysis also disappear at the net margin level, such as reclassifications from cost of goods sold to operating expenses.<sup>410</sup>

Could the TNMM provide an AL remuneration in our case scenario? Clearly, applying the TNMM based on an operating margin would bring the related distributor closer to an AL remuneration than the RP method applied on its own. Still, OECD WP6 demonstrates that, although a gross margin analysis presents a greater risk of error than a net margin analysis, the application of the TNMM based on an OM (a sales-based PLI) also presents a certain risk of error in cases involving differences in the intensity of the marketing function performed by the tested and comparable parties.<sup>411</sup> Using a combination of sales and cost-based PLIs therefore appears more precise. The

TNMM using the Berry ratio<sup>412</sup> as PLI could arguably be applied in this regard since it measures data from both the gross and net margin levels. Russo and Boykin incidentally report that, for the business community, “there could be more circumstances where the Berry ratio can be used to compensate customer-facing activities where also sales do take place”.<sup>413</sup>

However, the most significant obstacle to the application of the TNMM in our case scenario is due to the shortage of third-party information on operating expenses. As mentioned earlier, API prices are generally set using the RP method<sup>414</sup> and the net margins of third party distributors are generally unknown. Likewise, as Wündisch remarked, most independent licensees would be unwilling to disclose the level of profit they are making with licensed-in products.<sup>415</sup>

## **6 CONCLUSION**

In our view, the debate surrounding the MI concept is largely factual and needs to be dealt with on a case-by-case basis. The crucial starting point in our case scenario is that comparable AL transactions cannot necessarily be found in the marketplace. To what extent does the existing TP framework need new concepts to deal with this situation?

Having reviewed an important portion of the existing literature on the subject, we conclude that the partial economic ownership and atypical intangible approaches have proven themselves to be of little use in quantifying local distributors’ contributions to the realization of profits in the pharmaceutical industry. Considering the Guidelines’ explicit recognition that some of the most difficult aspects of TP rest with transactions involving intangibles,<sup>416</sup> this does not come as a surprise. Accordingly, we argue that the asset-based approaches to the MI concept fail to provide an AL remuneration in our case scenario.

That said, in cases where the excess marketing expenditures are clearly documented in the intra-MNE arrangements, or where third-party data allows for an identification and quantification of

such expenses (if not directly, at least through an inquiry into the comparative level of assistance provided by the manufacturer or MI owner to the related and AL distributors), provided also that the differential in operating expenses is found *not* to amount to a higher level of *risk* for the related distributor, the application of the RP method supplemented with a C+ on additional marketing expenses can provide an AL remuneration for the local distributor.

If sufficient information on the marketing expenses differential between related and AL distributors is not available, the expanded comparables pools suggested by Fris and incorporated in the Proposed Revision opens up interesting new avenues to solve our case scenario with the help of comparable-type PS methods.

Finally, in cases where there are no indirectly comparable transactions in the available data pool to apply comparable-type PS methods, or where the differences in the intensity of the marketing function entails an additional risk on the part of the related distributor, for instance through greater strategic input,<sup>417</sup> a PS analysis based on value chain economic insights would provide the best estimation of an AL remuneration.

Clearer and more solid foundations for evaluating the added value of a local pharmaceutical distributor's contribution are needed. As long as the conceptual grounds for a successful application of PS methods are not sufficiently developed, negotiation and litigation processes will suffer. We believe that PS methods based on value chain analyses have the potential to gather some degree of consensus since they are “not a standardized exercise based on arbitrary allocation keys”,<sup>418</sup> but a case-specific approach, designed to offer rational support for a successful application of the ALP. It may even be the ALP's last hope before formulary apportionment methods,<sup>419</sup> which to date have not been favored by tax authorities and business participants alike,<sup>420</sup> despite their low-compliance cost feature which is otherwise of general concern to the business community.<sup>421</sup>

This approach certainly takes further the meaning of the phrase “conditions ... which *would be made* between independent enterprises”, found in article 9 of the Model Tax Convention on Income and on Capital.<sup>422</sup> In our view, this necessary development is prompted by the consolidation of the industry<sup>423</sup> and firmly rooted in the ALP’s goal to replicate what AL parties would have agreed to in similar circumstances. After all, sociologists have long observed that social developments, including commercial ones, always precede the development of formalized legal frameworks.<sup>424</sup>

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<sup>1</sup> The opinions expressed in this text only reflect the author’s point of view and do not necessarily represent the opinions of the Department of Justice Canada or the Canada Revenue Agency.

<sup>2</sup> Clive Jie-A-Joen and Ramon Brandt, “U.S. Intangibles Regs – a Comparison with OECD Guidelines” (June 1, 2007) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), under the subheading “Concluding Remarks”. See also Steve Allen, Rahul Tomar, and Deloris R. Wright, “Sec. 482 Services Regulations: Implications for Multinationals” (2006), vol. 13, no. 6 *International Transfer Pricing Journal* 279-90, section 7, where the authors assimilate this issue as a “battleground” in the United States.

<sup>3</sup> This paper deals with the ethical (or research-based) pharmaceutical industry, as opposed to generics. For various descriptions of the terms “ethical pharmaceutical industry”, see Maurice H. Collins, *International Transfer Pricing in the Ethical Pharmaceutical Industry*, 2d ed., rev. Karl Wündisch (Amsterdam: IBFD Publications, 2003), at 21-3 and Sara Gustafson and Camilla Hallbäck, “The Global Effect of the Glaxo Case: The Increase of Transfer Pricing Conflicts between the OECD and the US” (MA thesis, Jönköping University, Jönköping International Business School, 2008) (available on the Web at <http://hj.diva-portal.org/smash/record.jsf?pid=diva2:3512>), at 8.

<sup>4</sup> See Wündisch, *supra* note 3, at 136, where Wündisch mentions that the compensation for the use of the MI “is usually subsumed in the transfer price for the goods”. See also *GlaxoSmithKline Inc. v. The Queen*, 2008 TCC 324, paragraph 50 (herein referred to as “the *Glaxo Canada* case”).

<sup>5</sup> Michelle Markham, “Transfer Pricing of Intangible Assets in the us, the oecd and Australia: Are Profit-Split Methodologies the Way Forward?” (2004), vol. 8, no. 3 *University of Western Sydney Law Review* 56 (available on the Web at <http://www.austlii.edu.au/au/journals/UWSLRev/2004/3.html>), under the subheading “Introduction”. The OECD’s TP Guidelines also recognize that, in cases which involve the integrated production of highly specialized goods, unique intangibles or the provision of specialized services, the ALP is “difficult and complicated to apply”: Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2009), paragraph 1.8 (herein respectively referred to as “the OECD” and “the Guidelines”).

<sup>6</sup> See Jean-Pierre Vidal, “La décision GlaxoSmithKline et ses surprises” (2009), vol. 29, no. 2 *Revue de planification fiscale et successorale* 273-328, at 326-7; Hubert Hamaekers, “Arm’s Length – How Long?” (2001), vol. 8, no. 2 *International Transfer Pricing Journal* 30-40, at 36; Lorraine Eden, *Taxing Multinationals: transfer pricing and corporate income taxation in North America* (Toronto: University of Toronto Press, 1998), at 617; Elena R. Tsaneva, “Transfer Pricing in the World of Services and Intangibles – A New Challenge to Preserving the Corporate Tax Base” (2004), vol. 9, *UCLA Journal of International Law and Foreign Affairs* 323-65 (available on the Web at <http://www.lexisnexis.com>), at 366.

<sup>7</sup> Paragraphs 1.12 and 1.45 of the Guidelines. See also Canada Revenue Agency, *Information Circular 87-2R*, “International Transfer Pricing”, September 27, 1999, paragraph 34.

<sup>8</sup> See the text accompanying note 26.

<sup>9</sup> Paragraph 6.3 of the Guidelines.

<sup>10</sup> Paragraph 6.4 of the Guidelines.

<sup>11</sup> Paragraph 6.2 of the Guidelines.

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<sup>12</sup> Paragraph 6.5 of the Guidelines.

<sup>13</sup> Paragraphs 6.6-7 of the Guidelines.

<sup>14</sup> OECD, Centre for Tax Policy and Administration, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines*, September 9, 2009 - January 9, 2010 (available on the Web at <http://www.oecd.org/dataoecd/1/57/43655703.pdf>).

<sup>15</sup> Herein referred to as “IRC reg.”

<sup>16</sup> IRC reg. section 1.482-4(b).

<sup>17</sup> IRC reg. section 1.482-4T(f)(3)(i)(A).

<sup>18</sup> Jean-Pierre Vidal, “Éthique, biens incorporels et prix de transfert” (2004), vol. 25, no. 4 *Revue de planification fiscale et successorale* 583-646, at 623. Our translation: “intangible property is made up of a group of information that affects the profit level of an enterprise by modifying its offer or demand curves, without modifying in the same way the offer or demand curves of enterprises that compete directly or indirectly with it.”

<sup>19</sup> Markus Brem and Thomas Tucha, “On Transfer Pricing: Conceptual Thoughts on the Nature of the Multinational Firm” (Working Paper W.P. No. 2005-11-03, Indian Institute of Management, November 2005) (available on the Web at <http://www.ssrn.com/abstract=874568>), at 5. Pim Fris also argues that human resources and knowledge management are the most important intangible resources of MNEs: Pim Fris, “Dealing with Arm’s Length and Comparability in the Years 2000” (2003), vol. 10, no. 6 *International Transfer Pricing Journal* 194-203, at 197.

<sup>20</sup> Wündisch, *supra* note 3, at 70.

<sup>21</sup> Marc M. Levey, Pamela Church, Monique van Herksen, and Philip Carmichael, “Marketing Intangibles Require Close Legal and Tax Scrutiny.” (2008), vol. 17, no. 3 Special Report *Tax Management Transfer Pricing Report S-3* (available on the Web at <http://www.bna.com>), section V.2.

<sup>22</sup> *Ibid.* In its decision *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue*, T.C. Memo 1998-461; 1998 Tax Ct. Memo LEXIS 461; 76 T.C.M. (CCH) 1122; T.C.M. (RIA) 98461 (December 30, 1998); *aff’d* in part, *rev’d* in part 285 F.3d 1210 (9th Cir. 2002), the United States Tax Court also recognized infrastructure and operating know-how as valuable intangibles.

<sup>23</sup> (Washington, D.C.: Brookings Institution Press, 2001).

<sup>24</sup> Martin Przysuski, Srini Lalapet, and Hendrik Swaneveld, “Transfer Pricing of Intangible Property: A Canadian – U.S. Comparison” (December 17, 2004) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section VIII.

<sup>25</sup> *Ibid.*, section IX.

<sup>26</sup> Monique van Herksen, Marc Levey, and Richard Fletcher, “Identifying, Valuing, and Migrating Intangibles: Trouble Ahead” (January 31, 2008), vol. 16 Special Report *Transfer Pricing Report 3* (available on the Web at <http://www.bna.com>), sections 5 and 11.

<sup>27</sup> *Ibid.*, section 5.

<sup>28</sup> *Ibid.*

<sup>29</sup> The United States have been identified as the originators of the ALP itself (see Hamaekers, *supra* note 6, at 30), and are recognized as the forerunners of many developments in the TP field beyond the concept of MI: see Fris, *supra* note 19, at 194.

<sup>30</sup> These rules were notably applied by the US Court of Appeals in *DHL Corporation and Subsidiaries v. Commissioner of Internal Revenue* (*supra*, note 22), in favor of the taxpayer’s position.

<sup>31</sup> Roger J. Mentz and Linda E. Carlisle, “The Tax Ownership of Intangibles Under the Arm’s-Length Principle” (October 27, 1997), vol. 77 *Tax Notes* 453-62, paragraphs 6-11. These tax planning schemes were notably used by pharmaceutical MNEs: see Hamaekers, *supra* note 6, at 31; Gustafson and Hallbäck, *supra* note 3, at 14, 17 and 31; *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 87 TNT 24-16 (1987); *Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 88 TNT 182-1 (7<sup>th</sup> Cir. 1988), *aff’g* 84 T.C. 996 (1985).

<sup>32</sup> François Vincent, “Marketing Intangibles in Canada: Myth or Reality?” in *Report of Proceedings of Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 28:1-13, at 28:3-4.

<sup>33</sup> Following the 1988 White Paper, and the proposed (1992) and temporary (1993) regulations: Hamaekers, *supra* note 6, at 31.

<sup>34</sup> Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”.

<sup>35</sup> Vincent, *supra* note 32, at 28:4.

<sup>36</sup> Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”.

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<sup>37</sup> Former IRC reg. section 1.482-4(f)(3)(iii), example 3: see Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”.

<sup>38</sup> Former IRC reg. section 1.482-4(f)(3)(iii), example 4: see Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”.

<sup>39</sup> Vincent, *supra* note 32, at 28:6-7; paragraphs 6.36 to 6.39 of the Guidelines.

<sup>40</sup> Paragraph 6.38 of the Guidelines.

<sup>41</sup> Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Ownership of intangible”. One exception is found however in paragraph 2.25 of the Guidelines.

<sup>42</sup> Australian Taxation Office, *International Transfer Pricing: Marketing Intangibles* (NAT 14586), November 2005 (available on the Web at <http://www.ato.gov.au>) (herein referred to as “the ATO’s Guide”).

<sup>43</sup> *Ibid.*, at 6.

<sup>44</sup> *Ibid.*, at footnote 7.

<sup>45</sup> The 2006 temporary IRC regulations are reproduced in “Excerpts on Marketing Intangibles from U.S. Temporary, Proposed § 482 Services and Intangibles Rules [IRS Announcement 2006-50, T.D. 9278, REG-146893-02, REG-115037-00, REG-138603-03, released 7/31/06]” (May 6, 2008), Special Report *Transfer Pricing Report* (available on the Web at <http://www.bna.com>). Sections 1.482-4(f)(3) and (4) were recently adopted without change: see “Final U.S. Regulations on Intercompany Services [T.D. 9456, 74 Fed. Reg. 38830, dated 8/4/09]” (August 6, 2009) *Tax Management Transfer Pricing Report* (available on the Web at <http://www.bna.com>).

<sup>46</sup> Allen, Tomar, and Wright, *supra* note 2, section 5.2.

<sup>47</sup> *Ibid.*

<sup>48</sup> IRC reg. section 1.482-4(f)(3)(i)(A). The 1994 regulations already contained one example to that effect: see Gregory J. Ossi, “The Significance of Intangible Property Rights in Transfer Pricing” (September 13, 1999), vol. 13 *Tax Notes International* 993-1010, at 998; Mentz and Carlisle, *supra* note 31, paragraph 23. In 2005, the ATO similarly suggested that the contractual rights arising from a long-term distribution agreement may constitute an intangible asset owned by the distributor, see ATO, *supra* note 42, at 6, footnote 11.

<sup>49</sup> IRC reg. section 1.482-4(f)(4)(i); Allen, Tomar, and Wright, *supra* note 2, section 5.2; Jie-A-Joen and Brandt, *supra* note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”.

<sup>50</sup> “Excerpts on Marketing Intangibles from U.S. Temporary, Proposed § 482 Services and Intangibles Rules [IRS Announcement 2006-50, T.D. 9278, REG-146893-02, REG-115037-00, REG-138603-03, released 7/31/06]”, *supra* note 45, under the subheading “Explanation of Provisions”. The notion was introduced in several examples of the regulations: see IRC reg. section 1.482-4(f)(4)(ii).

<sup>51</sup> “Excerpts on Marketing Intangibles from U.S. Temporary, Proposed § 482 Services and Intangibles Rules [IRS Announcement 2006-50, T.D. 9278, REG-146893-02, REG-115037-00, REG-138603-03, released 7/31/06]”, *supra* note 45, under the subheading “Explanation of Provisions”.

<sup>52</sup> IRC reg. section 1.482-1(d)(3)(ii)(C), examples 3, 4, and 6.

<sup>53</sup> Allen, Tomar, and Wright, *supra* note 2, section 5.3.

<sup>54</sup> Jamal Hejazi, “Transfer Pricing within the North American Pharmaceutical Industry: Has There Been a Structural Shift in Risk?” (2006), vol. 13, no. 1 *International Transfer Pricing Journal* 8-14, at 13, with respect to the Canada Revenue Agency. See also, with respect to the Canada Revenue Agency: Przysuski, Lalapet, and Swaneveld, *supra* note 24, section VI; generally: van Herksen, Levey, and Fletcher, *supra* note 26, sections 3 and 4 and Giammarco Cottani, “Transfer Pricing and Intangibles: Summary of Discussions at the 61st IFA Congress in Kyoto” (2008), vol. 15, no. 1 *International Transfer Pricing Journal* 58-60, at 59; with respect to the IRS: David P. Lewis and Deloris Wright, “Allocation of Functions and Risks within Multinational Enterprises” (1997), vol. 4, no. 6 *International Transfer Pricing Journal* (available on the Web at [http://www.wrighteconomics.com/index.php?option=com\\_content&view=article&id=4&Itemid=5](http://www.wrighteconomics.com/index.php?option=com_content&view=article&id=4&Itemid=5)), sections III.B and V. These arguments could be partly founded on paragraph 2.25 of the Guidelines.

<sup>55</sup> Vincent, *supra* note 32, at 28:8 and 28:11-13; Allen, Tomar, and Wright, *supra* note 2, section 4.6, with respect mainly to the atypical intangible approach. The ALP is set forth in Article 9 of the OECD Model Tax Convention as follows: where “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”: OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf). One author has suggested that the basis or foundation for the ALP is the “neutrality principle and equal treatment of controlled and uncontrolled enterprises”: Hamaekers, *supra* note 6, at 34, footnote 31.

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<sup>56</sup> Allen, Tomar, and Wright, *supra* note 2, section 5.2.

<sup>57</sup> *Ibid.*, section 5.3.

<sup>58</sup> *Ibid.*, commenting on IRC reg. section 1.482-1T(b)(2), Example 3.

<sup>59</sup> *Ibid.* (emphasis added).

<sup>60</sup> See *infra*, section 5.1.3.1 of this paper.

<sup>61</sup> Vincent, *supra* note 32.

<sup>62</sup> *Ibid.*, at 28:9.

<sup>63</sup> *Ibid.*, at 28:10-11.

<sup>64</sup> *Ibid.*, at 28:9-10.

<sup>65</sup> *Ibid.*, at 28:12.

<sup>66</sup> *Ibid.*, at 28:9.

<sup>67</sup> *Ibid.*, at 28:11-13.

<sup>68</sup> *Ibid.*, at 28:11.

<sup>69</sup> *Ibid.*, at 28:13.

<sup>70</sup> *Ibid.*, at 28:10.

<sup>71</sup> Nigel Dolman, “Life cycle of intangible property and the implications for arm’s length pricing” (June 1, 2007) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), under the subheading “Legal rights and economic ownership”.

<sup>72</sup> Mentz and Carlisle, *supra* note 31, paragraph 40; Vincent, *supra* note 32, at 28:12; Ossi, *supra* note 48, at 1006-7.

<sup>73</sup> Ossi, *supra* note 48, at 1007.

<sup>74</sup> Mentz and Carlisle, *supra* note 31, paragraph 44. Mentz and Carlisle’s view is presumably based on the 1994 IRC regulations: see *supra*, text accompanying note 38.

<sup>75</sup> *Ibid.*, paragraph 49.

<sup>76</sup> *Ibid.*

<sup>77</sup> Ossi, *supra* note 48, at 1008; Fred C. de Hosson, “Multinationals and Trademarks and Tradenames” (September 2000), *Journal of International Taxation* 22-48, at 30; paragraph 6.38 of the Guidelines; ATO, *supra* note 42.

<sup>78</sup> Paragraph 1.39 of the Guidelines (emphasis added).

<sup>79</sup> Brian C. Becker, “Projected and Actual Profit’s Impact on Licensees” (2008), vol. 17, no. 11 *Tax Management Transfer Pricing Report* 461 (available on the Web at <http://www.bna.com>). According to Becker, this type of long-term agreement occurs more frequently in licenses than in other types of intercompany transfers. Similarly, Wündisch states that periodic renegotiation is generally not included in all license contracts: *supra* note 3, at 241-5.

<sup>80</sup> Andrea Musselli and Alberto Musselli, “Observations on OECD Discussion Draft on Business Restructuring: Is the Notion of Control over Risk at Arm’s Length?” (2009), vol. 16, no. 4 *International Transfer Pricing Journal* 239-43, at 239.

<sup>81</sup> Przsuski, Lalapet, and Swaneveld, *supra* note 24, section IX.

<sup>82</sup> Ossi, *supra* note 48, at 1005. Also applied in US IP infringement cases with regards to a party’s standing-to-sue, the “all substantial rights” test has recently been extended to the realm of NY contractual disputes between legal owners and licensees (see *Biosynexus Inc. v. Glaxo Group Ltd.*, 2006 NY Slip Op 50359U; 11 Misc. 3d 1062A; 816 N.Y.S.2d 693; 2006 N.Y. Misc. LEXIS 468; 235 N.Y.L.J. 53), despite one author strongly arguing that it should remain within its previous boundaries: Alice Haemmerli, “Why Doctrine Matters: Patent and Copyright Licensing and the Meaning of Ownership in Federal Context” (Fall 2006), 30 *Columbia Journal of Law and Arts* 1-47. The test is found in various forms in other tax jurisdictions as well, such as the Netherlands: de Hosson, *supra* note 77, at 27-8.

<sup>83</sup> Przsuski, Lalapet, and Swaneveld, *supra* note 24, section IX.

<sup>84</sup> Dolman, *supra* note 71, under the subheading “Legal rights and economic ownership”.

<sup>85</sup> Przsuski, Lalapet, and Swaneveld, *supra* note 24, section VI. However, the Canadian legislation does not include TP regulations and the guidance found in the *Information Circular 87-2R* (*supra* note 7) does not specifically mention the notion of economic ownership.

<sup>86</sup> Dolman, *supra* note 71, under the subheading “Legal rights and economic ownership”. Vincent also writes that: “the OECD seems to recognize the existence of marketing intangibles”, noting that paragraphs 6.36-6.39 of the Guidelines “could be viewed as accepting the [1994] US approach”: Vincent, *supra* note 32, at 28:7.

<sup>87</sup> Przsuski, Lalapet, and Swaneveld, *supra* note 24, section VI.

<sup>88</sup> We express some reserves about these authors’ interpretation of paragraphs 6.36-6.39 of the Guidelines, as it may be confusing the partial economic ownership approach with the incremental marketing activities approach. Similarly to the view we express here, Jie-A-Joen and Brandt note the absence of specific guidance in the Guidelines on both

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the definition and identification of economic ownership: supra note 2, under the subheading “Ownership of intangible”.

<sup>89</sup> *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, paragraph 39; Sylvie Beaulieu, “La règle de la primauté du fond par rapport à la forme en droit fiscal canadien” (2005), vol. 53, no. 2 *Canadian Tax Journal*, 420-458. We would generally support the view that, in accordance with the Guidelines which are endorsed by the CRA, economic substance should however be afforded more room in TP analysis: CRA, supra note 7; paragraphs 1.26-9 of the Guidelines.

<sup>90</sup> Dolman, supra note 71.

<sup>91</sup> Ibid., under the subheading “Legal rights and economic ownership”.

<sup>92</sup> See for instance Srimi Lalapet, Martin Przysuski, and Hendrik Swaneveld, “Recognizing the Added Value Created by Incremental Innovation” (2004), vol. 12, no. 16 *Tax Management Transfer Pricing Report* 794 (available on the Web at <http://www.bna.com>).

<sup>93</sup> Przysuski, Lalapet, and Swaneveld, supra note 24, section IX.B.

<sup>94</sup> De Hosson, supra note 77, at 32-3. In his article, the author equates ‘beneficial’ with ‘economic’ and ‘tax’ ownership: *ibid.*, at 27.

<sup>95</sup> Ibid., at 33, referring to Kapferer, “Marketing Brands Work Around the World”, *Financial Times*, 1998 Global Business Series, annex no. 7. See also Philip Anderson and Melissa Heath, “Practical Difficulties in Applying the Transaction Net Margin Method” (December 2000) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section III.B.1.

<sup>96</sup> Martin Przysuski, Hendrik Swaneveld, and Srimi Lalapet, “Multinational Enterprise Business Strategies and Transfer Pricing in a Global Marketplace” (February 16, 2004), vol. 33 *Tax Notes International* 631-42.

<sup>97</sup> Ibid., at 641.

<sup>98</sup> Przysuski, Lalapet, and Swaneveld, supra note 24, section IX.I.

<sup>99</sup> Or decentralized model of decision-making combined with low global integration of the MNE’s activities: see Przysuski, Lalapet, and Swaneveld, supra note 96, at 635, referring to Sumantra Ghoshal, “Global Strategy: An Organizing Framework” (1987), vol. 8 *Strategic Management Journal* 425-40.

<sup>100</sup> Przysuski, Lalapet, and Swaneveld, supra note 96, at 641.

<sup>101</sup> Wündisch, supra note 3, at 5 and 66-9.

<sup>102</sup> Ibid., at 68.

<sup>103</sup> OECD, *Pharmaceutical Pricing Policies in a Global Market*, (Paris: oecd, 2008), at 69; Leonard M. Lodish, “Sales Force Sizing and Deployment Using a Decision Calculus Model at Syntex Laboratories” (1988), vol. 18, no. 1 *Interfaces* 5-20, at 7.

<sup>104</sup> OECD, supra note 103, at 69.

<sup>105</sup> Van Herksen, Levey, and Fletcher, supra note 26, section 5.

<sup>106</sup> Richard P. Rozek and George G. Korenko, “Using In-Country Comparables To Measure the Returns Due to Pharmaceutical Marketing and Distribution Affiliates” (2003), 10, no. 6 *International Transfer Pricing Journal* 211-7, at 211.

<sup>107</sup> Przysuski, Lalapet, and Swaneveld, supra note 24, section VIII.B.

<sup>108</sup> Ibid., section VIII.B (emphasis added).

<sup>109</sup> Ibid., section VIII.A. See also paragraph 6.6 of the Guidelines.

<sup>110</sup> Ibid., section VIII.B.

<sup>111</sup> Ibid., section VIII.M.

<sup>112</sup> Ibid., section X.

<sup>113</sup> Ibid., section VII.F.3.

<sup>114</sup> See *infra*, section 4 of this paper.

<sup>115</sup> Paragraph 1.13 of the Guidelines. In the words of authors Antonio Russo and Richard Boykin, “the comparability analysis constitutes the pivotal element of a transfer pricing review”: “OECD Developments on Comparability and Profit Methods” (December 12, 2008) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section I. See also OECD, Centre for Tax Policy and Administration, *Transactional Profit Methods: Discussion Draft for Public Comment*, January 25, 2008 (available on the Web at <http://www.oecd.org/dataoecd/18/48/39915180.pdf>), at 35-6.

<sup>116</sup> Paragraph 1.15 of the Guidelines.

<sup>117</sup> Paragraph 1.19 of the Guidelines.

<sup>118</sup> Paragraph 1.20 of the Guidelines.

<sup>119</sup> Paragraph 1.28 of the Guidelines.

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<sup>120</sup> Paragraph 1.30 of the Guidelines.

<sup>121</sup> Paragraph 1.31 of the Guidelines.

<sup>122</sup> As of 2006, the top 10 pharmaceutical firms reaped 46% of global sales, and the top 50 reaped a total of 71%: OECD, *supra* note 103, at 52, referring to IMS Health (2007), *Intelligence 360: Global Pharmaceutical Perspectives 2006* and “Holding Pattern – Pharm Exec 50”, (May 2007) *Pharmaceutical Executive* – Online Edition.

<sup>123</sup> Jean-Pierre Vidal, “Taking Imperfect Competition, Returns to Scale Into Account in Performing Transfer Pricing Analyses” (2002), vol. 11, no. 9 *Tax Management Transfer Pricing Report* 413-8, at 413.

<sup>124</sup> As of 1994, the four top selling firms individually reaped between 6 and 7 percent of global pharmaceutical sales; within a single therapeutic class however, the top three innovator drugs accounted for 80% or more of retail sales: United States, Congressional Budget Office, *How Increased Competition from Generic Drugs Has Affected Prices and Returns in the Pharmaceutical Industry*, July 1998 (available on the Web at <http://www.cbo.gov>), at 22.

<sup>125</sup> This term designates chemical entities “with a mode of action comparable to already existing products”: *Ibid.*, at 54-5. Me-toos are typically seen as a result of incremental innovation rather than radical innovation: Sarah Holland and Bernardo Bâtiz-Lazo, “The Global Pharmaceutical Industry,” teaching case prepared for the Manchester Business School and London South Bank University, 2004 (available on the Web at <http://129.3.20.41/eps/get/papers/0405/0405002.pdf>), at 8.

<sup>126</sup> *Ibid.*, at 3 and 73, note 1. Mark A. Hurwitz and Richard E. Caves consider that “[a] pharmaceutical firm that acquires a patent on a new ethical drug becomes a temporary monopolist”: “Persuasion or Information? Promotion and the Shares of Brand Name and Generic Pharmaceuticals” (1988), vol. 31, no. 2 *Journal of Law and Economics* 299-320, at 301. *Contra*: see Andrea Musselli and Donatella Marchetti Hunter, “Glaxo Transfer Pricing Case: Economic Rationale, Legal Framework and International Issues” (2007), vol. 14, no. 3 *International Transfer Pricing Journal* 165-173, at 167, where the two authors consider the view that the US pharmaceutical market is monopolistic as a common misconception, considering it instead as highly competitive.

<sup>127</sup> Vidal, *supra* note 123, at 413; Vidal, *supra* note 18, at 635.

<sup>128</sup> “Economic rent is analogous to economic profit as a surplus over the opportunity cost of capital”: Christopher T.S. Ragan and Richard G. Lipsey, *Microeconomics*, 11th ed. (Toronto: Pearson Addison Wesley, 2005), at 333.

<sup>129</sup> For a discussion on the interactions of volume and price in the pharmaceutical industry, see OECD, *Les prix des médicaments sur un marché global: Politiques et enjeux* (Paris: OECD, 2008), at 210.

<sup>130</sup> Brian C. Becker, “Comparable Profits Method: Accounting for Margin and Volume Effects of Intangibles” (February 6, 2002), vol. 10 *Transfer Pricing Report* 831 (available on the Web at <http://www.bna.com>), under the subheading “Effect of Intangibles”.

<sup>131</sup> *Ibid.*

<sup>132</sup> Deloris R. Wright and Harry A. Keates, “Comments on the OECD Discussion Draft on Transfer Pricing Aspects of Business Restructurings” (2009), vol. 16, no. 2 *International Transfer Pricing Journal* 115-22, at 119. On contract duration, see *supra*, text accompanying notes 78-79. On transfer prices that indirectly cover marketing expenses, see *infra*, section 5.1.3.1 of this paper.

<sup>133</sup> Anthony Barbera, “Considering Risk in Trademark Royalty Arrangements” (May 28, 2003), vol. 12 *Transfer Pricing Report* 71 (available on the Web at <http://www.bna.com>), under the subheading “Looking Closer at the Economics Of High-Risk License Arrangements”.

<sup>134</sup> Wündisch, *supra* note 3, at 67-9; Alfons R. Schmid, “Tax treatment of Services: Does the Value of Patents and Technical Know-How Prevail over the Value of Marketing Efforts?” (2005), vol. 12, no. 1 *International Transfer Pricing Journal* 16-9, at 16 and 18.

<sup>135</sup> Hejazi, *supra* note 54.

<sup>136</sup> Referring to regulations adopted in 2003 under the *Drug Price Competition and Patent Term Restoration Act of 1984*, Pub. L. No. 98-417, 98 Stat. 1585 (1984) (codified as amended 21 U.S.C. ' 355 (1994)) (herein referred to as the “Hatch Waxman Act”). Adopted by the United States in 1984, the Hatch Waxman Act “helped increase the supply of generic drugs [in the US] by lowering the cost of getting them approved by the Food and Drug Administration”: United States, Congressional Budget Office, *supra* note 124, at 37.

<sup>137</sup> Hejazi, *supra* note 54, at 13.

<sup>138</sup> *Ibid.*, at 12.

<sup>139</sup> United States, Congressional Budget Office, *supra* note 124, at 45-8. Erosion of patent protection in one jurisdiction may also have the ultimate effect of shifting of the R & D function to another jurisdiction, resulting in a ‘zero-sum game’ when looking at global R & D investments: OECD, *supra* note 129, at 204.

<sup>140</sup> See generally Wündisch, *supra* note 3, at 66-7.

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<sup>141</sup> Ernst R. Berndt, Linda Bui, David R. Reiley, and Glen L. Urban, “Information, Marketing, and Pricing in the U.S. Antiulcer Drug Market” (1995), vol. 85, no. 2 *American Economic Review* 100-5, at 101.

<sup>142</sup> OECD, *supra* note 103, at 68 and 71.

<sup>143</sup> *Ibid.*, at 69.

<sup>144</sup> *Ibid.*, at 63.

<sup>145</sup> United States, Congressional Budget Office, *supra* note 124, at 21.

<sup>146</sup> Holland and Bätz-Lazo, *supra* note 125, at 12.

<sup>147</sup> *Ibid.*, at 11.

<sup>148</sup> *Ibid.* Lodish (*supra* note 103, at 17) had already observed that, with respect to a sales force increase at Syntex Laboratories during the ‘80s, “[c]onsidering the extra cost of the additional salespeople and the incremental profitability of the sales increase, the return on the sales force investment is at least 100 percent.”

<sup>149</sup> Schmid, *supra* note 134, at 16; Wündisch, *supra* note 3, at 68-69.

<sup>150</sup> Holland and Bätz-Lazo, *supra* note 125, at 9; OECD, *supra* note 103, at 52; United States, Congressional Budget Office, *supra* note 124, at 48.

<sup>151</sup> Clinical trials lengthened the development time of new drugs and became, “by far, the most expensive element of the development process”: Holland and Bätz-Lazo, *supra* note 125, at 9.

<sup>152</sup> United States, Congressional Budget Office, *supra* note 124, at 15, footnote 2.

<sup>153</sup> Stock market valuations place as much importance on the R & D pipeline (products in development) than on currently marketed products: Holland and Bätz-Lazo, *supra* note 125, at 8.

<sup>154</sup> See *supra* note 125.

<sup>155</sup> Holland and Bätz-Lazo, *supra* note 125, at 2. In their statement, the authors appear to equate risk with potential for successful outcome. Incremental innovation remains quite costly however, since clinical trials are the most expensive part of the R & D process: OECD, *supra* note 103, at 55 and 63; Wündisch, *supra* note 3, at 43. See also OECD, *supra* note 129, at 203.

<sup>156</sup> Holland and Bätz-Lazo, *supra* note 125, at 11.

<sup>157</sup> A well-known example is found in the antiulcer H<sub>2</sub>-antagonist market, where the Zantac drug overtook the market developed by the pioneer drug Tagamet: see Berndt, Bui, Reiley, and Urban, *supra* note 141, at 100. Wündisch also remarks that blockbuster drugs “are not necessarily highly innovative medicines”: Wündisch, *supra* note 3, at 214.

<sup>158</sup> United States, Congressional Budget Office, *supra* note 124, at 21. The CBO adds however that this analysis is mainly based on list prices or average invoice prices and does not include many rebates: *Ibid.*, at 35.

<sup>159</sup> Paragraphs 1.20-7 of the Guidelines.

<sup>160</sup> Anderson and Heath, *supra* note 95, section III.B.2.

<sup>161</sup> Barbera, *supra* note 133, at footnote 1.

<sup>162</sup> For instance, Wündisch considers that the most important factor when examining transfer prices between subsidiaries is costs and risk-bearing, the latter essentially following the former: Wündisch, *supra* note 3, at 81.

<sup>163</sup> Paragraphs 1.25 and 6.37 of the Guidelines.

<sup>164</sup> ATO, *supra* note 42.

<sup>165</sup> Barbera, *supra* note 133.

<sup>166</sup> *Ibid.*, under the subheading “Low-Risk Trademark License Arrangements”.

<sup>167</sup> *Ibid.*, under the subheading “Looking Closer at the Economics Of High-Risk License Arrangements”.

<sup>168</sup> Barbera, *supra* note 133.

<sup>169</sup> *Ibid.*, at footnote 3. We will examine further this particular argument under the section on the Resale Price method: *infra* section 5.1.3.1.

<sup>170</sup> Ossi, *supra* note 48, at 1008.

<sup>171</sup> OECD, *Discussion Draft of Transfer Pricing Aspects of Business Restructuring*, September 19, 2008 – February 19, 2009, cited in Andrea Musselli and Alberto Musselli, *supra* note 80, at 242.

<sup>172</sup> *Supra*, note 171.

<sup>173</sup> *Ibid.*

<sup>174</sup> Lewis and Wright, *supra* note 54, section III.B.

<sup>175</sup> Chaid Dali-Ali, “OECD Draft on Transactional Profit Methods: Business Realities” (March 13, 2008), vol. 16 *Transfer Pricing Report* 817 (available on the Web at <http://www.bna.com>), under the subheading “Reducing Double Taxation”.

<sup>176</sup> Musselli and Musselli, *supra* note 171.

<sup>177</sup> Paragraph 1.30 of the Guidelines. The very notion of market, as evidenced in the Glaxo Canada case, is itself susceptible of debate: *supra* note 4, paragraphs 122-5. See on the subject Vidal, *supra* note 6, at 307-19.

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<sup>178</sup> Vidal, *supra* note 18, at 635, referring to Jean Tirole, *Théorie de l'organisation industrielle*, t. 1, (Paris: Economica, 1995), at 191.

<sup>179</sup> According to Brem and Tucha, market size is one of several regularly overlooked factors in “mainstream transfer pricing”: *supra* note 19, at 2.

<sup>180</sup> Wündisch, *supra* note 3, at 83-4 (emphasis added).

<sup>181</sup> *Ibid.*, at 80. A particular example of the “connection” factor can be found in a co-marketing agreement entered into between Glaxo and Meraniri, an independent Italian company influential with the Italian health authorities, and able to negotiate a high in-market price for the Zantac drug: Glaxo Canada, *supra* note 3, paragraph 52.

<sup>182</sup> Wündisch, *supra* note 3, at 80.

<sup>183</sup> The US alone accounted for 45% of global sales and Europe for 30% of same, with France and Germany accounting for 5% each, and Italy and the UK for 3.5% each. Spain and Canada each accounted for 2.6% of global sales, and Japan, the second largest pharmaceutical market in the world, accounted for 9% of same: OECD, *supra* note 103, at 58, referring to IMS Health, *supra* note 122. As these figures are based on sales in US dollars, they appear to reflect both price and volume and accordingly, are a reflection of both market size and power.

<sup>184</sup> See Becker, *supra* note 130, under the subheading “Conclusion”; Allen, Tomar, and Wright, *supra* note 2, section 5.2; Holland and Bâtiz-Lazo, *supra* note 125, at 18; Ossi, *supra* note 48, at 1009-10. See also several practitioners’ views reported in: “At IRS and Treasury - Treasury Economist Suggests Approach to Computing Marketing Intangibles Income” (2003), vol. 12, no. 3 *Tax Management Transfer Pricing Report* 84 (available on the Web at <http://www.bna.com>).

<sup>185</sup> Wündisch, *supra* note 3, at 72-5.

<sup>186</sup> Anderson and Heath, *supra* note 95, section I.

<sup>187</sup> “Australia: Roche v The Commissioner – a bitter pill to swallow, but for whom?” (April 1, 2008) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section II.C. Internal comparables refer to comparable transactions entered into between an entity of the tested MNE and an unrelated party, often bearing on the same product.

<sup>188</sup> *Supra* note 115, section I.

<sup>189</sup> *Ibid.*

<sup>190</sup> Wündisch, *supra* note 3, at 118.

<sup>191</sup> A drug’s net sale price by the distributor minus the price it paid for the api and its secondary manufacturing costs.

<sup>192</sup> *Supra*, note 106.

<sup>193</sup> Schmid links geographical differences affecting marketing efforts, such as regulatory hurdles, to differences at the operating profit level rather than at the gross profit level: *supra* note 134, at 18.

<sup>194</sup> *Supra*, note 106.

<sup>195</sup> *Ibid.*, at 211.

<sup>196</sup> *Ibid.*, at 215-6.

<sup>197</sup> Information from the website of Nutricia Ltd., available at <http://uk.nutricia.com/products> (February 20, 2010).

<sup>198</sup> Information from the website of Saada-Arzneimittel Aktiengesellschaft, english translation available at [http://translate.google.com/translate?hl=fr&sl=de&tl=en&u=http%3A%2F%2Fwww.stada.de%2Fgesundheitundmehr%2Fprodukte%2Fprodukt\\_uebersicht%2F%3Fnid%3D108%26vq%3D1](http://translate.google.com/translate?hl=fr&sl=de&tl=en&u=http%3A%2F%2Fwww.stada.de%2Fgesundheitundmehr%2Fprodukte%2Fprodukt_uebersicht%2F%3Fnid%3D108%26vq%3D1) (February 20, 2010).

<sup>199</sup> Information from the website of dsm Capua, available at [http://www.dsm.com/en\\_US/html/about/activities.htm](http://www.dsm.com/en_US/html/about/activities.htm) (February 20, 2010).

<sup>200</sup> Information from the website of Gifrer Barbezat, available at <http://www.gifrer.fr/publichtml/index.php?version=gifrer&language=en&menu=main&selection=healthcare> (February 20, 2010).

<sup>201</sup> Information from the website of Omega Pharma, available at <http://www.omega-pharma.fr/marques.php?docid=8> (February 20, 2010).

<sup>202</sup> Information from the website of the Securities and Exchange Commission, available at <http://www.secinfo.com/d14D5a.13A1e.9.htm#1stPage> (February 20, 2010).

<sup>203</sup> Information from the website of dsm Capua, available at [http://www.dsm.com/en\\_US/html/about/location\\_finder.htm](http://www.dsm.com/en_US/html/about/location_finder.htm) (February 20, 2010).

<sup>204</sup> Information from the website of Ferring Laboratories Ltd., available at <http://www.ferring.com/en/aboutus/> (February 20, 2010).

<sup>205</sup> Rozek and Korenko, *supra* note 106, at 216.

<sup>206</sup> Glaxo Canada, *supra* note 4, paragraphs 45-58.

<sup>207</sup> Paragraph 5.11 of the Guidelines.

<sup>208</sup> OECD, *supra* note 115, at 25.

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- <sup>209</sup> Russo and Boykin, *supra* note 115, section II; OECD, *supra* note 115; OECD, Centre for Tax Policy and Administration, *Comparability: Public Invitation to Comment on a Series of Draft Issues Notes*, May 10, 2006 (available on the Web at <http://www.oecd.org/dataoecd/59/38/36651642.pdf>).
- <sup>210</sup> Russo and Boykin, *supra* note 115, section II.
- <sup>211</sup> Nathalie Goyette, “Vérification par les autorités fiscales? Quoi faire ou ne pas faire”, in *Congrès, Association de Planification Fiscale et Financière*, 8 octobre 2008 (available on CD-Rom Arianne, CCH fiscalité), section 2.2.3.
- <sup>212</sup> Przysuski, Swaneveld, and Lalapet, *supra* note 96, at 636.
- <sup>213</sup> Paragraph 1.32 of the Guidelines. In Canada, the same could be said of IC87-2R (CRA, *supra* note 7, paragraph 35), while the IRC regulations appear to recognize both penetration and expansion strategies: Przysuski, Swaneveld, and Lalapet, *supra* note 96, at 638-9; IRC reg. section 1.482-1(d)(4)(i).
- <sup>214</sup> Przysuski, Swaneveld, and Lalapet, *supra* note 96, at 637.
- <sup>215</sup> Dolman, *supra* note 71, under the subheading “Life cycle of IP”.
- <sup>216</sup> Michael Stirling, “Intangibles Accounting, Economic and Legal Perspectives” (January 2002), *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section IV.
- <sup>217</sup> Dolman, *supra* note 71, under the subheading “Implications for transfer pricing”.
- <sup>218</sup> *Ibid.*
- <sup>219</sup> Wündisch, *supra* note 3, at 120.
- <sup>220</sup> Pim Fris and Sébastien Gonnet, “A European View on Transfer Pricing After Glaxo” (June 1, 2006) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), section I.A; *GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries v. Commissioner of Internal Revenue*, No. 5750-04 United States Tax Court (herein referred to as “the Glaxo US case”): Petition of GlaxoSmithKline filed on February 4, 2004, reproduced in Special Report (May 6, 2008) Transfer Pricing Report (available on the Web at <http://www.bna.com>), paragraph 7(h) (herein referred to as “Glaxo US Petition”). However, The IRS denied this allegation “for lack of sufficient information”: IRS answer filed on May 28, 2004, reproduced in (June 3, 2004) *Tax Notes Today* 107-10 (available on the Web at <http://www.lexisnexis.com>), paragraph 7(h).
- <sup>221</sup> Holland and Bátiz-Lazo, *supra* note 125, at 10 and 12. One possible strategy for product life extension entails moving a drug from prescription to OTC status, thereby using consumer brand loyalty as a defense against generic competition: *Ibid.*, at 12. See also OECD, *supra* note 103, at 68.
- <sup>222</sup> De Hosson, *supra* note 77, at 25.
- <sup>223</sup> *Ibid.*, at 25-7; see also paragraph 6.10 of the Guidelines.
- <sup>224</sup> Hamaekers, *supra* note 6, at 30. This number may be on a rising curve: from “over 60 percent” at the turn of the millenium (Markham, *supra* note 5, under the subheading “Introduction”; see also John Neighbour, “Transfer Pricing: Keeping it at arm’s length” (January 2002) *OECD Observer* (available on the Web at <http://www.oecdobserver.org>)), and up to 75 percent “depending upon the countries” as of November 2005: Brem and Tucha, *supra* note 19, at 1.
- <sup>225</sup> Fris, *supra* note 19; Pim Fris and Sébastien Gonnet, “ReAL Transfer Pricing: A New Paradigm for Transfer Pricing in Europe?” (June 1, 2006) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>); Fris and Gonnet, *supra* note 220.
- <sup>226</sup> Gustafson and Hallbäck, *supra* note 3, at 63-4; Emmanuel Llinares, “Profit split methods: Intangibles, market structure and the use of profit split methods” (2005), vol. 24, supplement *International Tax Review* 36-40 (available on the Web at <http://www.internationaltaxreview.com>), at 37. Wündisch is also of the view that “[t]ransfer pricing ideally produces an allocation of income reflecting the true value added of the respective group company”: *supra* note 3, at 110.
- <sup>227</sup> Fris, *supra* note 19, at 195.
- <sup>228</sup> Fris, *supra* note 19, at 196.
- <sup>229</sup> Paragraph 1.20 of the Guidelines.
- <sup>230</sup> Markham, *supra* note 5, under the subheading “The United States: choosing the ‘Best Method’” and footnote 19.
- <sup>231</sup> *Roche Products PTY Limited and Commissioner of Taxation*, [2008] AATA 261 (April 2, 2008), paragraphs 61-78 (herein referred to as “Roche Australia”).
- <sup>232</sup> *Ibid.*, paragraphs 117-23.
- <sup>233</sup> Referring solely here to the Comparable Uncontrolled Price, Cost plus and Resale Price methods: see *infra*, section 5.1
- <sup>234</sup> Fris, *supra* note 19, at 195.
- <sup>235</sup> *Ibid.*, at 196.

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- <sup>236</sup> Ibid., at 196 and 199-200, referring to Adam M. Brandenburger and Barry J. Nalebuff, *Co-opetition*, (New York: Doubleday, 1996). The economic game theory applies the mathematical theory of games to study optimal strategies that maximize pay-offs. It has risen to “perhaps the most important source of new ideas in microeconomics”, and “dominates almost any analysis of interactions between economic agents”: Graham Bannock, R.E. Baxter, and Evan Davis, *Dictionary of Economics*, 4th ed. (Princeton, New Jersey: Bloomberg Press, 2003), at 156-7.
- <sup>237</sup> See Fris and Gonnet, supra note 220. See also Brem and Tucha, supra note 19, at 6.
- <sup>238</sup> At least with respect to the European market: Fris, supra note 19, at 194.
- <sup>239</sup> Ibid., at 197-8.
- <sup>240</sup> Ibid., at 199.
- <sup>241</sup> Ibid., at 197 and 199-200.
- <sup>242</sup> See also Glaxo Canada, supra note 4, paragraph 46.
- <sup>243</sup> Wündisch, supra note 3, at 289.
- <sup>244</sup> Wündisch, supra note 3, at 35.
- <sup>245</sup> Wündisch, supra note 3, at 35.
- <sup>246</sup> Fris and Gonnet, supra note 225, section VI.
- <sup>247</sup> Ibid., section I.
- <sup>248</sup> Ibid., sections I-V; Fris and Gonnet, supra note 220, section II.C.
- <sup>249</sup> Brem and Tucha, supra note 19, at 7 and 14-5. They also attribute the failure of a bilateral, “simplified application of the Arm’s Length Principle” largely to a lack of comparable information, and especially transaction-based information, including the transactional context: Ibid., at 2,5 and 15.
- <sup>250</sup> Ibid., at 1 and 15.
- <sup>251</sup> Ibid., at 2 and 15.
- <sup>252</sup> Ibid., at 2, 8-11 and 15.
- <sup>253</sup> Ibid., at 1 and 9.
- <sup>254</sup> Ibid., at 1.
- <sup>255</sup> Ibid., at 3.
- <sup>256</sup> TCE is an interdisciplinary study of economic organization in which the transaction is made the basic unit of analysis. It maintains “the rebuttable presumption that organizational variety arises primarily in the service of transaction cost economizing”: Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985), at 387.
- <sup>257</sup> The terms “governance structure” were introduced by the economist Oliver E. Williamson to refer to the “discrete alternatives of exchanging transactions (spot-market, hybrid, hierarchy, bureaucracy)”: Brem and Tucha, supra note 19, at 12, note 27.
- <sup>258</sup> Ibid., at 3-4.
- <sup>259</sup> From related-party or hierarchy, through hybrid forms such as networks, joint-ventures, franchising and other long-term relationships without formal ownership, to “spot market” or external short-term transactions: Ibid., at 4 and 12-4.
- <sup>260</sup> The cost of searching (for a transacting partner), conducting, safeguarding and enforcing the transaction: Ibid., at 12, note 29.
- <sup>261</sup> Ibid., at 12-5.
- <sup>262</sup> Paragraph 3.16 of the Guidelines.
- <sup>263</sup> See for instance some excerpts from the expert reports filed with the Tax Court of Canada in *Glaxo Canada* (supra note 4), bearing on the relative importance of the marketing activities undertaken by the Canadian entity in reaping profits from the sale of pharmaceutical products on the Canadian market: Gregory K. Bell, expert report dated January 11, 2006 (public copy), paragraph 40 and sub-paragraph 50c; Charles King III, expert report dated January 9, 2006 (public copy), at 8-43; Charles King III, rebuttal expert report dated January 26, 2006 (public copy), paragraphs 22-7.
- <sup>264</sup> Fris and Gonnet, supra note 225, section II.
- <sup>265</sup> Ibid.
- <sup>266</sup> OECD, supra note 103, at 69. This study concludes that, when all diverse forms of pharmaceutical promotional activities are taken into account and free samples are valued at retail prices, the industry figures amongst the largest promotional spenders: Ibid., at 69-70.
- <sup>267</sup> Hurwitz and Caves, supra note 126, at 302; “Billion dollar pills” (January 27, 2007) *The Economist* 69-71, at 71. See also references cited in Charles King III, expert report dated January 9, 2006 (public copy), at 12, notes 45-6, filed in *Glaxo Canada*, supra note 4. Contra : Pharmaceutical Research and Manufacturers of America, “What goes

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into the cost of prescription drugs? ... and Other Questions about Your Medicines” (Washington: PhRMA, June 2005) (available on the Web at <http://www.phrma.org>), at 17. This phenomenon would not be new: Hurwitz and Caves, *supra* note 126, at 302.

<sup>268</sup> OECD, *supra* note 129, at 201 and 203-4.

<sup>269</sup> Wündisch, *supra* note 3, at 51 and 341.

<sup>270</sup> Wündisch, *supra* note 3, at 68.

<sup>271</sup> *Supra* note 141, at 101.

<sup>272</sup> Christopher Bogan and David Wang, “Launching a Blockbuster” (2000), vol. 20, no. 8 *Pharmaceutical Executive* 96-104, at 96.

<sup>273</sup> *Ibid.*

<sup>274</sup> See for example Schmid, *supra* note 134, at 18.

<sup>275</sup> Wündisch, *supra* note 3, at 67.

<sup>276</sup> Holland and Bátiz-Lazo, *supra* note 125, at 19. See also: Pierre-Jean Douvier, “Transfer Pricing and Research and Development” (2003), vol. 10, no. 6 *International Transfer Pricing Journal* 218-21, at 218.

<sup>277</sup> David Colker and Sang Kim, “GlaxoSmithKline v Commissioner: How Should \$10.6 Billion of Income in Dispute be Allocated Between Patents and Marketing Intangibles?” *DLA Piper*, May 1, 2004 (available on the Web at <http://www.dlapiper.com/global/publications/detail.aspx?ref=snapshot&pub=171>); Vincent, *supra* note 32, at 28:11.

<sup>278</sup> John W. Durnford, “Goodwill in the Law of Income Tax” (1981), vol. 29, no. 6 *Canadian Tax Journal* 759-808, at 771.

<sup>279</sup> Holland and Bátiz-Lazo, *supra* note 125, at 17-8. For example, Pfizer’s acquisition of Warner-Lambert gave it the rights to Lipitor, a cholesterol-lowering agent which it “then built into the world’s best-selling drug”: *Ibid.*, at 17. The recent acquisition of Schering-Plough Corp. by Merck & Co., at a time when Schering-Plough had promising drugs in “late-stage testing”, appears similarly driven. According to David Moskowitz, an industry analyst, the acquisition was “a tremendous deal” for Merck: Shannon Pettypiece, “Merck to Buy Schering-Plough for \$41 Billion (Update3),” *Bloomberg Business Week*, March 9, 2009 (available on the Web at <http://www.bloomberg.com/apps/news?pid=20601202&sid=aJXSizhf4SXU&refer=healthcare>).

<sup>280</sup> Wündisch, *supra* note 3, at 68.

<sup>281</sup> “The Role of Marketing in Pharmaceutical Research and Development” (2002), vol. 20, no. 3 supplement *Pharmacoeconomics* 77-85, at 82.

<sup>282</sup> Michael Stirling, “Valuing Marketing: A Mock Judgment in Glaxo’s Court Case” (October 26, 2004) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>), under the subheading “Discussion”.

<sup>283</sup> Fris and Gonnet, *supra* note 220, section II.B.

<sup>284</sup> *Ibid.*

<sup>285</sup> See *supra*, section 3.2.2.

<sup>286</sup> Wündisch, *supra* note 3, at 70.

<sup>287</sup> Wündisch, *supra* note 3, at 91.

<sup>288</sup> Bogan and Wang, *supra* note 272, at 104.

<sup>289</sup> Charles King III, *supra* note 267, at 11.

<sup>290</sup> *Ibid.*, citing IN 161257, Transcript of deposition of Sir Paul Girolami, July 12, 2002.

<sup>291</sup> OECD, *supra* note 14 (herein referred to as “the Proposed Revision”).

<sup>292</sup> *Ibid.*, at 26-8. This standard was first introduced by the United States in 1994, under the label “best method rule”: Hamaekers, *supra* note 6, at 31; Deloris R. Wright, “Practical Application of Transactional Profit Methods” (2000), vol. 7, no. 5 *International Transfer Pricing Journal* 198-203, at 198.

<sup>293</sup> OECD, *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979).

<sup>294</sup> Following the adoption of the Comparable Profits Method (CPM) in the United States in 1994: Deloris R. Wright, Caterina K. Nelson, and Jonathan C. Casdan, “TNMM – The OECD’s Response to CPM: Are They Really Different?” (1995), vol. 35, no. 10 *European Taxation* 306-14, at 306; Hamaekers, *supra* note 6, at 31.

<sup>295</sup> *Supra* note 115, section II. See also OECD, *supra* note 115, at 25.

<sup>296</sup> Markham, *supra* note 5, under the subheading “Profit split methods: Their practical application to intangible assets”. See also, with regards to the European market: Linares, *supra* note 226, at 37.

<sup>297</sup> Deloris Wright, *supra* note 292, at 200, referring to the United States Tax Court. James, Kenny and Houseman similarly noted that Mr. Justice Downe of the Australian Administrative Appeals Tribunal clearly preferred

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transactional methods over profit ones when rendering his decision in Roche Australia (supra, note 231): see supra note 187, section II.C.

<sup>298</sup> Wündisch, supra note 3, at 127; *Glaxo Canada*, supra note 4, paragraphs 47-9; Glaxo US petition, supra note 220, paragraph 6r.

<sup>299</sup> Paragraph 6.13 of the Guidelines.

<sup>300</sup> Paragraph 6.24 of the Guidelines.

<sup>301</sup> Wündisch, supra note 3, at 154-8; Alexandre Siciliano Borges, “Comparability in the Pharmaceutical Industry for Transfer Pricing Purposes” (MA thesis, Leiden University, School of Law, 2002) (available on the Web at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=400281](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=400281)), at 12-4.

<sup>302</sup> Dale Hill, “The Tax Court of Canada on Glaxo: Results and Implications” (July 17, 2008), vol. 17 *Transfer Pricing Report* 269 (available on the Web at <http://www.bna.com>); Jennifer Rhee, “The Tax Court of Canada in GlaxoSmithKline: Drawing the Boundaries of the Arm’s-Length Fiction” (December 18, 2008), vol. 17 *Transfer Pricing Report* 671 (available on the Web at <http://www.bna.com>); François Vincent, “GlaxoSmithKline Inc. v. The Queen : A Commentary” (June 19, 2008), vol. 17 *Transfer Pricing Report* 177 (available on the Web at <http://www.bna.com>); Muris Dujic, Sandra Goldberg, Bernard Barsalo and Rene Fleming, “Digesting the Glaxo Decision: A Difficult Pill to Swallow for Transfer Pricing Practitioners” (2008), vol. 15, no. 5 *International Transfer Pricing Journal* 203-12; Andrew F. McCrodan and Salvador M. Borraccia, “The Dilemma of GSK – Unreasonable in the Circumstances?” in *Report of Proceedings of the Sixtieth Tax Conference, 2008 Conference Report* (Toronto: Canadian Tax Foundation, 2009), 23:1-21.

<sup>303</sup> François Vincent, supra note 302, under the subheading “Conclusion”.

<sup>304</sup> See supra, text accompanying note 206.

<sup>305</sup> *Glaxo Canada*, supra note 4, paragraph 76. The Glaxo Group had in fact established a relatively low rate in this respect (6%): *Ibid.*, paragraph 14.

<sup>306</sup> Paragraphs 1.42-4 of the Guidelines; CRA, supra note 7, paragraphs 37-42.

<sup>307</sup> *Glaxo Canada*, supra note 4, paragraph 77; Income Tax Act, RSC 1985, c.1 (5th Supp), as amended, subparagraph 212(1)d)(i).

<sup>308</sup> Paragraph 6.6 of the Guidelines.

<sup>309</sup> Vincent, supra note 32, at 28:13. This view corresponds to the 1994 IRC reg. section 1.482-4(f)(3), Example 3 (Jie-A-Joen and Brandt, supra note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”), and also to current IRC reg. section 1.482-1(d)(3)(ii)(C), Example 5, but only where the incremental activities have been contemporaneously documented in a contract that clearly attributes the risks of marketing investment to the MI owner.

<sup>310</sup> See also Vidal, supra note 18, at 601-2.

<sup>311</sup> ATO, supra note 41, at 6.

<sup>312</sup> Wündisch, supra note 3, at 96.

<sup>313</sup> Jie-A-Joen and Brandt, supra note 2, under the subheading “Arm’s length compensation for (incremental) marketing activities”; Allen, Tomar, and Wright, supra note 2, section 2.1; Mentz and Carlisle, supra note 31, paragraph 26.

<sup>314</sup> Vincent, supra note 32, at 28:10.

<sup>315</sup> See the text accompanying note 415.

<sup>316</sup> Wündisch, supra note 3, at 92. Wündisch particularly notes that marketing expenses are lower in Scandinavian countries, because of their sizes and the geographic distribution of the doctor population, and in Sweden and the UK, because of government limitations on marketing expenses.

<sup>317</sup> Molly Moses, “Panelists Stress Need for Thorough Review of Facts when Marketing Intangibles Present” (2007), vol. 16, no. 11 *Tax Management Transfer Pricing Report* 382 (available on the Web at <http://www.bna.com>), under the subheading “Incremental Expenses”, citing a comment from John Breen.

<sup>318</sup> The OECD noted that there is a significant reliance by the pharmaceutical industry on the use of free samples to promote new drugs, because of their low marginal production costs: OECD, supra note 103, at 56. Calculated at approximate retail price, free samples “constitute by far the largest component of promotional spending”: *Ibid.*, at 69. The price paid by a related distributor for samples could therefore have a dramatic effect on its profit levels when compared to third party transactions where they would be provided free of charge.

<sup>319</sup> Paragraphs 2.16-7 of the Guidelines.

<sup>320</sup> Paragraph 2.14 of the Guidelines.

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<sup>321</sup> Paragraph 2.22 of the Guidelines. The CRA notes that RP becomes more and more difficult to apply as resellers perform functions that add value to the goods, especially where they create or maintain the value of an MI in carrying out their activities: supra note 7, paragraph 74.

<sup>322</sup> See for instance Wündisch, supra note 3, at 82 and 152.

<sup>323</sup> Wündisch, supra note 2, at 127-9. Glaxo US petition, supra note 220, paragraph 6r. In our case scenario, the resale price is generally the net price at which the pharmaceutical drug is sold to independent wholesalers, or directly to retailers and hospitals, by the local distributor: Wündisch, supra note 2, at 84.

<sup>324</sup> Supra note 4. See for instance Gregory K. Bell, supra note 263, paragraphs 33-4; J. Gregory Ballentine, expert report dated January 9, 2006 (public copy), at 20, filed in Glaxo Canada, supra note 4.

<sup>325</sup> Wündisch, supra note 3, at 129; Glaxo US petition, supra note 220.

<sup>326</sup> Wündisch, supra note 3, at 129 (emphasis added).

<sup>327</sup> Wündisch, supra note 3, at 168.

<sup>328</sup> Paragraph 3.34 of the Guidelines.

<sup>329</sup> Wündisch, supra note 3, at 127-8; Musselli and Hunter, supra note 126, at 170 and 172. See also Glaxo US petition, supra note 220, paragraph 6r.

<sup>330</sup> Musselli and Hunter, supra note 126, at 170 (note 21) and 172; Mentz and Carlisle, supra note 31, paragraph 42.

<sup>331</sup> Mentz and Carlisle, supra note 31, paragraph 42.

<sup>332</sup> Including unanticipated side effects and a competitor's early entry on the market, to name a few: see generally Wündisch, supra note 3, at 5.

<sup>333</sup> See for instance Glaxo US petition, supra note 220, paragraph 6r.

<sup>334</sup> Fris, supra note 19, at 195.

<sup>335</sup> Barbera, supra note 133, at footnote 3 (emphasis added).

<sup>336</sup> Wright, supra note 292, at 198.

<sup>337</sup> Ibid.

<sup>338</sup> Paragraphs 3.1-57 of the Guidelines.

<sup>339</sup> Fris, supra note 19, at 195.

<sup>340</sup> Russo and Boykin, supra note 115, section I; Wright, supra note 292, at 202. As such adjustments are made because of information becoming available after the transaction, they should not be regarded as a form of banned hindsight: Russo and Boykin, supra note 115, section I.

<sup>341</sup> Russo and Boykin, supra note 115, section I; Wright, supra note 292, at 203; Hamaekers, supra note 6, at 35.

<sup>342</sup> Markham, supra note 5, under the subheading "The increasing acceptability of profit-based methods for intangible transactions", referring to Philip Anderson and Melissa Heath, "Practical Application of Transactional Profit Methods: Australia" (2000), vol. 7, no. 5 *International Transfer Pricing Journal* 176-83, at 176. As early as 1994, the ATO noted that the transactional profit methods were becoming more acceptable in competent authority processes: Markham, supra note 5, under the subheading "Conclusion: The future of profit split methodologies".

<sup>343</sup> Markham, supra note 5, under the subheading "The increasing acceptability of profit-based methods for intangible asset transactions", referring to Matthew Setchell, "OECD Transfer Pricing Guidelines Likely to be Modified, Official Says" (April 12, 2002) *Tax Notes International* (available on the Web at <http://www.lexisnexis.com>). See also: OECD, supra note 115, at 7-8; Hamaekers, supra note 6, at 35.

<sup>344</sup> OECD, supra note 14.

<sup>345</sup> Ibid., proposed paragraph 2.3.

<sup>346</sup> OECD, supra note 115, at 29.

<sup>347</sup> Allen, Tomar, and Wright, supra note 2, section 4.6.

<sup>348</sup> Paragraph 3.5 of the Guidelines and OECD, supra note 14, proposed paragraph 2.62.

<sup>349</sup> OECD, supra note 115, at 60.

<sup>350</sup> Ibid.

<sup>351</sup> OECD, supra note 14, proposed paragraph 2.63. See also paragraph 3.5 of the Guidelines.

<sup>352</sup> Ibid.; Markham, supra note 5, under the subheading "Conclusion: The future of profit split methodologies".

<sup>353</sup> OECD, supra note 14, proposed paragraph 2.3 (emphasis added); paragraphs 3.5 and 4.82 of the Guidelines. See also Brem and Tucha, supra note 19, at 6, note 18.

<sup>354</sup> OECD, supra note 115, at 32.

<sup>355</sup> Paragraphs 3.15 and 3.19-21 of the Guidelines; OECD, supra note 14, proposed paragraphs 2.75-7; IRC reg. section 1.482-6.

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<sup>356</sup> Allen, Tomar, and Wright, *supra* note 2, section 5.3. Although revised, example 12 of the 2009 final IRC reg. section 1.482-8 retains this expressed preference: “Final U.S. Regulations on Intercompany Services [T.D. 9456, 74 Fed. Reg. 38830, dated 8/4/09]”, *supra* note 45.

<sup>357</sup> OECD, *supra* note 115, at 30.

<sup>358</sup> *Ibid.*

<sup>359</sup> Paragraphs 3.15 and 3.19-21 of the Guidelines; OECD, *supra* note 14, proposed paragraphs 2.75-7; IRC reg. section 1.482-6.

<sup>360</sup> Paragraphs 3.15-8 of the Guidelines; OECD, *supra* note 14, proposed paragraphs 2.73-4.

<sup>361</sup> The 1993 Temporary IRC regulations proposed four PS methods and the 1994 Final IRC regulations kept only two, namely the residual and comparable PS methods: Markham, *supra* note 5, under the subheading “Profit split in the United States”. The various PS methods are not mutually exclusive: OECD, *supra* note 14, proposed paragraph 2.72.

<sup>362</sup> Or data from the taxpayer’s own operations: OECD, *supra* note 14, proposed paragraphs 2.62 and 2.95-9.

<sup>363</sup> OECD, *supra* note 14, proposed paragraph 2.94.

<sup>364</sup> Paragraph 247(2)(b) of the Income Tax Act, *supra* note 307.

<sup>365</sup> Subparagraph 247(2)(b)(ii) of the Income Tax Act, *supra* note 307. To fulfill this legal test, the CRA must demonstrate that the transaction “can reasonably be considered not to have been entered into primarily for bona fide purposes other than to obtain a tax benefit”. This higher threshold for the CRA has given rise to a tendency among taxpayers to argue that TP adjustments actually constitute recharacterization of the transaction, thereby broadening the scope of this concept. See for example the Notice of Appeal of Tregaskiss Limited filed on July 4, 2005 with the Tax Court of Canada in *Tregaskiss Limited v. The Queen*, 2005-2244(IT)G, paragraphs 91-3; Stephen C. Doyle, “The CRA’s Growing Use of the Transfer Pricing Recharacterization Provision : Changing More Than Just the Price”, *Tax Practitioners’ Forum – Transfer Pricing*, March 30, 2007 (available on the Web at <http://www.taxnetpro.com>).

<sup>366</sup> Paragraphs 1.36-1.41 of the Guidelines, renumbered 1.63-1.68 in the Proposed Revision.

<sup>367</sup> OECD, *supra* note 115, at 65; OECD, *supra* note 14, proposed paragraph 2.70.

<sup>368</sup> OECD, *supra* note 115, at 65. This has been slightly modified in the Proposed Revision: see notably proposed paragraphs 2.65 and 2.73.

<sup>369</sup> OECD, *supra* note 115, at 68.

<sup>370</sup> See for instance Wright, *supra* note 292, at 200.

<sup>371</sup> OECD, *supra* note 115, at 67-8; OECD, *supra* note 14, proposed paragraph 2.86.

<sup>372</sup> OECD, *supra* note 115, at 69; OECD, *supra* note 14, proposed paragraph 2.91.

<sup>373</sup> The Guidelines also caution that costs may not always reflect value: see paragraphs 6.6 and 6.27 of the Guidelines and OECD, *supra* note 14, proposed paragraph 2.92.

<sup>374</sup> Moses, *supra* note 317, under the subheading “Incremental Expenses”.

<sup>375</sup> Musselli and Hunter, *supra* note 126, at 166, note 4. See also: Douvier, *supra* note 276, at 218; Wündisch, *supra* note 3, at 134.

<sup>376</sup> Wündisch, *supra* note 3, at 93-5.

<sup>377</sup> Brem and Tucha, *supra* note 19, at 7.

<sup>378</sup> Fris and Gonnet, *supra* note 225; Brem and Tucha, *supra* note 19.

<sup>379</sup> OECD, *supra* note 115, at 31.

<sup>380</sup> In this regard, we join our voice to Gustafson and Hallbäck, *supra* note 3, at 63.

<sup>381</sup> Wündisch, *supra* note 3, at 150-1 and 163; Schmid, *supra* note 134, at 16 and 18, where the author notes that in competent authority negotiations, difficulties in the application of the PS method are met both on the identification of the combined profit (due to differing cost accounting rules) and on fixing a reasonable and economically defensible allocation key.

<sup>382</sup> Fris and Gonnet, *supra* note 220, section I.A.

<sup>383</sup> See notably Markham, *supra* note 5, under the subheading “Conclusion: The future of profit split methodologies”; Levey, Church, van Herksen, and Carmichael, *supra* note 21, section V.3.

<sup>384</sup> Fris and Gonnet, *supra* note 220, section II.A.

<sup>385</sup> *Ibid.*, section II.C.

<sup>386</sup> Llinares, *supra* note 226, at 39.

<sup>387</sup> See *supra*, note 236.

<sup>388</sup> Fris, *supra* note 19, at 202.

<sup>389</sup> Brem and Tucha, *supra* note 19, at 7, note 20. See also OECD, *supra* note 14, proposed paragraph 2.88.

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<sup>390</sup> Moses, supra note 317, under the subheading “Incremental Expenses”. See also supra, text accompanying note 44.

<sup>391</sup> Paragraph 3.26 of the Guidelines.

<sup>392</sup> Hamaekers, supra note 6, at 31; Fris and Gonnet, supra note 220; Wright, Nelson, and Casdan, supra note 294.

<sup>393</sup> Fris and Gonnet, supra note 220; Fris, supra note 19, at 200-1.

<sup>394</sup> OECD, supra note 115, at 42.

<sup>395</sup> Paragraph 3.28 of the Guidelines. See also: Fris and Gonnet, supra note 220, section II.C.

<sup>396</sup> Russo and Boykin, supra note 115, section II; James, Kenny and Houseman, supra note 187, section II.C.

<sup>397</sup> Llinares, supra note 226, at 36.

<sup>398</sup> Fris, supra note 19, at 194. See also: Richard P. Rozek and George G. Korenko, “Transfer Prices for the Intangible Property Embodied in Products with Extraordinary Profit Potentials” (October 18, 1999) 19 *Tax Notes International* 1553-65, at 1556, where the authors argue that differences in cost structure, business experience and management efficiency diminish the reliability of the CPM “as an arm’s length measure”.

<sup>399</sup> Roche Australia, supra note 231, paragraph 117; James, Kenny and Houseman, supra note 187, section II.C.

<sup>400</sup> Roche Australia, supra note 231, paragraph 185.

<sup>401</sup> Llinares, supra note 226, at 37. Such adjustments are quite difficult to perform: see paragraph 1.9 of the Guidelines. In this regard, Vidal suggested the use of an economic tool designed to apply the specific degree of the tested party’s levels of imperfect competition and economies of scale (as those levels can vary indefinitely) to comparables operating in a perfectly competitive market, before making the actual comparison: Vidal, supra note 123, at 413-4.

<sup>402</sup> Paragraph 3.27 of the Guidelines.

<sup>403</sup> Becker, supra note 130, under the subheading “Payment for Intangibles Under Standard CPM”, citing Richard Clark, “Choosing a Reliable Profit Level Indicator”, (April 9, 1997), vol. 5 *Transfer Pricing Report* 807.

<sup>404</sup> Becker, supra note 130, under the subheading “Payment for Intangibles Under Standard CPM”. For a brief discussion on volume-increasing versus price-increasing or cost-reducing intangibles, see supra, text accompanying notes 130-131.

<sup>405</sup> Ibid.

<sup>406</sup> OECD, supra note 115, at 45. See also OECD, supra note 14, proposed paragraphs 2.127-8. The most often used PLI is EBIT (Earnings Before Interest and Taxes) to sales or costs: Anderson and Heath, supra note 95, section II; Wright, supra note 292, at 198. See also OECD, supra note 14, proposed paragraph 2.121, with respect to EBIT only.

<sup>407</sup> OECD, supra note 115, at 52. See also: OECD, supra note 14, proposed paragraph 2.131; Russo and Boykin, supra note 115, section II.

<sup>408</sup> See supra, text accompanying note 310.

<sup>409</sup> OECD, supra note 14, proposed paragraph 2.3. See also paragraphs 3.27 and 3.34 of the Guidelines.

<sup>410</sup> Ibid., at 37. However, careful attention must be given when using either methods to the accounting of rebates and discounts, whether as a reduction of sales or as operating expenses: Ibid., at 50. See also Moses, supra note 317, under the subheading “Incremental Expenses”, citing a comment from Keshvari.

<sup>411</sup> OECD, supra note 115, at 38.

<sup>412</sup> Identified as a cost-based PLI by OECD WP6, the Berry ratio is obtained after dividing the gross margin by operating expenses: Ibid., at 52. See Appendix B, last column.

<sup>413</sup> Russo and Boykin, supra note 115, section II.

<sup>414</sup> See supra, text accompanying notes 323-324.

<sup>415</sup> Wündisch, supra note 3, at 242. See also: Rozek and Korenko, supra note 398, at 1557.

<sup>416</sup> Paragraph 6.1 of the Guidelines.

<sup>417</sup> An expert report filed in the *Glaxo Canada* case suggests that Glaxo Canada developed strategic approaches that were subsequently applied in other countries: see Charles King III, supra note 267, at 36 and sources cited at note 174.

<sup>418</sup> Fris and Gonnet, supra note 220, section II.C. The dangers of confusing profit split methods with global apportionment formulas was also underlined in Llinares, supra note 226, at 38.

<sup>419</sup> Markham, supra note 5, under the subheading “Profit split methods: Their practical application to intangible assets”.

<sup>420</sup> Paragraph 3.74 of the Guidelines; Wündisch, supra note 3, at 148-50, 163, 179 and 295-7; Russo and Boykin, supra note 115, section II; Markham, supra note 5, under the subheading “Profit split methods: Their practical application to intangible assets”.

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<sup>421</sup> See for example Monique van Herksen and Clive Jie-a-Joen, “The increasing price of your transfer pricing: a discussion of the proposed revision of Chapters I-III of the Transfer Pricing Guidelines” (November 17, 2009) *Tax Planning International Transfer Pricing* (available on the Web at <http://www.bnai.com>).

<sup>422</sup> *Supra*, note 55 (emphasis added).

<sup>423</sup> Which has been going on for decades and still goes on in the pharmaceutical industry (see for instance *supra*, note 279), despite an industry consultant’s opinion that “big drug firms must [now] move towards a ‘disaggregated model’”: “Billion dollar pills”, *supra* note 267, at 70, citing a comment from Roger Longman.

<sup>424</sup> See for instance Pierre Noreau, “L’innovation sociale et le droit - est-ce bien compatible?”, in Conseil québécois de la recherche sociale and Fonds québécois de la recherche sur la société et la culture, eds., *Le développement social au rythme de l’innovation* (Sainte-Foy: Presses de l’Université du Québec, 2004), 73-108, at 73.

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## APPENDIX A

### LIST OF ABBREVIATIONS

AL	Arm's Length or Arm's-Length
ALP	Arm's Length Principle
API	Active Pharmaceutical Ingredient
ATO	Australian Taxation Office
C+	Cost Plus
CPM	Comparable Profits Method
CRA	Canada Revenue Agency
CUP	Comparable Uncontrolled Price
EBIT	Earnings Before Interest and Tax
Glaxo Canada	GlaxoSmithKline Inc.
Glaxo US	GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries
Glaxo	Glaxo Group
IP	Intellectual Property
IRC	Internal Revenue Code
IRC reg.	Internal Revenue Code regulations
IRS	Internal Revenue Service
MI	Marketing Intangible
MNE	Multinational Enterprise
OECD	Organization for Economic Cooperation and Development
OECD WP6	OECD's Working Party No. 6

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OM	Operating Margin
PLI	Profit Level Indicator
PS	Profit Split
R & D	Research and development
RP	Resale Price
TCE	Transaction-Cost Economics
TNMM	Transactional Net Margin Method
TP	Transfer Pricing

## APPENDIX B

<u>Line</u>	<u>Item</u>	<u>Third party</u>	<u>Tested party</u>	<u>Source</u>	<u>RP method</u>	<u>TNMM with operating margin</u>	<u>TNMM with Berry ratio</u>
1	Net sales	10 000	10 000	Data	10000	10000	10000
2	Cost of goods sold & royalty	4 000	4 250	Data	4000	3050	2500
3	Gross income (GI)	6 000	5 750	line 1 - line 2	6000	6950	7500
4	Gross profit margin (GPM), %	60%	58%	line 3 / line 1	60%	70%	75%
5	Operating expenses (OE)	3 800	4 750	Data	4750	4750	4750
6	EBIT	2 200	1 000	line 3 - line 5	1250	2200	2750
7	EBIT, % to net sales	22%	10%	line 6 / line 1	13%	22%	28%
8	Berry ratio (GI / OE)	158%	121%	line 3 / line 5	126%	146%	158%

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