DISCUSSION DRAFT

REVISION OF THE SPECIAL CONSIDERATIONS FOR INTANGIBLES IN CHAPTER VI OF THE OECD TRANSFER PRICING GUIDELINES AND RELATED PROVISIONS

6 June to 14 September 2012

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
CENTRE FOR TAX POLICY AND ADMINISTRATION

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In 2010, the OECD announced the commencement of a project on the transfer pricing aspects of intangibles. A scoping paper was published on the OECD website for public comment. In the interim three public consultations have been held with interested commentators. At the business consultation held in November 2011, representatives of the business community suggested that it would be helpful if the OECD were to release interim drafts of its work as it progresses for further detailed public comment.

This document is such an interim draft. It contains two principal elements: (i) a proposed revision of the provisions of Chapter VI of the Transfer Pricing Guidelines; and (ii) a proposed revision of the Annex to Chapter VI containing examples illustrating the application of the provisions of the revised text of Chapter VI.

Because this is an interim draft it should be recognised that it is not necessarily a consensus document and that the Committee on Fiscal Affairs has not yet considered the draft. One or another country may not be in full agreement with one or more of its provisions. Nevertheless, OECD Working Party No. 6 believes that it will be extremely helpful to its ongoing work on the intangibles project to have detailed business input with regard to the various provisions of this draft.

It should also be recognised that the Discussion Draft does not represent a complete draft of all of the provisions ultimately expected to form a part of the output for this project. In particular, the Working Party still intends to address at least the following topics not currently addressed in this draft: (i) any necessary modifications to Chapter VIII of the Transfer Pricing Guidelines related to cost contribution arrangements that may be necessitated as a result of the modification of Chapter VI; (ii) the transfer pricing consequences of various items treated in this draft as comparability factors rather than intangibles, including market specific advantages, location-based advantages, corporate synergies and workforce issues; and (iii) any additional conforming changes to Chapters I – III and Chapter VII of the Transfer Pricing Guidelines required as a result of the changes to Chapter VI. Discussion drafts of additional proposed changes will be released for comment at a future date.

Written comments on this Discussion Draft are requested to be provided by **14 September 2012**. Comments in Word format should be addressed to Joseph L. Andrus, Head of Transfer Pricing Unit, Centre for Tax Policy and Administration (joe.andrus@oecd.org). Unless otherwise requested at the time of submission, comments received will be posted on the OECD website.

It is anticipated that a public consultation on this Discussion Draft will be held in Paris during the week of 5 November 2012. Participants at the November public consultation will be drawn primarily from those providing timely written comments on this Discussion Draft.

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It is proposed that the current provisions of Chapter VI of the Transfer Pricing Guidelines be deleted in their entirety, and that they be replaced by the following language.

CHAPTER VI
SPECIAL CONSIDERATIONS FOR INTANGIBLES

1. Under Article 9 of the OECD Model Tax Convention, where the conditions made or imposed in the use or transfer of intangibles between two associated enterprises differ from those that would be made between independent enterprises, then any profits that 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.

2. The purpose of this Chapter VI is to provide guidance specially tailored to determining arm's length conditions for transactions that involve the use or transfer of intangibles. Article 9 of the OECD Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning particular labels to such transactions. Consequently, the key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other items or activities. The fact that an item or activity is not specifically addressed in Chapter VI, or is not treated as an intangible for purposes of Chapter VI, does not imply that the item or activity does not convey economic value or that it need not be considered in determining arm's length prices and other conditions for controlled transactions.

3. The principles of Chapters I through III of these Guidelines apply equally to transactions involving intangibles and those transactions which do not. As is the case with other transfer pricing matters, the analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis. That functional analysis should identify the functions performed, assets used, and risks assumed by each relevant member of the MNE group. Indeed, in cases involving the use or transfer of intangibles, it is especially important to ground the analysis on an understanding of the MNE's global business and the manner in which intangibles are used by the MNE to add or create value.

4. In order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis: (i) the identification of specific intangibles; (ii) the identification of the party(ies) that should be entitled to retain the return derived from the use or transfer of the intangibles; (iii) the nature of the controlled transactions and whether they involve the use of intangibles and/or lead to the transfer of intangibles between the parties; and (iv) the remuneration that would be paid between independent parties for the use or transfer of such intangibles.

A. Identifying Intangibles

A.1. In general

5. In these Guidelines, the word "intangible" is intended to address something which is not a physical asset or a financial asset[1], and which is capable of being owned or controlled for use in commercial activities. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

6. Intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalised for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless carry significant economic value and may need to be considered for transfer pricing purposes. Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, whether an item should be considered to be an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterisation for accounting purposes, but will not be determined by such characterisation only. Furthermore, the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterisation for general tax purposes, as, for example, an expense or an amortisable asset.

7. The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes.

8. It is important to distinguish intangibles from market conditions or other circumstances that are not capable of being owned, controlled or transferred by a single enterprise. For example, features of a local market, such as the level of disposable income of households in that market or the size or relative competitiveness of the market, may affect the determination of an arm's length price for a particular transaction and should be taken into account in a comparability analysis. They are not, however, intangibles for purposes of Chapter VI.

9. The identification of an item as an intangible is separate and distinct from the determination of the value of the item or the return attributable to the item under the facts and circumstances of a given case. Depending on the industry sector and other facts specific to a particular case, intangibles can account for either a large or small part of the MNE's value creation. It should be emphasized that not all intangibles deserve separate compensation in all circumstances, and not all intangibles give rise to premium returns in all circumstances. For example, consider a situation in which an enterprise performs a service using non-unique know-how, where other comparable service providers have comparable know-how. In that case, even though know-how constitutes an intangible, it may be determined under the facts and circumstances

[1] As used in this paragraph, a financial asset is any asset that is cash, an equity instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples include bonds, bank deposits, stocks, shares, forward contracts, futures contracts, and swaps.

that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns to the functions it performs. See TPG 1.39.

10. Care should be taken in determining whether or when an intangible exists and whether an intangible has been used or transferred. For example, not all research and development expenditures produce or enhance an intangible, and not all marketing activities result in the creation or enhancement of an intangible.

11. In a transfer pricing analysis of a matter involving the use or transfer of intangibles, it is important to identify the relevant intangibles with some specificity. The functional analysis should identify the economically significant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value. While it may be appropriate to aggregate intangibles for purposes of determining arm's length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified economically significant intangibles in the MNE's global business, should support the determination of arm's length conditions.

A.2. Relevance of this Chapter for other tax purposes

12. The guidance contained in this Chapter is intended to address transfer pricing matters exclusively. It is not intended to have relevance for other tax purposes. For example, the Commentary on Article 12 of the OECD Model Tax Convention contains a detailed discussion of the definition of royalties under that Article (paragraphs 8 to 19). The Article 12 definition of "royalties" is not intended to provide any guidance on whether, and if so at what price, the use or transfer of intangibles would be remunerated between independent parties. It is therefore not relevant for transfer pricing purposes. Moreover, the manner in which a transaction is characterised for transfer pricing purposes has no relevance to the question of whether a particular payment constitutes a royalty or may be subjected to withholding tax under Article 12. The concept of intangibles for transfer pricing purposes and the definition of royalties for purposes of Article 12 of the OECD Model Tax Convention are two different notions that do not need to be aligned. It may occur that a payment made between associated enterprises may be regarded as not constituting a royalty for purposes of Article 12, and nevertheless be treated for transfer pricing purposes as a payment made in remuneration for intangibles to which the principles of this Chapter apply. Examples could include certain payments related to goodwill or ongoing concern value. It may also occur that a payment properly treated as a royalty under Article 12 of a relevant treaty may not be made in remuneration for intangibles for purposes of this Chapter. Examples could include certain payments for technical services. Similarly, the guidance in this Chapter is not intended to have relevance for customs purposes.

A.3. Categorisation of intangibles

13. In discussions of transfer pricing issues related to intangibles, it is sometimes the case that various categories of intangibles are described and labels applied. Distinctions are sometimes made between trade intangibles and marketing intangibles, between "soft" intangibles and "hard" intangibles, between routine and non-routine intangibles, and between other classes and categories of intangibles. The approach contained in this Chapter for determining arm's length prices in cases involving intangibles does not turn on these categorisations. Accordingly, no attempt is made in these Guidelines to delineate various classes or categories of intangibles.

A.4. Illustrations

14. This section provides illustrations of items often considered in transfer pricing analyses involving intangibles. The illustrations are intended to clarify the provisions of section A.1. The illustrations are not intended to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles. Numerous items not included in this listing of illustrations may be intangibles for transfer pricing purposes. The illustrations in this section should be adapted to the specific legal and regulatory environment that prevails in each country. Furthermore, they should be viewed in the context of the comparability analysis (including the functional analysis) of the controlled transaction with the objective of better understanding how intangibles and items not treated as intangibles contribute to the creation of value.

(i) Patents

15. A patent is a legal instrument that grants an exclusive right to its owner to use a given invention for a limited period of time within a specific geography. A patent may relate to a physical object or to a process. Patentable inventions are often developed through risky and costly research and development activities. In some circumstances, however, small research and development expenditures can lead to highly valuable patentable inventions. The developer of a patent may try to recover its development costs (and earn a return) through the sale of products covered by the patent, by licensing others to use the patented invention, or by an outright sale of the patent. The exclusivity granted by a patent may, under some circumstances, allow the patent owner to earn premium returns from the use of its invention. In other cases, a patented invention may provide cost advantages to the owner that are not available to competitors. Patents are intangibles within the meaning of section A.1.

(ii) Know-how and trade secrets

16. Know-how and trade secrets are proprietary information or knowledge that assist or improve a commercial activity, but that are not registered for protection in the manner of a patent or trademark. Know-how and trade secrets generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise. The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret. The confidential nature of know-how and trade secrets may be protected to some degree (i) under unfair competition or similar laws, (ii) under employment contracts, and (iii) by economic and technological barriers to competition. Know-how and trade secrets are intangibles within the meaning of section A.1.

(iii) Trademarks, trade names and brands

17. A trademark is a unique name, symbol, logo or picture that the owner may use to distinguish its products and services from those of other entities. Proprietary rights in trademarks are generally established through a registration system. The registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace. A trademark registration may continue indefinitely if the trademark is continuously used and the registration appropriately renewed. Trademarks may be established for goods or services, and may apply to a single product or service, or to a line of products or services. Trademarks are perhaps most familiar at the consumer market level, but they are likely to be encountered at all market levels. Trademarks are intangibles within the meaning of section A.1.

18. A trade name (often but not always the name of an enterprise) may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark. The trade

names of certain MNEs may be readily recognised, and may be used in marketing a variety of goods and services. Trade names are intangibles within the meaning of section A.1.

19. The term "brand" is sometimes used interchangeably with the terms "trademark" and "trade name." In other contexts a brand is thought of as a trademark or trade name imbued with social and commercial significance. A brand may, in fact, represent a combination of intangibles including, among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill. It may sometimes be difficult or impossible to segregate or separately transfer the various intangibles contributing to brand value. A brand may consist of a single intangible, or a collection of intangibles, within the meaning of section A.1.

(iv) Licences and similar limited rights in intangibles

20. Rights to use intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licenced rights may be limited as to field of use, term of use, geography or in other ways. Such limited rights in intangibles are themselves intangibles within the meaning of section A.1.

(v) Goodwill and Ongoing Concern Value

21. Depending on the context, the term goodwill can be used to refer to a number of different concepts. In some accounting and business valuation contexts, goodwill reflects the difference between the aggregate value of an operating business and the sum of the values of all separately identifiable tangible and intangible assets. Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognized. In still other contexts goodwill is referred to as the expectation of future trade from existing customers. The term ongoing concern value is sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets. It is generally recognized that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets. See TPG paragraphs 9.93 – 9.95 for a discussion of the related notion of a transfer of all of the elements of an ongoing concern in connection with a business restructuring.

22. It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes. It is important to recognize, however, that the terms goodwill and ongoing concern value are often used to describe an important and monetarily significant part of the compensation paid between independent parties when some or all of the assets of an operating business are transferred. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price. Similarly, when the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise by means of a trademark or other licence that reputational value should be taken into account in determining an appropriate royalty. To assure that such values are taken into account in appropriate situations, goodwill and ongoing concern value are treated as intangibles within the meaning of section A.1. Such treatment in no way implies, however, that the residual measures of goodwill derived for some specific accounting or business valuation purposes are necessarily appropriate measures of the price that would be paid for the transferred business or license rights, together with their associated goodwill and ongoing concern value, by independent parties. In most instances, accounting and business valuation measures of goodwill and ongoing concern value are not relevant for purposes of transfer pricing analysis.

(vi) Group synergies

23. In some circumstances group synergies contribute to the level of income earned by an MNE group. Such group synergies can take many different forms including streamlined management, elimination of costly duplication of effort, integrated systems, purchasing power, etc. Such features may have an effect on the determination of arm's length conditions of controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by a single enterprise, they are not intangibles within the meaning of section A.1.

(vii) Market specific characteristics

24. Specific characteristics of a given market may affect the arm's length conditions of transactions in that market. For example, the high purchasing power of households in a particular market may affect the prices paid for certain luxury consumer goods. Similarly, low prevailing labor costs, proximity to markets, favourable weather conditions and the like may affect the prices paid for specific goods and services in a particular market. Such market specific characteristics may not, however, be owned, controlled and transferred by an individual enterprise. Such items are not intangibles within the meaning of section A.1., and should be taken into account in a transfer pricing analysis through the required comparability analysis. See TPG Chapter III and paragraphs 9.148 – 9.153.

(viii) Assembled workforce

25. Some businesses are successful in assembling a uniquely qualified or experienced cadre of employees. The existence of such an employee group may affect the arm's length price for services provided by the employee group or the efficiency with which services are provided or goods are produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis.

26. Additionally, it should be recognised that:

- Contractual rights and obligations may be intangibles within the meaning of section A.1. so that a long term contractual commitment to make available the services of a particular group of uniquely qualified employees may constitute an intangible in a particular circumstance;

- The transfer of an existing assembled workforce may provide a benefit to the transferee by saving it the expense and difficulty of hiring and training a new workforce, and may affect the compensation required in connection with the transaction;

- While the transfer or secondment of isolated employees does not, in and of itself, constitute the transfer of an intangible, as a factual matter such a transfer may result in the transfer of valuable know-how or trade secrets for which compensation may be required in arm's length dealings.

In each case, the specific facts, as reflected in a detailed functional analysis, should control the transfer pricing outcome.

Working Party No. 6 delegates are uniformly of the view that transfer pricing outcomes in cases involving intangibles should reflect the functions performed, assets used, and risks assumed by the parties. This suggests that neither legal ownership, nor the bearing of costs related to intangible development, taken separately or together, entitles an entity within an MNE group to retain the benefits or returns with respect to intangibles without more. This view is consistent with other sections of the Guidelines and does not reflect an intention to depart from the principles of Article 9.

This approach could be expressed in different ways in the Guidelines. As drafted, Section B., below, identifies a concept of intangible related returns and suggests that such returns should follow the contributions to the value of the intangibles. The same approach could perhaps also be described without reference to a concept of intangible related returns, by requiring the compensation of the various functions, assets and risks of the MNE members to be consistent with the intangible value they create.

Business is requested to comment as to whether the formulation contained in section B. successfully communicates the economic principles at issue, or whether another approach would more clearly convey the message that the determination of returns that are attributable to intangibles within an MNE group should be determined on the basis of relevant functions, assets and risks.

B. Identification of Parties Entitled to Intangible Related Returns

27. A second threshold inquiry in any transfer pricing analysis involving the use or transfer of intangibles involves the identification of the member or members of an MNE group that are entitled to intangible related returns in arm's length transactions. Entitlement to intangible related returns for transfer pricing purposes should be determined on the basis of an analysis of the relevant facts and circumstances present in a particular case. Depending on the facts, more than one party to a transaction involving the use or transfer of intangibles may be entitled to intangible related returns with respect to a given intangible or with respect to different intangibles.

28. As used in Chapter VI, the intangible related return attributable to a particular intangible is the economic return from business operations involving use of that intangible after deducting (i) the costs and expenses related to the relevant business operations; and (ii) returns to business functions, assets other than the particular intangible in question, and risks, taking into account appropriate comparability adjustments. In a particular circumstance, intangible related returns with respect to an intangible may be positive, negative, or zero.

29. In determining which members of an MNE group are entitled to intangible related returns with respect to an intangible, the following factors should be considered: (i) the terms and conditions of legal arrangements including relevant registrations, licence agreements, and other relevant contracts; (ii) whether the functions performed, the assets used, the risks assumed, and the costs incurred by members of the MNE group in developing, enhancing, maintaining and protecting intangibles are in alignment with the allocation of entitlement to intangible related returns in the relevant registrations and contracts; and (iii) whether services rendered, in connection with developing, enhancing, maintaining and protecting intangibles, by other members of the MNE group to the member or members of the MNE group entitled to intangible related returns under the relevant registrations and contracts, are compensated on an arm's length basis under the relevant circumstances.

B.1. Registrations and contractual arrangements

30. Legal registrations and contractual arrangements are the starting point for determining which members of an MNE group are entitled to intangible related returns. The terms of a transaction may be found in written contracts or in correspondence and/or other communications between the parties. Where no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.

31. From a legal perspective, the right to use some types of intangibles may be protected under specific intellectual property laws and registration systems. Patents, trademarks, and copyrights are examples of such intangibles. In general terms, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible and has the right to prevent others from using the intangible. These legal rights may be granted for a specific geographic area and/or for a specific period of time.

32. There are also intangibles that are not protectable under specific intellectual property registration systems, but are legally protected against unauthorised appropriation or imitation via unfair competition legislation or other enforceable laws, or by means of employment contracts. Trade dress, trade secrets, and know-how may fall under this category of intangibles. There may also be intangibles whose use is not protected under any applicable law.

33. The conditions and extent of the available protection under applicable law may vary from country to country. For instance, depending on local law, availability of legal protection may be subject to continued commercial use of the intangible or timely renewal of registrations.

34. It is often the case that an entity legally entitled to exclude others from using intangibles will enter into contracts making full or partial rights to use the intangibles available to others. A licence or other grant of partial rights can be limited in a number of ways (including as to geographical scope, time period, or class of products), and may be granted on an exclusive or non-exclusive basis. Such contracts may impose restrictions on the use, exploitation, reproduction, further transfer, and further development of the intangibles. In assessing the respective entitlements of members of an MNE group to intangible related returns, it is important to examine the specific terms of such agreements and of the restrictions imposed in the agreements, if any.

35. Except as otherwise provided in this section B. or in section C., below, where the relevant registrations and contractual arrangements are in alignment with the conduct of the parties, the entity entitled to use the intangible and to exclude others from using the intangible, under applicable law and under relevant contracts, is the entity entitled to intangible related returns with respect to that intangible for transfer pricing purposes. In the case of a licence or similar arrangement, the licensee will be the entity entitled to intangible related returns attributable to its licenced rights, subject to its obligation to provide arm's length compensation for the grant of the licence.

36. Because legal registrations and relevant contracts form the starting point for an analysis of which members of an MNE group are entitled to intangible related returns, it is good practice for associated enterprises to document in writing their decisions to allocate significant rights in intangibles before the time transactions leading to the development, enhancement, maintenance, or protection of intangibles occur.

B.2. Functions, risks, and costs related to intangibles

37. In evaluating which members of an MNE group are entitled to intangible related returns, it is important to examine whether the conduct of the parties is in alignment with the terms of the legal

registrations and contracts or whether the parties' conduct indicates that the legal forms and contractual terms have not been followed. When evaluating the alignment between a contractual claim to entitlement to all or part of the intangible related returns attributable to an intangible, and the conduct of the parties, examination of functions, risks, and costs related to the development, enhancement, maintenance and protection of the intangibles is necessary. Where the conduct of the parties is not aligned with the terms of legal registrations and contracts, it may be appropriate to allocate all or part of the intangible related returns to the entity or entities that, as a matter of substance, perform the functions, bear the risks, and bear the costs that relate to development, enhancement, maintenance and protection of the intangibles. The parties' conduct should generally be taken as the best evidence concerning the true allocation of entitlement to intangible related returns.

(i) Functions

38. Where the parties' conduct is aligned with the terms of registrations and contracts, the member of the MNE group contractually entitled to intangible related returns will either perform the functions related to the development, enhancement, maintenance and protection of the intangible, or arrange to have such functions performed under its control by independent enterprises or by associated enterprises dealing on an arm's length basis. Where intangibles are transferred, in a transaction where contractual rights and conduct are aligned, such functions will be performed or controlled by the transferee following the transfer.

39. The specific functions that should be examined in evaluating entitlement to intangible related returns will depend on the particular facts of a case. Functions leading to the development of intangibles, including research and development functions leading to the development and enhancement of product related intangibles, and sales and marketing functions leading to the development and enhancement of trademarks and related intangibles will be especially important in evaluating which members of an MNE group are entitled to intangible related returns. Functions related to preserving the legal protections accorded to intangibles and the defence of intangibles against infringement similarly are often important.

40. It is not essential that the party claiming entitlement to intangible related returns physically performs all of the functions related to the development, enhancement, maintenance and protection of intangibles through its own employees. In transactions between independent enterprises, some of these functions are sometimes outsourced to other entities. A member of an MNE group claiming entitlement to intangible related returns could similarly be expected to retain, in some cases, either independent enterprises or associated enterprises transacting on an arm's length basis to perform certain functions related to the development, enhancement, maintenance and protection of intangibles. It is expected, however, that where functions are in alignment with claims to intangible related returns in contracts and registrations, the entity claiming entitlement to intangible related returns will physically perform, through its own employees, the important functions related to the development, enhancement, maintenance and protection of the intangibles. Depending on the facts and circumstances, these functions would generally include, among others, design and control of research and marketing programmes, management and control of budgets, control over strategic decisions regarding intangible development programmes, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible.

41. Moreover, where associated enterprises are retained to perform functions related to the development, enhancement, maintenance or protection of intangibles, it is expected that, in a situation where contractual entitlements and functions are in alignment, the party or parties claiming contractual entitlement to intangible related returns will exercise control over the performance of those functions and the associated risks, will bear the necessary costs required to support the performance of the function, and will provide arm's length compensation to any associated enterprise physically performing a relevant

function. In assessing whether the member of the MNE group claiming entitlement to intangible related returns in fact controls the performance of the relevant functions, principles analogous to those of paragraphs 9.23 through 9.28 should be applied.

(ii) Risks

42. Where the conduct of the parties is aligned with the terms of relevant registrations and contracts, the member or members of the MNE group entitled to intangible related returns will bear and control the risks associated with the development, enhancement, maintenance and protection of the intangibles. Where intangibles are transferred, in a transaction where contractual rights and conduct are aligned, such risks will be borne and controlled by the transferee following the transfer. See TPG paragraph 9.23-9.28.

43. Particular types of risk that may have importance in considering the entity or entities entitled to intangible related returns include (i) risks related to development of intangibles including the risk that costly research and development or marketing activities will prove to be unsuccessful; (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risk, including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming and/or costly; and (iv) product liability and similar risks related to products and services based on the intangibles.

44. It is especially important, in assessing the degree of alignment between contractual allocations of the entitlement to intangible related returns among members of the MNE group and the members' conduct, to determine whether costs incurred when relevant risks come to fruition are in fact borne by the entity claiming entitlement to intangible related returns. Where there is a mismatch between the contractual allocation among associated enterprises of entitlement to intangible related returns, and the allocation among those associated enterprises of related risk-associated costs, an arrangement will not have the requisite level of alignment between actual conduct and the contractual allocation of intangible related returns.

45. In assessing which members of an MNE group bear risks associated with entitlement to intangible related returns, the principles of paragraphs 9.10 through 9.46 apply.

(iii) Costs related to development, enhancement, maintenance and protection of intangibles

46. Where the parties' conduct is aligned with the terms of registrations and contracts, costs incurred to develop, enhance, maintain and protect intangibles should be borne by the member or members of the MNE group claiming entitlement to intangible related returns. It will therefore be important in evaluating entitlement to intangible related returns to consider which entities have borne the relevant costs. In some circumstances, bearing the relevant costs may involve providing arm's length compensation to associated enterprises for functions performed by such associated enterprises under the control of the member of the MNE group claiming contractual entitlement to intangible related returns.

47. It is important to recognise, however, that bearing costs related to the development, enhancement, maintenance and protection of intangibles does not, in and of itself, create an entitlement to intangible related returns.

B.3. Arm's length compensation for functions performed by associated enterprises related to the development, enhancement, maintenance or protection of intangibles

48. One condition for concluding that the contractual and other arrangements of an MNE group related to entitlement to intangible related returns are aligned with the conduct of the parties is that associated enterprises that perform functions related to the development, enhancement, maintenance or

protection of intangibles, but do not claim entitlement to intangible related returns, be provided with arm's length compensation for the functions they perform. In evaluating whether associated enterprises retained to perform functions related to the development, enhancement, maintenance and protection of intangibles have been compensated on an arm's length basis, it is necessary to consider both the amount of compensation paid and the level of activity undertaken. Reference should be made to both the level of activity and the compensation received by comparable uncontrolled entities performing similar functions in assessing whether the compensation provided is consistent with the arm's length principle.

49. A common situation where these principles must be applied relates to the performance of marketing functions by associated enterprises other than the member of the MNE group asserted, under legal registrations and contracts, to be entitled to intangible related returns attributable to trademarks and related customer oriented intangibles (*e.g.* a marketing and/or distribution arrangement). In such a case it is necessary to determine how the marketer/distributor should be compensated for its activities. One important issue is whether the marketer/distributor should be compensated as a service provider, *i.e.* for providing promotion and distribution services, or whether the marketer/distributor should share in any present and future intangible related returns attributable to the trademarks and related intangibles.

50. The analysis of this issue requires an assessment of the obligations and rights implied by the legal registrations and agreements between the parties, of the functions undertaken, the risks assumed, the assets used, and the costs incurred by the parties, and of the compensation provided for the functions, risks, assets and costs of the marketer/distributor. It will often be the case that the return on marketing functions, risks, assets and costs will be sufficient and appropriate. One relatively clear case is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures and being directed and controlled in its activities by the entity claiming entitlement to intangible related returns with respect to the trademarks and related intangibles. In that case, the distributor ordinarily would be entitled to compensation appropriate to its agency activities alone. It would not bear or control the risks associated with the development of the trademark and other intangibles, and would therefore not be entitled to share in any intangible related returns.

51. Where the distributor actually bears the cost of its marketing activities (*i.e.* there is no arrangement for the owner to reimburse the expenditures), the issue is the extent to which the distributor is able to share in the potential benefits deriving from its functions, assets, risks and costs currently or in the future. In general, in arm's length transactions the ability of a party that is not the registered or legal owner of trademarks and related intangibles to obtain the benefits of marketing activities that increase the value of those intangibles will depend principally on the substance of the rights of that party. For example, a distributor may have the ability to obtain benefits from its functions performed, assets used, risks borne, and costs incurred in developing the value of a trademark from its turnover and market share where it has a long-term contract of sole distribution rights for the trademarked product. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would obtain in comparable circumstances. In some cases, a distributor may incur marketing costs, incur risks, or perform functions beyond those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities. An independent distributor in such a case might obtain a share of the intangible related returns of the owner of the trademark or related intangibles, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate in order to compensate it for its functions, assets, risks and costs.

52. The principles set out in the foregoing paragraphs also apply in situations involving the performance of research and development functions by a member of an MNE group under a contractual arrangement with an associated enterprise that claims entitlement to intangible related returns. Those principles similarly apply in situations where a member of an MNE group provides manufacturing services

on behalf of an associated enterprise that claims entitlement to intangible related returns and the manufacturing service provider engages in functions that may lead to process or product improvements.

B.4. Disregard of transactions, registrations and contracts

53. In the extraordinary circumstances described in paragraphs 1.64 – 1.69, contractual allocations of entitlement to intangible related returns may be disregarded by tax authorities notwithstanding the fact that the registrations and contractual entitlements are fully in alignment with the functions, risks and costs related to the development, enhancement, maintenance and protection of the intangibles. See TPG paragraphs 9.164 – 9.167.

B.5. Transfer pricing adjustments in cases involving entitlement to intangible related returns

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

- Perform and control important functions related to the development, enhancement, maintenance and protection of the intangibles and control other related functions performed by independent enterprises or associated enterprises that are compensated on an arm's length basis;

- Bear and control the risks and costs related to developing and enhancing the intangible; and,

- Bear and control risks and costs associated with maintaining and protecting its entitlement to intangible related returns.

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

55. Where relevant functions, risks, and costs are in alignment with legal registrations and the terms of relevant contracts, the contractual allocation of entitlement to intangible related returns should generally be respected by tax authorities and transfer pricing determinations should be made on the basis of that contractual allocation of intangible related returns. Where such risks, functions, and costs are not in alignment with contractual allocations, part or all of the intangible related returns may be allocated to parties performing such functions and bearing such risks, and transfer pricing adjustments may be appropriate to assure that each member of the group is properly rewarded for its risks, functions and costs.

B.6. Illustrations

56. For examples illustrating the application of the principles contained in this section B, see Examples 1 through 11 in the Annex to Chapter VI.

C. Transactions involving the use or transfer of intangibles

57. In addition to identifying with specificity the intangibles involved in a particular transfer pricing matter, and identifying which member or members of the MNE group are entitled to intangible related returns arising from the use or transfer of such intangibles, a third threshold issue needs to be addressed at the beginning of any transfer pricing analysis of controlled transactions involving the use or transfer of intangibles. This issue involves the identification and proper characterisation of the specific controlled

transactions involving intangibles. The principles of Chapter I apply in identifying and characterising transactions involving the use or transfer of intangibles. The characterisation of a transaction for transfer pricing purposes has no relevance for determinations under Article 12 of the OECD Model Tax Convention. See paragraph 12 of the OECD Model Tax Convention.

58. There are two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes. These two categories of transactions are described in this section.

C.1. Transactions involving the use of intangibles in connection with sales of goods or services

59. In the first type of transaction, intangibles may be used in connection with controlled transactions in situations where there is no transfer of the intangible or of rights in the intangible. For example, intangibles may be used by one or both parties to a controlled transaction in connection with the manufacture of goods sold to an associated enterprise, in connection with the marketing of goods purchased from an associated enterprise, or in connection with the performance of services on behalf of an associated enterprise. The nature of such a transaction should be clearly specified, and any intangibles used by one of the parties in connection with such a controlled transaction should be identified and taken into account in the comparability analysis (including the functional analysis), in the selection and application of the most appropriate transfer pricing method for that transaction, and in the choice of the tested party. See paragraphs 1.39, 1.42, 1.44, 2.109 and 3.18.

60. The need to consider the use of intangibles by a party to a controlled transaction involving a sale of goods can be illustrated as follows. Assume that a car manufacturer uses valuable proprietary patents to manufacture the cars that it then sells to associated distributors. Assume that the patents significantly contribute to the value of the cars. The patents and the value they contribute should be taken into account in the comparability analysis of the transaction consisting in the sales of cars by the car manufacturer to its associated distributors, in selecting the most appropriate transfer pricing method for the transactions, and in selecting the tested party. The associated distributors purchasing the cars do not, however, acquire any right in the manufacturer's patents. In such a case, the patents are used in the manufacturing and may affect the value of the cars, but the patents themselves are not transferred.

61. As another example of the use of intangibles in connection with a controlled transaction, assume that an exploration company has acquired or developed valuable geological data and analysis, and sophisticated exploratory software and know-how. Assume further that it uses those intangibles in providing exploration services to an associated enterprise. Those intangibles should be taken into account in the comparability analysis of the service transactions between the exploration company and the associated enterprise, in selecting the most appropriate transfer pricing method for the transaction, and in selecting the tested party. Assuming that the associated enterprise of the exploration company does not acquire any rights in the exploration company's intangibles, the intangibles are used in the performance of the services, but are not transferred.

C.2. Transactions involving transfers of intangibles

(i) Transfers of intangibles or rights in intangibles

62. In the second type of transaction, rights in intangibles themselves may be transferred in controlled transactions. Such a transfer may encompass all the rights in the intangibles in question (*e.g.* a sale of the intangible) or only limited rights (*e.g.* a licence or similar transfer of rights to use an intangible which may be subject to geographical restrictions, limited duration, restrictions with respect to the right to use, exploit, reproduce, further transfer, further develop).

63. In transactions involving the transfer of intangibles or rights in intangibles, it is essential to identify with specificity the nature of the intangibles and rights in intangibles that are transferred between associated enterprises. Where limitations are imposed on the rights transferred, it is also essential to identify the nature of such limitations and the full extent of the rights transferred.

64. Restrictions imposed in licence and similar agreements on the use of an intangible in the further development of new intangibles or new products using the intangibles are often of significant importance in a transfer pricing analysis. It is therefore important in identifying the nature of a transfer of rights in intangibles to consider whether the transferee receives the right to use the transferred intangible for the purpose of further product development. In transactions between unrelated parties, arrangements are observed where the transferor/licensor retains the full right to any enhancements of the licensed intangible that may be developed during the term of the licence. Transactions between unrelated parties are also observed where the transferee/licensee retains the right to any enhancements it may develop, either for the term of its license or in perpetuity. The nature of any limitations on further development of transferred intangibles, or on the ability of the transferee and the transferor to derive an economic benefit from such enhancements, can affect the value of the rights transferred and the comparability of two transactions involving otherwise identical or closely comparable intangibles.

65. The provisions of paragraphs 1.52 – 1.54 and paragraphs 1.64 – 1.69 apply in identifying the specific nature of a transaction involving a transfer of intangibles, in identifying the nature of any intangibles transferred, and in identifying any limitations imposed by the terms of the transfer on the use of those intangibles. For example, under paragraphs 1.52 – 1.54, a written specification that a licence is non-exclusive or of limited duration need not be respected by the tax authority if such specification is not consistent with the conduct of the parties.

(ii) Transfers of combinations of intangibles

66. Intangibles (including limited rights in intangibles) may be transferred individually or in combination with other intangibles. In considering transactions involving transfers of combinations of intangibles, two related issues often arise.

67. The first of these involves the nature and economic consequences of interactions between different intangibles. It may be the case that some intangibles are more valuable in combination with other intangibles than would be the case if the intangibles were considered separately. It is therefore important to identify the nature of the legal and economic interactions between intangibles that are transferred in combination.

68. For example, a pharmaceutical product will often have associated with it three or more types of intangibles. The active pharmaceutical ingredient may be protected by one or more patents. The product will also have been through a testing process and a government regulatory authority may have issued an approval to market the product in a given geographic market and for specific approved indications based on that testing. The product may be marketed under a particular trademark. In combination these intangibles may be extremely valuable. In isolation, one or more of them may have much less value. For example, the trademark without the patent and regulatory marketing approval may have limited value since the product could not be sold without the marketing approval and generic competitors could not be excluded from the market without the patent. Similarly, the value of the patent may be much greater once regulatory marketing approval has been obtained than would be the case in the absence of the marketing approval. The interactions between each of these classes of intangibles, as well as which parties incurred the risks and costs associated with securing the intangibles, are therefore very important in performing a transfer pricing analysis with regard to a transfer of the intangibles. It is important to consider the relative contribution to the value creation where different associated enterprises hold rights in the intangibles used.

69. A second and related issue involves the importance of assuring that all intangibles transferred in a particular transaction have been identified. It may be the case, for example, that intangibles are so intertwined that it is not possible, as a substantive matter, to transfer one without transferring the other. Indeed, it will often be the case that a transfer of one intangible will necessarily imply the transfer of other intangibles. In such cases it is important to identify all of the intangibles made available to the transferee as a consequence of an intangibles transfer, applying the principles of paragraphs 1.52 – 1.54.

70. Similarly, it is important to identify situations where taxpayers or tax authorities may seek to artificially separate intangibles that, as a matter of substance, cannot be separated.

(iii) Transfers of intangibles in combination with other business transactions

71. In some situations intangibles may be transferred in combination with tangible business assets, or in combination with services. It is important in such a situation to determine whether intangibles have in fact been transferred in connection with the transaction. It is also important that all of the intangibles transferred in connection with a particular transaction be identified and taken into account in the transfer pricing analysis.

72. In some situations it may be both possible and appropriate to separate transactions in tangible goods or services from transfers of intangibles or rights in intangibles for purposes of conducting a transfer pricing analysis. In these situations the price of a package contract should be disaggregated in order to confirm that each element of the transaction is consistent with the arm's length principle. In other situations transactions may be so closely related that it will be difficult to segregate tangible goods or service transactions from transfers of intangibles.

73. One situation where transactions involving transfers of intangibles may be combined with other transactions involves a so-called business franchise arrangement. Under such an arrangement, one member of an MNE group may agree to provide a combination of services and intangibles to an associated enterprise in exchange for a single fee. If the nature of the services and intangibles made available under such an arrangement are sufficiently unique that reliable comparables cannot be identified for the entire service/intangible package, it may be necessary to segregate the various parts of the package of services and intangibles for separate transfer pricing consideration. It should be kept in mind, however, that the interactions between various intangibles and services may enhance the value of both.

74. In other situations, the provision of a service and the transfer of one or more intangibles may be so closely intertwined that it is difficult to separate the transactions for purposes of a transfer pricing analysis. For example, some transfers of rights in software may be combined with an undertaking by the transferor to provide ongoing software maintenance services, which may include periodic updates to the software. In situations where services and transfers of intangibles are intertwined, determining arm's length prices on an aggregate basis may be necessary.

75. It should be emphasised that the characterisation of the transaction as the provision of products or services or the transfer of intangibles or a combination of both does not necessarily dictate the use of a particular transfer pricing method. For example, a cost plus approach will not be appropriate for all service transactions, and not all intangibles transactions require complex valuations or the application of profit split methods. The facts of each specific situation, and the results of the required functional analysis, will guide the manner in which transactions are combined, characterised and analysed for transfer pricing purposes, as well as the selection of the most appropriate transfer pricing method in a particular case. The ultimate objective is to identify the prices and other conditions that would be established between unrelated persons in comparable transactions.

C.3. Illustrations

76. For illustrations of the principles set out in this Section C., see Examples 12 through 17 in the Annex to Chapter VI.

D. Determining Arm's Length Conditions in Cases Involving Intangibles

77. After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, and identifying which entity or entities are entitled to intangible related returns with respect to those intangibles, it should be possible to identify arm's length conditions for the relevant transactions. The principles set out in Chapters I through III of these Guidelines should be applied in determining arm's length conditions for transactions involving the use or transfer of intangibles. In particular, the recommended nine-step process set out in paragraph 3.4 can be helpful in identifying arm's length conditions for transactions involving the use or transfer of intangibles. As an essential part of applying the principles of Chapter III to conduct a comparability analysis under the process described in paragraph 3.4, the principles contained in sections A., B., C., D.1., and D.2. of this Chapter should be considered.

78. However, the principles of Chapters I through III can sometimes be difficult to apply to controlled transactions involving the use or transfer of intangibles. Intangibles may have a special character complicating the search for comparables, and in some cases making value difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. See paragraph 1.11. This section D. describes special considerations that may arise in applying the principles of Chapters I through III to determine arm's length conditions for controlled transactions involving the use or transfer of intangibles.

D.1. Conducting a comparability analysis in a matter involving intangibles

(i) In general

79. Paragraphs 1.33 through 1.63 and Chapter III contain principles to be considered and a recommended process to be followed in conducting a comparability analysis. The principles described in those sections of the Guidelines apply to controlled transactions involving the use or transfer of intangibles.

80. In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving the use or transfer of intangibles, a transfer pricing analysis must consider the options realistically available to each of the parties to the transaction. In considering the realistically available options of the parties to a transaction, the principles of paragraphs 9.59 through 9.64 should be applied.

81. In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A one-sided comparability analysis does not provide a sufficient basis for evaluating a transaction involving the use or transfer of intangibles.

82. While it is important to consider the perspectives of both parties to the transaction in conducting a comparability analysis, the specific business circumstances of one of the parties should not be used to dictate an outcome contrary to the realistically available options of the other party. For example, a transferor would not be expected to accept a price for the transfer of an intangible or rights in the intangible that is lower than its other realistically available options (including making no transfer at all), merely because a particular associated enterprise transferee lacks the resources to effectively exploit the

transferred intangible. Similarly, a transferee should not be expected to accept a price for a transferred intangible that would make it impossible for the transferee to anticipate earning a profit using the intangible in its business. Such an outcome would be less favourable to the transferee than its realistically available option of not engaging in the transfer at all.

83. It will often be the case that a price for a transaction can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations, at least on an after tax basis. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34 – 9.38 or 9.122 should be applied, or whether the conditions of the transaction should otherwise be adjusted. This discussion highlights the importance of taking all relevant facts and circumstances into account in the comparability analysis.

(ii) Intangibles as a comparability factor in transactions involving the use of intangibles

84. While the general rules of paragraphs 1.33 – 1.63 and Chapter III apply to guide the comparability analysis, the use of intangibles in connection with a controlled transaction involving the sale of goods or the performance of services may raise challenging comparability issues.

85. In a transfer pricing analysis where the most appropriate transfer pricing method is the resale price method, the cost-plus method, or the transactional net margin method, the less complex of the parties to the controlled transaction is often selected as the tested party. In many cases, an arm’s length price or level of profit for the tested party can be determined without the need to value the intangibles used in connection with the transaction. That would generally be the case where only the non-tested party uses intangibles. In some cases, however, the tested party may in fact use intangibles and be entitled to the intangible related returns with respect to such intangibles notwithstanding its relative lack of complexity. Similarly, parties to potentially comparable uncontrolled transactions may use intangibles. Where either of these is the case, it becomes necessary to consider the intangibles used by the tested party and by the parties to potentially comparable uncontrolled transactions as one comparability factor in the analysis.

86. For example, a tested party engaged in the marketing and distribution of goods purchased in controlled transactions may have developed trademarks and related intangibles in its geographic area of operation, including customer lists and customer relationships. It may also have developed advantageous logistical know-how or software and other tools that it uses in conducting its distribution business. The impact of such intangibles on the profitability of the tested party should be considered in conducting a comparability analysis.

87. It is important to note, however, that in many cases where the tested party uses such intangibles, parties to comparable uncontrolled transactions will also have the same types of intangibles at their disposal. Thus, in the distribution company case, an uncontrolled entity engaged in providing distribution services in the tested party’s industry and market is also likely to have knowledge of and contacts with potential customers, have its own effective logistical systems, and in other respects have similar intangibles to the tested party. Where that is the case, the level of comparability may be sufficiently high that it is possible to rely on prices paid or margins earned by the potential comparables as an appropriate measure of arm’s length compensation for both the functions performed and the intangibles owned by the tested party.

88. Where the tested party and the potential comparable have similar intangibles, no comparability adjustments will be required. However, if either of them have and use in their business section D.1.(vi)

intangibles, it may be necessary either to make appropriate comparability adjustments or to revert to a different transfer pricing method. (See section D.1.(iii) for matters to be considered in evaluating comparability of intangibles).

89. It is appropriate for both taxpayers and tax administrations to exercise restraint in rejecting potential comparables based on the use of intangibles by either the parties to potentially comparable transactions or by the tested party. Potential comparables should generally not be rejected on the basis of the asserted existence of unspecified intangibles or on the basis of the asserted significance of goodwill. If identified transactions or companies are otherwise comparable, they may provide the best available indication of arm's length pricing notwithstanding the existence and use by either the tested party or the parties to the potentially comparable transactions of relatively insignificant intangibles. Potentially comparable transactions should be disregarded on the basis of the existence and use of non-comparable intangibles only where the intangibles in question can be clearly and distinctly identified and where the intangibles are manifestly section D.1.(vi) intangibles.

(iii) Comparability of intangibles and rights in intangibles

90. In transactions involving the use or transfer of intangibles or rights in intangibles, the comparability of the intangibles themselves must be considered. Particularly where the CUP method is considered to be the most appropriate transfer pricing method, the comparability of the transferred intangible to intangibles transferred in potentially comparable uncontrolled transactions must be evaluated. Intangibles often have unique characteristics and, as a result, have the potential for generating returns and creating future benefits that differ widely. Moreover, grants of rights to use intangibles may have important limitations that have a direct and important bearing on the price that would be paid for such rights. In conducting a comparability analysis with regard to a transfer of intangibles or rights in intangibles, it is essential to consider the unique features of the intangibles and the specific terms of the transfers, including the nature of any limitations on the rights of the transferee to use the intangibles following the transfer.

91. Set out below is a description of some of the specific features of intangibles that may prove important in a comparability analysis. The following list is not exhaustive and in a specific case consideration of additional or different factors may be an essential part of a comparability analysis.

(a) Exclusivity

92. Whether the rights in intangibles relevant to a particular transaction are exclusive or non-exclusive can be an important comparability consideration. Some intangibles allow the party entitled to intangible related returns to exclude others from using the intangible. A patent, for example, grants an exclusive right to use the invention covered by the patent for a period of years. If the party controlling intangible rights can exclude other enterprises from the market, or exclude them from using intangibles that provide a market advantage, that party may have a degree of market power or market influence. A party with non-exclusive rights to intangibles will not be able to exclude all competitors and will generally not have the same degree of market power or influence. Accordingly, the exclusive or non-exclusive nature of intangibles or rights in intangibles should be considered in connection with the comparability analysis.

(b) Extent and duration of legal protection

93. The extent and duration of legal protection of the intangibles relevant to a particular transaction can be an important comparability consideration. Legal protections associated with some intangibles can prevent competitors from entering a particular market. For other intangibles, such as know-how or trade

secrets, available legal protections may have a different nature and not be as strong or last as long. For intangibles with limited useful lives, the duration of legal protections can be important since the duration of the intangible rights will affect the expectation of the parties to a transaction with regard to the future benefits attributable to the intangible. For example, two otherwise comparable patents will not have equivalent value if one expires at the end of one year while the other expires only after ten years.

(c) Geographic scope

94. The geographic scope of the intangibles or rights in intangibles will be an important comparability consideration. A global grant of rights to intangibles may be more valuable than a grant limited to one or a few countries, depending on the nature of the product, the nature of the intangible, and the nature of the markets in question.

(d) Useful life

95. Many intangibles have a limited useful life. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded to the intangible, as noted above. The useful life of some intangibles can also be affected by the rate of technological change in an industry and by the development of new and potentially improved products. It may also be the case that the useful life of particular intangibles can be extended.

96. In conducting a comparability analysis, it will therefore be important to consider the expected useful life of the intangibles in question. In general, intangibles expected to provide market advantages for a longer period of time will be more valuable than similar intangibles providing such advantages for a shorter period of time, other things being equal. In evaluating the useful life of intangibles it is also important to consider the use being made of the intangible. For example, if an intangible is used as a base for ongoing research and development, the commercial life of the current generation product line relying on that intangible may not be the relevant inquiry.

(e) Stage of development

97. In conducting a comparability analysis, it may be important to consider the stage of development of particular intangibles. It is often the case that an intangible is transferred in a controlled transaction at a point in time before it has been fully demonstrated that the intangible will support commercially viable products. A common example arises in the pharmaceutical industry, where chemical compounds may be patented, and the patents (or rights to use the patents) transferred in controlled transactions, well in advance of the time when further research, development and testing demonstrates that the compound constitutes a safe and effective treatment for a particular medical condition.

98. As a general rule, intangibles relating to products with established commercial viability will be more valuable than otherwise comparable intangibles relating to products whose commercial viability is yet to be established. In conducting a comparability analysis involving partially developed intangibles, it is important to evaluate the likelihood that further development will lead to commercially significant future benefits. In certain circumstances, industry averages regarding the risks associated with further development can be helpful to such evaluations. However, the specific circumstances of any individual situation should always be considered.

(f) Rights to enhancements, revisions, and updates

99. Often, an important consideration in a comparability analysis involving intangibles relates to the rights of the parties with regard to future enhancements, revisions and updates of the intangibles. Products protected by intangibles can become obsolete or uncompetitive in a relatively short period of time in the

absence of continuing development and enhancement of the intangibles. As a result, having access to updates and enhancements can be the difference between deriving a short term advantage from the intangibles and deriving a longer term advantage. It is therefore necessary to consider for comparability purposes whether or not a particular grant of rights in intangibles includes access to enhancements, revisions, and updates of the intangibles.

100. A very similar question, often important in a comparability analysis, involves whether the transferee of intangibles obtains the right to use the intangibles in connection with research directed to developing new and enhanced intangibles. For example, the right to use an existing software platform as a basis for developing new software products can shorten development times and can make the difference between being the first to market with a new product or application, or being forced to enter a market already occupied by established competitive products. A comparability analysis with regard to intangibles should, therefore, consider the rights of the parties regarding the use of the intangibles in developing new and enhanced versions of products.

(g) Expectation of future benefit

101. Each of the foregoing comparability considerations has a consequence with regard to the expectation of the parties to a transaction regarding the future benefits to be derived from the use of the intangibles in question. If for any reason there is a significant discrepancy between the anticipated future benefit of using one intangible as opposed to another, it is difficult to consider the intangibles as being sufficiently comparable to support a comparables-based transfer pricing analysis in the absence of reliable comparability adjustments. Specifically, it is important to consider the actual and potential profitability of products or potential products that are based on the intangible. Intangibles that provide a basis for high profit products or services are not likely to be comparable to intangibles that support products or services with only industry average profits. Any factor materially affecting the expectation of the parties to a controlled transaction of obtaining future benefits from the intangible should be taken into account in conducting the comparability analysis.

(iv) Comparison of risk in cases involving intangibles

102. In conducting a comparability analysis where intangibles are present, the existence of risks related to the likelihood of obtaining future economic benefits from the intangibles must be considered. The following types of risks, among others, should be considered in evaluating whether intangibles or combinations of intangibles are comparable.

- Risks related to the future development of the intangibles. This includes an evaluation of whether the intangibles relate to commercially viable products, whether the intangibles may support commercially viable products in the future, the expected cost of required future development and testing, the likelihood that such development and testing will prove successful and similar considerations. The consideration of development risk is particularly important in situations involving partially developed intangibles.

- Risks related to product obsolescence and depreciation in the value of the intangibles. This includes an evaluation of the likelihood that competitors will introduce products or services in the future that would materially erode the market for products dependent on the intangibles being analysed.

- Risks related to infringement of the intangible rights. This includes an evaluation of the likelihood that others might successfully claim that products based on the intangibles infringe their own intangible rights and an evaluation of the likely costs of defending against such claims. It also includes an evaluation of the likelihood that the holder of intangible rights could successfully prevent others from infringing the intangibles, including the risk that counterfeit products could erode the profitability of relevant markets.

- Product liability and similar risks related to the future use of the intangibles.

(v) Comparability adjustments with regard to intangibles

103. The principles of paragraphs 3.47 – 3.54 relating to comparability adjustments apply with respect to transactions involving the use or transfer of intangibles. It is important to note that differences between intangibles can have significant economic consequences that may be difficult to adjust for in a reliable manner. Particularly in situations where amounts attributable to comparability adjustments represent a large percentage of the compensation for the intangible, there may be reason to believe that the computation of the adjustment is not reliable and that the intangibles being compared are in fact not sufficiently comparable to support a valid transfer pricing analysis. If reliable comparability adjustments are not possible, it may be necessary to select a transfer pricing method that is less dependent on the identification of comparable intangibles or comparable transactions.

104. Comparability, and the possibility of making comparability adjustments, is especially important in considering potentially comparable intangibles and related royalty rates drawn from commercial data bases or proprietary compilations of publicly available licence or similar agreements. The principles of paragraphs 3.30 through 3.34 apply fully in assessing the usefulness of transactions drawn from such sources. In particular, it is important to assess whether publicly available data drawn from commercial data bases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific features of intangibles described above that may be important in conducting a comparability analysis.

(vi) Section D.1.(vi) intangibles

105. An intangible (i) that is not similar to intangibles used by or available to parties to potentially comparable transactions, (ii) whose use in business operations (e.g. in manufacturing, provision of services, marketing, sales, or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible, and (iii) whose use or transfer would be remunerated in dealings between independent parties, will be referred to as a Section D.1.(vi) intangible.

D.2. Selecting the most appropriate transfer pricing method in a matter involving the use or transfer of intangibles

(i) In general

106. The principles of these Guidelines related to the selection of the most appropriate transfer pricing method to the circumstances of the case are described in paragraphs 2.1 through 2.11. Those principles apply fully to cases involving the use or transfer of intangibles. The nature of intangibles, the difficulty of identifying comparable uncontrolled transactions for all intangibles, and the difficulty of applying certain transfer pricing methods in cases involving intangibles, require consideration of several issues in connection with the selection of transfer pricing methods under the Guidelines.

107. In applying the principles of paragraphs 2.1 through 2.11 to matters involving the use or transfer of intangibles, it is important to recognise that transactions structured in different ways may have similar economic consequences. For example, the performance of a service using intangibles may have very similar economic consequences to a transaction involving the transfer of an intangible (or the transfer of rights in the intangible). Accordingly, in selecting the most appropriate transfer pricing method in

connection with a transaction involving the use or transfer of intangibles, it is important to consider the economic consequences of the transactions, rather than proceeding on the basis of an arbitrary label.

108. In matters involving the use or transfer of intangibles, caution should be exercised in adopting a transfer pricing methodology that too readily assumes that all residual profit from transactions after routine functional returns should necessarily be allocated to the party entitled to intangible related returns. The selection of the most appropriate transfer pricing method should be based on a functional analysis that provides a clear understanding of the MNE's global business processes and how intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify other factors that contribute to value creation, which may include risks borne, specific market characteristics, location, business strategies, and MNE group synergies among others. The transfer pricing method selected, and any adjustments incorporated in that method based on the comparability analysis, should appropriately reflect all of the relevant factors materially contributing to the creation of value, not merely reflect intangibles and routine functions.

(ii) Use of valuation techniques

109. Some valuation techniques drawn from financial valuation practice may have application both in cases involving the use of intangibles in connection with sales of goods or services, and in cases involving transfers of intangibles or rights in intangibles. Depending on the circumstances, they may be used either as a part of one of the five OECD approved methods described in Chapter II (e.g. in determining how to split profits as part of a transactional profit split method), or as a tool that can be usefully applied in identifying an arm's length price. The application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows, may be particularly useful when properly applied and when based on appropriate assumptions. Sections D.3. and D.4. of this Chapter provide further guidance regarding the application of valuation techniques for transfer pricing purposes.

110. While some valuation techniques may be useful analytical tools in matters involving the use or transfer of intangibles, caution should be used in applying such techniques. In particular, it is important to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes be biased in favour of conservative estimates of the value of assets reflected in a company's balance sheet. This inherent conservatism can lead to definitions that are too narrow for transfer pricing purposes and to valuation approaches that are not necessarily consistent with the arm's length principle. Caution should therefore be exercised in accepting valuations performed for accounting purposes as necessarily reflecting arm's length prices or values for transfer pricing purposes without a thorough examination of the underlying assumptions. In particular, valuations of intangibles contained in purchase price allocations performed for accounting purposes are not relevant for transfer pricing purposes.

111. It is essential to consider the purpose for which a valuation is conducted. Valuations conducted for business planning purposes may be either more or less relevant than valuations conducted purely for tax purposes, depending on the circumstances.

(iii) Use of transfer pricing methods based on intangible development cost

112. In a transfer pricing analysis, the use of valuation techniques that seek to estimate the value of intangibles based on the cost of intangible development plus a return is generally discouraged. There is little reason to believe that there is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, financial valuation techniques based on the cost of intangible development should usually be avoided.

113. In some limited circumstances, valuations of intangibles based on the estimated cost of reproducing or replacing the intangible may be proposed. Such approaches may sometimes have valid application with regard to the development of non-unique intangibles used for internal business operations (*e.g.* internal software systems). Where intangibles relating to products sold in the marketplace are at issue, replacement cost valuation methods raise serious comparability issues. Among other concerns, it is necessary to evaluate the effect of time delays associated with deferred development on the value of the intangibles. Often, there may be a significant first mover advantage in having a product on the market at an early date. As a result, an identical product (and the supporting intangibles) developed in future periods will not be as valuable as the same product (and the supporting intangibles) available currently. In such a case, the estimated replacement cost will not be a valid proxy for the value of an intangible transferred currently. Similarly, where an intangible carries legal protections or exclusivity characteristics, the value of being able to exclude competitors from using the intangible will not be reflected in an analysis based on replacement cost. Cost based valuations generally are not reliable when applied to determine the value of partially developed intangibles for transfer pricing purposes.

(iv) Use of more than one method

114. The principles set out in paragraphs 2.11, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the use or transfer of intangibles.

(v) Aggregation of transactions

115. Paragraphs 3.9 through 3.12 and paragraph 3.37 provide guidance regarding the aggregation of separate transactions for purposes of transfer pricing analysis. Those principles apply fully to cases involving the use or transfer of intangibles. Indeed, it is often the case that intangibles may be used or transferred in combination with other intangibles, or in combination with transactions involving the sale of goods or services. In such situations it may well be that the most reliable transfer pricing analysis will consider the interrelated transactions in the aggregate as necessary to improve the reliability of the analysis.

(vi) Application of rules of thumb

116. In cases involving the use or transfer of intangibles or rights in intangibles, it is sometimes suggested that certain rules of thumb may apply to determine a correct transfer price or to allocate intangible related returns between a transferor and transferee of rights in intangibles. The application of a general rule of thumb does not provide an adequate substitute for a complete comparability analysis conducted under the principles of Chapters I through III. Accordingly, application of a rule of thumb to divide intangible related returns between, for example, a licensor and a licensee is discouraged.

D.3. Determining arm's length prices for transactions involving the use of intangibles in connection with sales of goods or services

117. This section D.3. contains guidance for determining arm's length prices and other conditions for a controlled transaction involving the sale of goods or services where intangibles are used by one or both parties in connection with the transaction.

118. Two general categories of cases can arise. In the first category of cases, the comparability analysis, including the functional analysis, will reveal the existence of sufficiently reliable comparables to permit the determination of arm's length conditions for the transaction using a transfer pricing method based on comparables. In the second category of cases, the comparability analysis, including the functional analysis, will fail to identify reliable comparable uncontrolled transactions, often as a direct result of the

use by one or both parties to the transaction of section D.1.(vi) intangibles. Transfer pricing approaches to these two categories of cases are described below.

(i) Situations where reliable comparables exist

119. It will often be the case that, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or services, reliable comparables can be identified. Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method where the transaction involves the use of intangibles in connection with a controlled sale of goods or services and reliable comparables are present.

(a) Importance of section D.1. (vi) intangibles

120. An issue commonly arising in matters involving the use of intangibles in connection with the sale of goods or services involves the nature of the intangibles used by one or both parties to the controlled transaction. In some circumstances, intangibles used by the tested party will be comparable to intangibles used by parties to comparable uncontrolled transactions. In other circumstances, the intangibles used by the tested party in connection with the transaction will be section D.1.(vi) intangibles.

121. The principles described in section D.1.(ii) of this Chapter should be applied in determining whether the use of intangibles by the tested party will preclude reliance on identified comparable uncontrolled transactions or require comparability adjustments. Only when the intangibles used by the tested party are section D.1.(vi) intangibles will the need arise to make comparability adjustments or to adopt a transfer pricing method less dependent on comparable uncontrolled transactions. Where intangibles used by the tested party are not section D.1.(vi) intangibles, prices paid or received, or margins or returns earned by parties to comparable uncontrolled transactions may provide a reliable basis for determining arm's length conditions.

(b) Comparability adjustments

122. Paragraphs 3.47 through 3.54 and paragraph 103 contain guidance related to comparability adjustments. That guidance applies fully to matters involving the use of intangibles in connection with controlled sales of goods or services.

123. Where the need to make comparability adjustments arises because of differences in the intangibles used by the tested party in a controlled transaction and the intangibles used by a party to a potentially comparable uncontrolled transaction, difficult factual questions can arise in quantifying reliable comparability adjustments. These issues require thorough consideration of the relevant facts and circumstances and of the available data regarding the impact of the intangibles on prices and profits. Where the impact on price of a difference in the nature of the intangibles used is clearly material, but not subject to accurate estimation, it may be necessary to utilise an alternative transfer pricing method that is less dependent on identification of reliable comparables, as discussed in section D.3.(ii) of this Chapter.

124. It should also be recognised that comparability adjustments for factors other than differences in the nature of the intangibles used may be required in matters involving the use of intangibles in connection with a controlled sale of goods or services. In particular, comparability adjustments may be required for matters such as differences in markets, locational advantages, business strategies, assembled workforce, corporate synergies and other similar factors. While such factors may not be intangibles as that term is described in section A.1. of this Chapter, they can nevertheless have important effects on arm's length prices in matters involving the use of intangibles.

(ii) Situations where reliable comparables do not exist

125. In some situations it will be the case that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price for a controlled transaction involving the use of intangibles. This may be because the intangibles utilised by one or both parties to the controlled transaction are section D.1.(vi) intangibles, and that reliable comparability adjustments are not possible. It may also result from a lack of available data regarding potentially comparable transactions involving the use or transfer of intangibles or from other causes. Notwithstanding the lack of reliable comparables, it is possible to determine the arm's length price for the controlled transaction, except in situations where paragraph 1.65 applies.

(a) Determining the price that would have been agreed between uncontrolled parties

126. Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle nevertheless requires use of another method to determine the price that uncontrolled parties would have agreed under comparable circumstances. In making such determinations, it is important to consider:

- The functions, assets and risks of the respective parties to the transaction.
- The business reasons for engaging in the transaction.
- The perspectives of and options realistically available to each of the parties to the transaction.
- The market advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles.
- Other important factors such as locational advantages and market differences.

127. In identifying prices that would have been agreed by uncontrolled parties under comparable circumstances, it is often essential to carefully identify idiosyncratic aspects of the controlled transaction that arise by virtue of the relationship between the parties. There is no requirement that associated enterprises structure their transactions in precisely the same manner as unrelated parties might have done. However, where transactional structures are utilised by associated enterprises that are not typical of transactions between independent parties, the effect of those structures on prices and other conditions that would have been agreed between uncontrolled parties under comparable circumstances should be taken into account in evaluating the profits that would have accrued to each of the parties at arm's length.

(b) Application of profit split methods

128. In some circumstances where reliable uncontrolled transactions cannot be identified, transactional profit split methods may be utilised to determine an arm's length allocation of profits for sales of goods or services involving the use of intangibles. One circumstance in which the use of transactional profit split methods may be appropriate is where both parties to the transaction make unique and valuable contributions to the transaction. See paragraph 2.109.

129. Paragraphs 2.108 through 2.145 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the use of intangibles in connection with the sale of goods or services in controlled transactions.

130. In applying a profit split method in a case involving the use of intangibles, care should be taken to identify the intangibles in question, to evaluate the manner in which those intangibles contribute to the creation of value, and to evaluate other income producing functions, risks and assets. Vague assertions of the existence and use of unspecified intangibles will not support a reliable application of a profit split method.

(c) Use of valuation techniques

131. In appropriate circumstances, transfer pricing methods or valuation techniques not dependent on the identification of reliable comparable uncontrolled transactions may be utilised to determine arm's length conditions for the sale of goods or services where intangibles are used in connection with the transaction. The alternative selected should reflect the nature of the goods or services sold and the contribution of intangibles and other relevant factors to the creation of value.

D.4 Determining arm's length prices for transactions involving the transfer of intangibles or rights in intangibles

132. This section D.4. contains guidance for determining arm's length prices in a controlled transaction involving the transfer of intangibles or rights in intangibles.

133. Two general categories of cases can arise. In the first category of cases, the comparability analysis, including the functional analysis, will reveal the existence of sufficiently reliable comparables to permit the determination of arm's length conditions for the transaction using a transfer pricing method based on comparables. In the second category of cases, the comparability analysis, including the functional analysis, will fail to identify reasonably reliable comparable uncontrolled transactions. Transfer pricing approaches to these two categories of cases are described below.

(i) Transfer pricing methods where comparable uncontrolled transactions can be identified

134. Depending on the specific facts, any of the five OECD transfer pricing methods described in Chapter II might constitute the most appropriate transfer pricing method to the circumstances of the case where the transaction involves a controlled transfer of intangibles or a controlled transfer of rights in intangibles. The use of other alternatives may also be appropriate.

135. Extreme caution should be used, however, in applying certain of the methods. Valuation of intangibles on the basis of mark-ups over development cost is unlikely to provide an accurate measure of value and is generally discouraged. See paragraphs 112 and 113. Moreover, application of a resale price method analysis will be unlikely to constitute the most appropriate method for determining an arm's length price for intangibles or rights in intangibles in most situations.

136. Experience has shown that the transfer pricing methods most likely to prove useful in matters involving transfers of intangibles or rights in intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools in some circumstances.

137. Where the CUP method is utilised, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions. The comparability factors described in paragraphs 1.38 through 1.63 should be considered. The matters described in section D.1. of this Chapter are of particular importance in evaluating the comparability of specific transferred intangibles and rights in intangibles and in making comparability adjustments, where possible.

138. In some situations, intangibles acquired by an MNE group from unrelated parties are transferred to a member of the MNE group in a controlled transaction immediately following the acquisition. In such a case the price paid for the acquired intangibles will usually (after any appropriate adjustments for acquired assets not re-transferred) represent a useful comparable for determining the arm's length price for the controlled transaction under a CUP method. Depending on the circumstances, the third party acquisition price in such situations will have relevance in determining arm's length prices and other conditions for the controlled transaction, even where the intangibles are acquired indirectly through an acquisition of shares or where the price paid to the third party for shares or assets exceeds the book value of the acquired assets.

(ii) Situations where reliable comparables are not available

139. Where information regarding reliable comparable uncontrolled transactions cannot be identified, the principles of paragraphs 126 and 127 apply to transactions involving transfers of intangibles to the same extent as they do to transactions involving the use of intangibles in connection with the sale of goods or services.

(iii) Application of profit split methods

140. In some circumstances, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles or rights to intangibles where it is not possible to identify reliable comparable uncontrolled transactions. Paragraphs 2.108 through 2.145 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles.

(a) Application of profit split methods in connection with licence transactions

141. Where limited rights in intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method often can be utilised to evaluate the respective contributions of the parties to earning combined income. The profit contribution of the rights in intangibles made available by the licensor or other transferor would, in such a circumstance, be one of the factors contributing to the earning of income following the transfer. However, other factors would also need to be considered. In particular, functions performed and risks assumed by the licensee/transferee should specifically be taken into account in such an analysis. Other intangibles used by the licensor/transferor and by the licensee/transferee in their respective businesses should similarly be considered, as well as other relevant factors. Careful attention should be given in such an analysis to the limitations imposed by the terms of the transfer on the use of the intangibles by the licensee/transferee and on the rights of the licensee/transferee to use the intangibles for purposes of ongoing research and development. Further, assessing appropriate intangible related returns of the licensee for its enhancements to licensed intangibles may be important. The allocation of income in such an analysis would depend on the findings of the functional analysis, including an analysis of the relevant risks assumed. It should not be assumed that all of the residual profit after functional returns would necessarily be allocated to the licensor/transferor in a profit split analysis related to a licensing arrangement.

(b) Application of profit split methods in connection with transfers of full rights in intangibles

142. Profit split methods may also have application in connection with the sale of full rights in intangibles. As with other applications of the profit split method, a full functional analysis that considers the functions performed, risks assumed and assets used by each of the parties is an essential element of the analysis. Where a profit split analysis is based on projected revenues and expenses, the concerns with the

accuracy of such projections described in paragraphs 154 through 158 should be taken into account. Some applications of valuation techniques can be characterised as applications of a profit split method.

(c) Application of profit split methods in connection with transfers of partially developed intangibles

143. It is sometimes suggested that a profit split analysis can be applied to transfers of partially developed intangibles. In such an analysis, the relative value of contributions to the development of intangibles before and after a transfer of the intangibles in question is sometimes examined. Such an approach may include an attempt to amortise the transferor's contribution to the partially developed intangible over the asserted useful life of that contribution, assuming no further development. Such approaches are generally based on projections of cash flows and benefits expected to arise at some future date following the transfer and the assumed successful completion of further development activities.

144. It is unlikely that such approaches will readily yield a reliable estimate of the contributions of the parties to the creation of income in years following the transfer. In such an analysis, a variety of difficult to evaluate factors would need to be taken into account. These would include the relative riskiness and value of research contributions before and after the transfer, the relative risk, and the value of that risk, for other development activities carried out before and after the transfer, the useful life of the intangibles, the amortisation rate for various contributions to the intangible value, assumptions regarding the time at which speculative new products might be introduced, and the value of contributions other than intangibles to the ultimate generation of profit. Income and cash flow projections in such situations can be especially speculative. These factors can combine to call the reliability of such an analysis into serious question.

(iv) Use of valuation techniques

145. In situations where reliable comparable uncontrolled transactions for a transfer of intangibles cannot be identified, it may be possible to use valuation techniques to estimate the arm's length price for intangibles transferred between associated enterprises.

146. Where valuation techniques are utilised in a transfer pricing analysis, it is necessary to apply such techniques in a manner that is consistent with the arm's length principle and the principles of these Guidelines. In particular, due regard should be given to the principles contained in Chapters I through III. Principles related to realistically available options (see paragraph 1.34), perspective of the parties, attribution of risk (see paragraphs 9.10 through 9.46), and aggregation of transactions (see paragraphs 3.9 through 3.12) apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Furthermore, normal rules on selection of transfer pricing methods apply in determining when such techniques should be used (see paragraphs 2.1 through 2.10). The principles of sections A., B., C., D.1., and D.2. of this Chapter apply where use of valuation techniques is considered.

147. It is not the intention of these Guidelines to set out a comprehensive summary of the valuation techniques utilised by valuation professionals. Similarly, it is not the intention of these Guidelines to endorse or reject one or more sets of valuation standards utilised by valuation or accounting professionals or to describe in detail one or more specific valuation techniques or methods that may be especially suitable for use in a transfer pricing analysis. However, where valuation techniques are applied in a manner that gives due regard to these Guidelines, to the specific facts of the case, to generally accepted valuation practices, and with appropriate consideration of the validity of the assumptions underlying the valuation and the consistency of those assumptions with the arm's length principle, such techniques can be useful tools in a transfer pricing analysis where reliable comparable uncontrolled transactions are not available. See, however, paragraphs 112 and 113 for a discussion of the reliability of valuation techniques based on intangible development costs.

148. Valuation approaches that estimate the discounted value of projected future cash flows attributable to the transferred intangible or intangibles can be particularly useful analytical tools. There are many variations of valuation techniques based on the discounted value of projected future cash flows. In general terms, such valuation techniques begin by projecting the revenue anticipated to be produced in a given business over the useful life of the intangibles being valued. They then deduct, from those projected revenues, estimates of projected cost of sales and operating expenses to yield an estimated projection of operating income over the anticipated useful life of the intangible. Estimates of cash flows attributable to business activities and/or assets other than the intangible being valued may be deducted from the projections of operating income. Depending on the specific facts, these deducted cash flows can include projected routine functional returns as well as projected income attributable to other activities, attributes and other intangibles. The resulting residual stream of projected cash flows attributable to the intangible being valued is discounted to calculate the present value of the stream of intangible related cash flows. The discount rate or rates used in calculating present values of the stream of projected cash flows reflects both the time value of money and the risk that future cash flows may not materialise. Depending on the facts and circumstances of the individual case, the calculation of the discounted present value of the streams of cash flows attributable to the intangible from the perspectives of both parties to the transaction will generally be necessary. In these cases the arm's length price will fall somewhere within the range of both present values, after taking into account taxes required to be paid with respect to the transaction.

(v) Specific areas of concern in applying methods based on the discounted value of projected cash flows

149. When applying valuation techniques, it is important to recognise that the estimates of value based on such techniques can be highly volatile. Small changes in one or another of the assumptions underlying the valuation model or in one or more of the valuation parameters can lead to extreme swings in the intangible value the model produces. A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumptions regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters.

150. The reliability of the intangible value produced using a valuation model is highly dependent on the reliability of the underlying assumptions and estimates on which it is based and on the due diligence and judgment exercised in confirming assumptions and in estimating valuation parameters.

151. Because of the importance of the underlying assumptions and valuation parameters, taxpayers and tax administrations making use of valuation techniques in determining arm's length prices for transferred intangibles should explicitly set out each of the relevant assumptions made in creating the valuation model, should describe the basis for selecting valuation parameters, and should be prepared to defend the reasonableness of such assumptions and valuation parameters. Moreover, it is a good practice for taxpayers relying on valuation techniques to present as part of their transfer pricing documentation some sensitivity analysis reflecting the consequential change in estimated intangible value produced by the model when alternative assumptions and parameters are adopted.

152. It may be relevant in assessing the reliability of a valuation model to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. (See paragraph 111) It would be reasonable for a tax administration to request an explanation for any inconsistencies in the assumptions made in a valuation of an intangible undertaken for transfer pricing purposes and valuations undertaken for other purposes. For example, such requests would be appropriate if high discount rates are used in a transfer pricing analysis when the company routinely uses lower discount rates in evaluating possible mergers and acquisitions, or where it is asserted that particular

intangibles have short useful lives if projections used in other business planning contexts show products related to those intangibles producing cash flows in years beyond the useful life asserted for transfer pricing purposes.

153. The following sections identify some of the specific concerns that should be taken into account in evaluating certain important assumptions underlying calculations in a valuation model based on discounted cash flows. These concerns are important in evaluating the reliability of the particular application of a valuation technique.

(a) Accuracy of financial projections

154. The reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is highly dependent on the accuracy of the projections of future cash flows or income on which the valuation is based. However, because the accuracy of financial projections will depend on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, and may be speculative, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.

155. In evaluating financial projections, the source and purpose of the projections can be particularly important. In some cases, taxpayers will regularly prepare financial projections for business planning purposes. It can be that such analyses are used by management of the business in making business and investment decisions. It is usually the case that projections prepared for non-tax business planning purposes are more reliable than projections prepared exclusively for tax purposes, or exclusively for purposes of a transfer pricing analysis.

156. The length of time covered by the projections should also be considered in evaluating the reliability of the projections. Projecting cash flows or income far into the future is particularly perilous. The further into the future the intangible in question can be expected to produce positive cash flows, the less reliable projections of income and expense are likely to be.

157. A further consideration in evaluating the reliability of projections involves whether the intangibles and the products or services to which they relate have an established track record of financial performance. Caution should always be used in assuming that past performance is a reliable guide to the future, as many factors are subject to change. However, past operating results can provide some useful guidance as to likely future performance of products or services that rely on intangibles. Projections with respect to products or services that have not been introduced to the market or that are still in development are inherently less reliable than those with some track record.

158. Where, for the foregoing reasons, or any other reason, there is reason to believe that the projections relied on in the valuation are unreliable or speculative, attention should be given to the guidance in section D.4.(vi) regarding situations where valuation is highly uncertain at the time of the transaction.

(b) Assumptions regarding growth rates

159. A key element of some cash flow projections that should be carefully examined is the projected growth rate. Often projections of future cash flows are based on current cash flows (or assumed initial cash flows after product introduction in the case of partially developed intangibles) expanded by reference to a percentage growth rate. Where that is the case, the basis for the assumed growth rate should be considered. In particular, it is unusual for revenues derived from a particular product to grow at a steady rate over a long period of time. Caution should therefore be exercised in too readily accepting simple models containing linear growth rates not justified on the basis of either experience with similar products

and markets or a reasonable evaluation of likely future market conditions. It would generally be expected that a reliable application of a valuation technique based on projected future cash flows would examine the likely pattern of revenue and expense growth based on industry and company experience with similar products.

(c) Discount rates

160. The discount rate or rates used in converting a stream of projected cash flows into a present value is a critical element of a valuation model. The discount rate takes into account the time value of money and the risk or uncertainty of the anticipated cash flows. As small variations in selected discount rates can generate very large variations in the calculated value of intangibles using these techniques, it is essential for taxpayers and tax administrations to give close attention to the analysis performed and the assumptions made in selecting the discount rate or rates utilised in the valuation model.

161. There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. Neither taxpayers nor tax authorities should assume that a discount rate that is based on a Weighted Average Cost of Capital ("WACC") approach or any other measure should always be used in transfer pricing analyses where determination of appropriate discount rates is important. Instead the specific conditions and risks associated with the facts of a given case and the particular cash flows in question should be evaluated in determining the appropriate discount rate.

162. It should be recognised in determining and evaluating discount rates that in some instances, particularly those associated with the valuation of intangibles still in development, intangibles may be among the most risky components of a taxpayer's business. It should also be recognised that some businesses are inherently more risky than others and some cash flow streams are inherently more volatile than others. For example, the likelihood that a projected level of research and development expense will be incurred may be higher than the likelihood that a projected level of revenues will ultimately be generated. The discount rate or rates should reflect the level of risk in the overall business and the expected volatility of the various projected cash flows under the circumstances of each individual case.

163. Since certain risks can be taken into account either in arriving at financial projections or in calculating the discount rate, care should be taken to avoid double discounting for risk.

(d) Useful life of intangibles and terminal values

164. Valuation techniques are often premised on the projection of cash flows attributable to the intangible over the useful life of the intangible in question. In such circumstances, the determination of the actual useful life of the intangible will be one of the critical assumptions supporting the valuation model.

165. The projected useful life of particular intangibles is a question to be determined on the basis of all of the relevant facts and circumstances. The useful life of a particular intangible can be affected by the nature and duration of the legal protections afforded the intangible. The useful life of intangibles also may be affected by the rate of technological change in the industry. The principles of paragraphs 95 and 96 should be observed in estimating the useful life of intangibles for purposes of applying a valuation technique.

166. In some circumstances, particular intangibles may contribute to the generation of cash flow in years after the legal protections have expired or the products to which they specifically relate have ceased to be marketed. This can be the case in situations where one generation of intangibles forms the base for the development of future generations of intangibles and new products. It may well be that some portion of continuing cash flows from projected new products should properly be attributed to otherwise expired intangibles where such follow on effects exist. It should be recognised that, while some intangibles have an

indeterminate useful life at the time of valuation, that fact does not imply that nonroutine returns are attributable to such intangibles in perpetuity,

167. In this regard, where specific intangibles contribute to continuing cash flows beyond the period for which reasonable financial projections exist, it will sometimes be the case that a terminal value for the intangible related cash flows is calculated. Where terminal values are used in valuation calculations, the assumptions underlying their calculation should be clearly set out and the underlying assumptions critically examined. Often, large amounts can be associated with such terminal values such that the reasonableness of the terminal value calculation should not be overlooked in the analysis.

(e) Assumptions regarding tax rates

168. Where the purpose of the valuation technique is to isolate the projected cash flows associated with an intangible, it may be necessary to evaluate and quantify the effect of future income taxes on the projected cash flows. Two issues can arise in this regard.

169. First, in practice, annual financial projections used in discounted cash flow based valuations are carried out on a post-tax basis, using discount rates that are similarly determined on a post-tax basis. However, prices for transfer pricing purposes under a discounted cash flow analysis must typically be determined on a pre-tax basis. Therefore, appropriate adjustments may need to be made to ensure both the internal consistency of the discounted cash flow model and the ultimate determination of arm's length prices on a pre-tax basis.

170. Second, the question arises whether the relevant tax rates to take into account in performing a discounted cash flow based valuation are those of the transferor or the transferee. The particular facts of the case, including the specific tax situations of the transferor and transferee, should dictate adjustments to be made to take account of the impact of taxes on the valuation. It is important to take into account the perspectives of both parties to the transaction in this regard and to consider how unrelated parties might account for the relative tax advantages or disadvantages faced by the transferee following the transfer in determining the arm's length price.

(vi) Arm's length pricing for transfers of intangibles when valuation is highly uncertain at the time of the transaction

171. Intangible property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of a controlled transaction involving the property. When valuation of intangible property at the time of the transaction is highly uncertain, the question is raised how arm's length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction. See paragraphs 9.87 and 9.88.

172. Depending on the facts and circumstances, there are a variety of steps that independent enterprises might undertake to deal with high uncertainty in valuation when pricing a transaction. One possibility is to use anticipated benefits (taking into account all relevant economic factors) as a means for establishing the pricing at the outset of the transaction. In determining the anticipated benefits, independent enterprises would take into account the extent to which subsequent developments are foreseeable and predictable. Financial valuation techniques, particularly those based on the discounted value of projected cash flows, may be helpful tools in assessing anticipated benefits, as described above, although the uncertainty of an intangible's value may be compounded by uncertainties regarding critical parameters and assumptions in the valuation analysis. In some cases, independent enterprises might find

that the projections of anticipated benefits are sufficiently reliable to fix the pricing for the transaction at the outset on the basis of those projections, without reserving the right to make future adjustments.

173. In other cases, independent enterprises might not find that pricing based on anticipated benefits alone provides an adequate protection against the risks posed by the high uncertainty in valuing the intangible property. In such cases, independent enterprises might adopt shorter-term agreements or include price adjustment clauses in the terms of the agreement, to protect against subsequent developments that might not be predictable. For example, a royalty rate could be set to increase as the sales of the licensee increase.

174. Also, independent enterprises may determine to bear the risk of unpredictable subsequent developments to a certain degree, although with the joint understanding that major unforeseen developments changing the fundamental assumptions upon which the pricing was determined would lead to the renegotiation of the pricing arrangements by mutual agreement of the parties. For example, such renegotiation might occur at arm's length if a royalty rate based on sales for a patented drug turned out to be vastly excessive due to an unexpected development of an alternative low-cost treatment. The excessive royalty might remove the incentive of the licensee to manufacture or sell the drug at all, in which case the agreement might be renegotiated (although whether renegotiation would take place would depend upon all the facts and circumstances).

175. When tax administrations evaluate the pricing of a controlled transaction involving intangible property where valuation is highly uncertain at the outset, the arrangements that would have been made in comparable circumstances by independent enterprises should be followed. Thus, if independent enterprises would have fixed the pricing based upon a particular projection, the same approach should be used by the tax administration in evaluating the pricing. In such a case, the tax administration could, for example, inquire into whether the associated enterprises made adequate projections, taking into account all the developments that were reasonably foreseeable, without using hindsight.

176. It is recognised that a tax administration may find it difficult, particularly in the case of an uncooperative taxpayer, to establish what profits were reasonably foreseeable at the time that the transaction was entered into. For example, such a taxpayer, at an early stage, may transfer intangibles to an affiliate, set a royalty that does not reflect the subsequently demonstrated value of the intangible for tax or other purposes, and later take the position that it was not possible at the time of the transfer to predict the subsequent success of the product. In such a case, the subsequent developments might prompt a tax administration to inquire what independent enterprises would have done on the basis of information reasonably available at the time of the transaction. In particular, consideration should be given to whether the associated enterprises intended to and did make projections that independent enterprises would have considered adequate, taking into account the reasonably foreseeable developments and in light of the risk of unforeseeable developments, and whether independent enterprises would have insisted on some additional protections against the risk of high uncertainty in valuation.

177. If independent enterprises would have insisted on a price adjustment clause in comparable circumstances, the tax administration should be permitted to determine the pricing on the basis of such a clause. Similarly, if independent enterprises would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of a transaction, such developments should also lead to a modification of the pricing of a comparable controlled transaction between associated enterprises.

178. It is recognised that tax administrations may not be able to conduct an audit of a taxpayer's return until several years after it has been filed. In such a case, a tax administration would be entitled to adjust the amount of consideration with respect to all open years up to the time when the audit takes place, on the

basis of the information that independent enterprises would have used in comparable circumstances to set the pricing.

(vii) Form of payment

179. Taxpayer's have substantial discretion in defining the form of payment for transferred intangibles. In transactions between independent parties, it is common to observe payments for intangibles that take the form of a single lump sum. It is also common to observe payments for intangibles that take the form of periodic payments over time. Arrangements involving periodic payments can be structured either as a series of instalment payments fixed in amount, or may take the form of contingent payments where the amount of payments depends on the level of sales of products supported by the intangibles, on profitability, or on some other factor. Taxpayer agreements with regard to the form of payment should be respected, except as may be provided in paragraphs 1.64 through 1.69.

180. In evaluating the provisions of taxpayer agreements related to the form of payment, it should be noted that some payment forms will entail greater or lesser levels of risk to one of the parties. For example, a payment form contingent on future sales will involve greater risk to the transferor than a payment form calling for either a single lump-sum payment at the time of the transfer or a series of fixed instalment payments, because of the existence of the contingency. The chosen form of the payment must be consistent with the facts and circumstances of the case, including the written contracts, the actual conduct of the parties, and the ability of the parties to bear and manage the relevant payment risks. In particular, the amount of the specified payments should reflect the relevant time value of money and risk features of the chosen form of payment. For example, if a valuation technique is applied and results in the calculation of a lump-sum present value for the transferred intangible, and if a taxpayer applies a payment form contingent on future sales, the discount rate used in converting the lump-sum valuation to a stream of contingent payments over the useful life of the intangible should reflect the increased risk to the transferor that sales may not materialise and that payments would therefore not be forthcoming, as well as the time value of money consequences arising from the deferral of the payments to future years.

D.5. Illustrations

181. For illustrations of the principles of this Section D., see Examples 18 through 22 in the Annex to Chapter VI.

It is proposed that the provisions of the Annex to Chapter VI of the Transfer Pricing Guidelines be deleted in their entirety and that they be replaced by the following language.

ANNEX
EXAMPLES TO ILLUSTRATE THE GUIDANCE ON SPECIAL CONSIDERATIONS FOR INTANGIBLE PROPERTY

Examples Illustrating the Provisions of Chapter VI.B.

Example 1

182. Premiere is the parent company of an MNE group. Company S is a wholly owned subsidiary of Premiere and a member of the Premiere group. Premiere performs ongoing R&D functions in support of its business operations. When its R&D functions result in patentable inventions, it is the practice of the Premiere group that all rights in such inventions be assigned to Company S in order to centralise and simplify global patent administration. Company S employs three lawyers to perform its patent administration work. It does not, however, conduct or control any of the R&D activities of the Premiere group. Company S has no technical R&D personnel, nor does it incur any of the Premiere group's R&D expense. At the time of each assignment of rights from Premiere to Company S, Company S makes a 100 Euro payment to Premiere in consideration of the assignment of rights to a patentable invention and simultaneously grants to Premiere an exclusive, royalty free, patent license for the full life of the registered patent. The nominal payments of Company S to Premiere are made purely to satisfy technical contract law requirements related to the assignments and are generally much lower than the arm's length price of the assigned rights to patentable inventions.

183. Under these circumstances Company S is not entitled to intangible related returns for transfer pricing purposes, notwithstanding the fact that it holds patent registrations and other contractual rights to intangibles. Company S neither bears nor controls risks related to intangible development or enhancement. It does not perform or control any functions related to intangible development or enhancement and does not bear any expense related to the development or enhancement of intangibles. Accordingly, Premiere, and not Company S, is entitled to all intangible related returns attributable to patents developed through Premiere's research and development efforts. Company S should receive arm's length compensation from Premiere for its patent administration services, including amounts to cover its nominal payments to Premiere for patent rights, its other patent administration costs, and an appropriate profit element, but should not receive intangible related returns related to the patents for which it holds registrations.

Example 2

184. Primero is the parent company of an MNE group engaged in the pharmaceutical business. It does business in country M. Primero develops patents and other intangibles relating to Product X and registers those patents in countries around the world.

185. Primero retains its wholly owned country N subsidiary, Company S, to distribute Product X throughout Europe and the Middle East on a limited risk basis. Company S purchases Product X from Primero and resells Product X to unrelated customers in countries throughout its geographical area of operation. In the first three years of operations, Company S earns arm's length returns from its distribution functions, consistent with its limited risk characterisation and the fact that Primero, and not Company S, is entitled to intangible related returns with respect to Product X. After three years of operation, it becomes apparent that Product X causes serious side effects in a significant percentage of those patients that use the product and it becomes necessary to recall the product and remove it from the market. Company S incurs substantial costs in connection with the recall. Primero does not reimburse Company S for these recall related costs or for the resulting product liability claims.

186. Under these circumstances, there is a mismatch between Primero's asserted entitlement to intangible related returns with respect to Product X and the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the mismatch. In all likelihood, the most appropriate adjustment would be an allocation of the recall and product liability related costs from Company S to Primero, although in some circumstances an appropriate alternative may be to adjust the product pricing for all years between Primero and Company S to reflect the fact that the relationship was not actually a limited risk relationship.

Example 3

187. Primair, a resident of country X, manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Primair is the registered owner of the R trademark and trade name. The R name is widely known in countries where the watches are sold and has obtained considerable economic value in those markets through the efforts of Primair. R watches have never been marketed in country Y, however, and the R name is not known in the country Y market.

188. In Year 1, Primair decides to enter the country Y market and incorporates a wholly owned subsidiary in country Y, Company S, to act as its distributor in country Y. At the same time, Primair enters into a long-term royalty-free marketing and distribution agreement with Company S. Under the agreement, Company S is granted the exclusive right to market and distribute watches bearing the R trademark and using the R trade name in country Y for a period of five years, with an option for a further five years. Company S obtains no other rights relating to the R trademark and trade name from Primair, and in particular is prohibited from re-exporting watches bearing the trademark and trade name. The sole activity of Company S is marketing and distributing watches bearing the R trademark and trade name. It is assumed that the R watches are not part of a portfolio of products distributed by Company S in country Y. Company S undertakes no secondary processing, as it imports packaged watches into country Y ready for sale to the final customer.

189. Under the contract between Primair and Company S, Company S purchases the watches from Primair in country Y currency, takes title to the branded watches and performs the distribution function in country Y, incurs the associated carrying costs (e.g. inventory and receivables financing), and assumes the corresponding risks (e.g. inventory, credit and financing risks). Under the contract between Primair and Company S, Company S is required to act as a marketing agent to assist in developing the market for R watches in country Y. Company S consults with Primair in developing the country Y marketing strategy for R watches. Primair develops the overall marketing plan based largely on its experience in other countries, it develops and approves the marketing budgets, and it makes final decisions regarding advertising designs, product positioning and core advertising messages. The costs and risks of developing the market are primarily borne by Primair, which reimburses Company S for the cost of advertising and other marketing efforts that Company S incurs in assisting with market development for R watches in country Y. Company S consults on local market issues related to advertising, assists in executing the

marketing strategy under Primair's direction, and provides evaluations of the effectiveness of various elements of the marketing strategy. As compensation for providing these marketing support activities, Company S receives from Primair a fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

190. Assume for the purpose of this example that, based upon a thorough comparability analysis, including a detailed functional analysis, it is possible to conclude that the price Company S pays Primair for the R watches should be analysed separately from the compensation Company S receives for the marketing it undertakes on behalf of Primair. Assume further that based upon identified comparable transactions, the price paid for the watches is arm's length and that this price enables Company S to earn an arm's length level of compensation from selling the watches for the distribution function it performs and the associated risks it assumes.

191. In Years 1 to 3, Company S embarks on a strategy that is consistent with its agreement with Primair to develop the country Y market for R watches. In the process, Company S incurs marketing expenses. Consistent with the contract, Company S is reimbursed by Primair for the marketing expenses it incurs, together with a markup on those expenses. By the end of Year 2, the R trademark and trade name have become well established in country Y. The compensation derived by Company S for the marketing activities it performed on behalf of Primair is determined to be arm's length, based upon comparison to that paid to independent advertising and marketing agents identified and determined to be comparable as part of the comparability analysis.

192. Under these circumstances, Primair is entitled to the intangible related returns attributable to the R trademark and trade name. While Company S's performance of certain marketing functions contributes to the value of the trademark in country Y, the best measure of Company S's arm's length return for those contributions is determined by reference to the returns earned by identified independent advertising and marketing agents whose functions, risks and assets have been determined to be comparable to those of Company S through the comparability analysis.

Example 4

193. The facts in this example are the same as in Example 3, except as follows:

- Under the contract between Primair and Company S, Company S is now obligated to develop and execute the marketing plan for country Y without detailed control of specific elements of the plan by Primair. Company S bears the costs and assumes certain of the risks associated with the marketing activities. The agreement between Primair and Company S does not specify the amount of marketing expenditure Company S is expected to incur, only that Company S is required to use its best efforts to market the watches. Company S receives no reimbursement from Primair in respect of any expenditure it incurs, nor does it receive any other indirect or implied compensation from Primair, and Company S expects to earn its reward solely from its profit from the sale of R brand watches to third party customers in the country Y market.

- A thorough functional analysis reveals that Primair exercises a lower level of control over the marketing activities of Company S in that it does not review and approve the marketing budget or design details of the marketing plan. Company S bears different risks and is compensated differently than was the case in Example 3. The contractual arrangements between Primair and Company S are very different and the risks assumed by Company S are greater in Example 4 than in Example 3. Company S does not receive cost reimbursements or a separate fee for marketing activities. The only controlled transaction between Primair and

Company S in Example 4 is the transfer of the branded watches. As a result, Company S can obtain its reward only through selling R brand watches to third party customers.

- As a result of these differences, Primair and Company S adopt a lower price for watches in Example 4 than the price for watches determined for purposes of Example 3. As a result of the differences identified in the functional analysis, different criteria are used for identifying comparables and for making comparability adjustments than was the case in Example 3.

194. Assume that in Years 1 through 3, Company S embarks on a strategy that is consistent with its agreement with Primair and, in the process, incurs marketing expenses. As a result, Company S has high operating expenditures and slim margins in Years 1 through 3. By the end of Year 2, the R trademark and trade name have become established in country Y because of Company S's efforts. Where the marketer/distributor actually bears the costs and associated risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. Assume that the enquiries of the country Y tax authorities conclude that Company S would have been expected to have incurred its actual level of marketing expense if it were unrelated to Primair.

195. Given that Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the R watches, there is an opportunity for Company S to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. Based on an analysis of reasonably reliable comparable data, it is concluded that, for purposes of this example, the benefits obtained by Company S result in profits similar to those made by independent marketers and distributors bearing the same types of risks and costs as Company S in the first few years of comparable long-term marketing and distribution agreements for similarly unknown products.

196. Based on the foregoing assumptions, Company S's return is arm's length and its marketing activities, as illustrated by its marketing expenses, are not significantly different than those performed by independent marketers and distributors in comparable uncontrolled transactions. Under these circumstances, while Primair and Company S may each be entitled to a portion of the intangible related returns associated with the R trademark and related intangibles, the information on comparable uncontrolled arrangements suggests that the return earned by Company S provides it with the arm's length return for its functions, risks, costs and its resulting entitlement to intangible related returns. No separate or additional compensation is required to Company S.

Example 5

197. The facts in this example are the same as in Example 4, except that the market development functions undertaken by Company S in this Example 5 are far more extensive than those undertaken by Company S in Example 4.

198. Where the marketer/distributor actually bears the costs and risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. A thorough comparability analysis identifies several uncontrolled companies engaged in similar marketing and distribution functions under similar long-term marketing and distribution arrangements. Assume, however, that the level of marketing expense Company S incurred in Years 1 through 5 far exceeds that incurred by the identified comparable independent marketers and distributors. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has assumed significantly greater costs and risks than comparable independent enterprises (and substantially higher costs and risks than in Example 4). There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profits made by the identified comparable

independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

199. As in Example 4, Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive marketing and distribution rights for the R watches, and therefore has an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case Company S has borne marketing expenditures beyond what independent enterprises in comparable transactions with similar rights incur for their own benefit, resulting in significantly lower profits for Company S than are made by such enterprises.

200. Based on these facts, it is evident that by incurring marketing expenditure substantially in excess of the levels of such expenditure incurred by independent marketer/distributors in comparable transactions, Company S has acted to increase the value of the intangibles of Primair and has not been adequately compensated for doing so by the margins it earns on the resale of R watches. Under such circumstances it would be appropriate for the country Y tax authority to propose a transfer pricing adjustment based on compensating Company S for the marketing activities performed and expenditure incurred for the benefit of Primair, consistent with what independent enterprises dealing at arm's length in comparable transactions might be expected to have agreed. Depending on the facts and circumstances, such an adjustment could be based on:

- Reducing the price paid by Company S for the R brand watches purchased from Primair. Such an adjustment could be based on applying a resale price method or transactional net margin method using available data about profits made by comparable marketers and distributors with a comparable level of marketing and distribution expenditure.

- An alternative approach might apply a residual profit split method that would split the combined profits from sales of R branded watches in country Y by first giving Company S and Primair a basic return for the functions they perform and then splitting the residual profit on a basis that takes into account the relative entitlements to intangible related returns of Company S and Primair and the relative contributions of both Company S and Primair to the value of the R trademark and trade name.

- Directly compensating Company S for the excess marketing expenditure it has incurred over and above that incurred by comparable independent enterprises including an appropriate profit element for the functions and risks reflected by those expenditures.

201. In this example, the proposed adjustment is based on Company S's having performed functions, incurred risks, and incurred costs that provide it with an entitlement to intangible related returns for which it is not adequately compensated under its arrangement with Primair. If the arrangements between Company S and Primair were such that Company S could expect to obtain an arm's length return on its additional investment during the remaining term of the distribution agreement, a different outcome could be appropriate.

Example 6

202. The facts in this example are the same as in Example 4, except that Company S now enters into a three-year royalty-free agreement to market and distribute the watches in the country Y market, with no option to renew. At the end of the three-year period, Company S does not enter into a new contract with Primair.

203. Assume that it is demonstrated that independent enterprises do enter into short-term distribution agreements where they incur marketing and distribution expenses, but only where they stand to earn a reward commensurate with the functions performed, assets used and the risks assumed. Evidence derived from comparable independent enterprises shows that they do not invest large sums of money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation. The potential short-term nature of the marketing and distribution agreement is such that Company S could not, or may not be able to, benefit from the marketing and distribution expenditure it incurs at its own risk. The same factors mean that Company S's efforts may well benefit Primair in the future.

204. The risks assumed by Company S are substantially higher than in Example 4 and Company S has not been compensated on an arm's length basis for bearing these additional risks. In this case, Company S has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profits for Company S than are made by comparable enterprises. The short term nature of the contract makes it unreasonable to expect that Company S has the opportunity of obtaining appropriate benefits under the contract within the limited term of the agreement with Primair. Under these circumstances, Company S is entitled to intangible related returns in the form of higher compensation for having acted to increase the value of the R trademark and trade name during the term of its arrangement with Primair.

205. Such compensation could take the form of direct compensation from Primair to Company S for the marketing expenditures and market development functions it has undertaken. Alternatively, such an adjustment could take the form of a reduction in the price paid by Company S to Primair for R watches during Years 1 through 3.

Example 7

206. The facts in this example are the same as in Example 4 with the following additions:

- By the end of Year 3, the R brand is successfully established in the country Y market and Primair and Company S renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, which is to commence at the beginning of Year 4, is for five years with Company S having an option for a further five years. Under this agreement, Company S agrees to pay a royalty to Primair based on the gross sales of all watches bearing the R trademark. In all other respects, the new agreement has the same terms and conditions as in the previous arrangement between the parties. There is no adjustment made to the price payable by Company S for the branded watches as a result of the introduction of the royalty.

- Company S's sales of R brand watches in Years 4 and 5 are consistent with earlier budget forecasts. However, the introduction of the royalty from the beginning of year 4 results in Company S's profitability declining substantially.

207. Assume that there is no evidence that independent marketers/distributors of similar branded products have agreed to pay royalties. Company S's level of marketing expenditure and activity, from Year 4 on, is consistent with that of independent enterprises, but Company S's profits are consistently lower than the profits made by independent enterprises during the corresponding years of similar long-term marketing and distribution agreements because of the royalty.

208. For transfer pricing purposes, it would not generally be expected that a royalty would be paid in arm's length dealings where a marketing and distribution entity obtains no rights for transfer pricing

purposes in trademarks and similar intangibles other than the right to use such intangibles in distributing a branded product supplied by the entity entitled to the intangible related returns attributable to such intangibles. In this circumstance, the royalty causes Company S's income to be lower than that of independent enterprises with comparable functions, risks and assets. Accordingly, a transfer pricing adjustment disallowing the royalties paid would be appropriate based on the facts of this example.

Example 8

209. The facts in this example are the same as those set out in Example 5 with the following additions:

- At the end of Year 3, Primair stops manufacturing watches and contracts with a third party to manufacture them on its behalf. As a result, Company S will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the R name and logo and package the watches before sale to the final customer. It will then sell and distribute the watches in the manner described in Example 5.

- As a consequence, at the beginning of Year 4, Primair and Company S renegotiate their earlier agreement and enter into a new long term licensing agreement. The new agreement, to start at the beginning of Year 4, is for five years, with Company S having an option for a further five years.

- Under the new agreement, Company S is granted the exclusive right within country Y to process, market and distribute watches bearing the R trademark in consideration for its agreement to pay a royalty to Primair based on the gross sales of all such watches. Company S receives no compensation from Primair in respect of the renegotiation of the original marketing and distribution agreement. It is assumed for purposes of this example that the purchase price Company S pays for the watches from the beginning of Year 4 is arm's length and that no consideration with respect to the R name is embedded in that price.

210. In connection with a tax audit conducted by country Y tax authorities in Year 6, it is determined, based on a proper functional analysis, that the level of marketing expenses Company S incurred during Years 1 through 3 far exceeded those incurred by independent marketers and distributors with similar long term marketing and distribution agreements. It is also determined that the level of marketing activity undertaken by Company S exceeded that of independent marketers and distributors. Given the extent of the market development activities undertaken by Company S, it is evident from the comparability and functional analysis that Company S has assumed significantly greater costs and risks than comparable independent enterprises. There is also evidence that the profits realised by Company S are significantly lower than the profits made by comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

211. The country Y audit also identifies that in Years 4 and 5, Company S bears the costs and associated risks of its marketing activities under the new long-term licensing arrangement with Primair, and because of the long-term nature of the agreement has an opportunity to benefit (or suffer a loss) from those activities. However, Company S has undertaken market development activities and incurred marketing expenditure far beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit, resulting in significantly lower profits for Company S than are made by comparable enterprises.

212. Based on these facts, Company S has become entitled to intangible related returns by virtue of the functions, risks and costs it has assumed. It should be compensated by an additional return for the market development activities undertaken by Company S on Primair's behalf. For Years 1 through 3, the

possible bases for such an adjustment would be as described in Example 5. For Years 4 and 5 the bases for an adjustment would be similar, except that the adjustment could reduce the royalty payments from Company S to Primair, rather than the purchase price of the watches. Depending on the facts and circumstances, consideration could also be given to whether Company S should have been compensated for its entitlement to intangible related returns in some manner in connection with the renegotiation of the arrangement at the end of Year 3.

Example 9

213. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X and the other operated by Company S, a subsidiary of Shuyona operating in country Y. The Shuyona R&D centre is responsible for the overall research programme of Shuyona group. The Shuyona R&D centre designs research programmes, develops and controls budgets, makes decisions as to where R&D activities will be conducted, monitors the progress on all R&D projects and, in general, controls the R&D function for the MNE group, operating under strategic direction of Shuyona group senior management.

214. The Company S R&D centre operates on a separate project by project basis to carry out specific projects assigned by the Shuyona R&D centre. Suggestions of Company S R&D personnel for modifications to the research programme are required to be formally approved by the Shuyona R&D centre. The Company S R&D centre reports on its progress on at least a monthly basis to supervisory personnel at the Shuyona R&D centre. If Company S exceeds budgets established by Shuyona for its work, approval of Shuyona R&D management must be sought for further expenditures. Contracts between the Shuyona R&D centre and the Company S R&D centre specify that Shuyona will bear all risks and costs related to R&D undertaken by Company S. All patents, designs and other intangibles developed by Company S research personnel are registered by Shuyona, pursuant to contracts between the two companies. Shuyona pays Company S a service fee for its research and development activities.

215. Under these circumstances, Shuyona is entitled to intangible related returns that may be derived from intangibles developed through the R&D efforts of Company S. In determining the amount of the service fee payable to Company S, the relative skill and efficiency of the Company S R&D personnel should be considered as a comparability factor. To the extent transfer pricing adjustments are required to reflect the amount a comparable R&D service provider would be paid for its services, such adjustments should generally relate to the year the service is provided and would not affect the entitlement of Shuyona to future intangible related returns derived from the Company S R&D activities.

Example 10

216. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y.

217. The Shuyona group sells two lines of products. All R&D with respect to product line A is conducted by Shuyona. All R&D with respect to product line B is conducted by the R&D centre operated by Company S. Company S also functions as the regional headquarters of the Shuyona group in North

America and has global responsibility for the operation of the business relating to product line B. However, all patents developed by Company S research efforts are registered by Shuyona.

218. The Shuyona and Company S R&D centres operate autonomously. Each bears its own operating costs. Under the general policy direction of Shuyona senior management, the Company S R&D centre develops its own research programmes, establishes its own budgets, makes determinations as to when R&D projects should be terminated or modified, and hires its own R&D staff. The R&D centre reports to the product line B management team in Company S, and does not report to the Shuyona R&D centre. Joint meetings between the Shuyona and Company S R&D teams are sometimes held to discuss research methods and common issues.

219. Under these circumstances, Company S is entitled to intangible related returns derived from the research outputs of its own R&D centre related to product line B, notwithstanding Shuyona's registration of Company S developed patents.

Example 11

220. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in country X, and the other operated by Company S, a subsidiary of Shuyona, operating in country Y. The relationships between the Shuyona R&D centre and the Company S R&D centre are as described in Example 9.

221. In Year 1, Shuyona transfers patents and other technology related intangibles to a new subsidiary, Company T, organized in country Z. Company T establishes a manufacturing facility in country Z and begins to supply products to members of the Shuyona group around the world. For purposes of this example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles reflects the arm's length value of the transferred intangibles.

222. At the same time as the transfer of patents and other technology related intangibles, Company T enters into a contract research agreement with Shuyona and a separate contract research agreement with Company S. Pursuant to these agreements, Company T agrees to bear the risk of future R&D, to assume the cost of all future R&D activity, and to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a markup equivalent to the profit markup over cost earned by allegedly comparable companies engaged in providing research services.

223. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design its own R&D programme, to establish its own R&D budgets, and to determine its own levels of R&D staffing. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 9.

224. Under these circumstances, Shuyona should be treated as the party entitled to intangible related returns with respect to R&D conducted after the date of the transfer of patents and related technology intangibles. It should be entitled to intangible related returns both with respect to its own R&D activities and to the R&D activities conducted by Company S. Company T should not be entitled to intangible related returns related to the ongoing R&D because it does not control risks or perform and control the key R&D functions.

Examples Illustrating the Provisions of Chapter VI.C.

Example 12

225. Primarni is organised in and conducts business in country A. Company S is an associated enterprise of Primarni. Company S is organised in and does business in country B. Primarni develops a patented invention and manufacturing know-how related to Product X. Primarni and Company S enter into a written license agreement pursuant to which Primarni grants Company S the right to use the Product X patents and know-how to manufacture and sell Product X in country B, while Primarni retains the patent and know-how rights to Product X throughout the rest of the world.

226. Assume Company S uses the patents and know-how to manufacture Product X in country B. It sells Product X to unrelated customers in country B and also sells Product X to related distribution entities pursuant to sales agreements that call for title to the products to pass from Company S to the distribution entities at Company S's factory in country B. The distribution entities resell the units of Product X to customers throughout Asia and Africa. The prices paid for Product X by the distribution companies enable those distribution entities to earn an arm's length return for their distribution functions, but no return related to the Product X intangibles. Primarni does not exercise its retained patent rights for Asia and Africa to prevent the resale of Product X by the distribution entities or to demand royalties or other compensation for intangibles from the distribution entities operating in those geographies.

227. Under these circumstances, the conduct of the parties suggests that the transaction between Primarni and Company S should be characterised as a license of the Product X patent and know-how for country B, plus Asia and Africa. The provision of the agreement limiting Company S's rights to country B should not be respected for purposes of a transfer pricing analysis of the amount of compensation due Primarni from Company S for the licensed intangibles.

Example 13

228. Ilcha is organised in country A. It has for many years manufactured and sold Product Q in country B through a branch or permanent establishment located in that country. Ilcha owns patents related to the design of Product Q and has developed a unique trademark and other brand intangibles. The patents and trademarks are registered by Ilcha in country B.

229. For sound business reasons, Ilcha determines that its business in country B would be enhanced if it were operated through a separate subsidiary in that country. Ilcha therefore organizes Company S in country B as a wholly owned subsidiary. It transfers the tangible manufacturing and marketing assets previously used by the branch to Company S and enters into a long-term license agreement with Company S granting it the exclusive right to use the Product Q patents, trademarks and other intangibles in country B. Company S thereafter conducts the Product Q business in country B.

230. Assume that over the years of its operation in branch form, Ilcha developed substantial goodwill and ongoing concern value in country B. The transfer of the going business to Company S, together with the license of rights to use the patents, trademarks and other intangibles in country B, implicitly conveys the value of that continuing goodwill to Company S. In conducting a transfer pricing analysis related to the amount to be paid by Company S to Ilcha, for the tangible assets transferred and the licensed right to use the intangibles in country B, the goodwill and ongoing concern value of the going business transferred to Company S should be taken into account.

Example 14

231. Första is a consumer goods company organised and operating in country A. Prior to Year 1, Första produces Product Y in country A and sells it through affiliated distribution companies in many countries around the world. The Product Y trademark is well recognised and valuable, and Första is entitled to intangible related returns with respect to the Product Y trademark.

232. In Year 2, Första organises Company S, a wholly owned subsidiary, in country B. Company S acts as a superdistributor and invoicing centre. Första continues to ship Product Y directly to its distribution affiliates, but title to the products passes to Company S, which reinvoices the distribution affiliates for the products.

233. Beginning in Year 2, Company S reimburses the distribution affiliates for a portion of their advertising costs. Prices from Company S to the distribution affiliates are adjusted upward so that the distribution affiliate margins remain constant notwithstanding the shift of advertising cost to Company S. Assume that the margins earned by the distribution affiliates are arm's length both before and after Year 2. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

234. In Year 3, the prices charged by Första to Company S are reduced. Första and Company S claim such a reduction in price is justified because Company S is entitled to intangible related returns associated with goodwill in respect of Product Y created through the advertising costs it has borne.

235. In substance, Company S has no claim to a return to goodwill with respect to Product Y and transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate. Company S has not performed or controlled functions and risks related to the creation, enhancement, maintenance and protection of that goodwill. A transfer pricing adjustment would be appropriate to deny any intangible related return to Company S.

Example 15

236. Birincil acquires all of the shares of an unrelated company, Company T for 100. Company T is a company that engages in research and development and has partially developed several promising technologies but has only minimal sales. The purchase price is justified primarily by the value of the promising, but only partly developed, technologies and by the potential of Company T personnel to develop further new technologies in the future. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to tangible property and identified intangibles, including patents, and 80 to goodwill.

237. Immediately following the acquisition, Birincil causes Company T to transfer all of its rights in developed and partially developed technologies, including patents, trade secrets and technical know-how to Company S, a subsidiary of Birincil. Company S simultaneously enters into a contract research agreement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of the transferred technologies and on the development of new technologies on behalf of Company S. The agreement provides that Company T will be compensated for its research services by payments equal to its cost plus a mark-up, and that all rights to intangibles developed or enhanced under the research agreement will belong to Company S. As a result, Company S will fund all future research and will assume the financial risk that some or all of the future research will not lead to the development of commercially viable products. Company S has a large research staff, including management personnel responsible for technologies of the type acquired from Company T. Following the transactions in question, the Company S research and management personnel assume full management responsibility for the

direction and control of the work of the Company T research staff. Company S approves new projects, develops and plans budgets and in other respects controls the ongoing research work carried on at Company T. All company T research personnel will continue to be employees of Company T and will be devoted exclusively to providing services under the research agreement with Company S.

238. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for intangibles transferred by Company T, and of the price to be paid for ongoing R&D services to be provided by Company T, it is important to identify the specific intangibles transferred to Company S and those retained by Company T. The definitions and valuations of intangibles contained in the purchase price allocation are irrelevant for transfer pricing purposes. The 100 paid by Birincil for the shares of Company T represents a risk-adjusted arm's length price for the business of Company T. The full value of that business should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. Depending on the facts, a substantial portion of the value described in the purchase price allocation as goodwill of Company T may have been transferred to Company S together with the other Company T intangibles. Depending on the facts, some portion of the value described in the purchase price allocation as goodwill may also have been retained by Company T. Under arm's length transfer pricing principles, Company T should be entitled to compensation for such value, either as part of the price paid by Company S for the transferred rights to technology intangibles, or through the compensation Company T is paid in years following the transaction for the R&D services of its workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring.

Example 16

239. Zhu is a company engaged in software development consulting. In the past Zhu has developed software supporting ATM transactions for client Bank A. In the process of doing so, Zhu created and retained an interest in proprietary software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customisation.

240. Assume that Company S, an associated enterprise of Zhu, enters into a separate agreement to develop software supporting ATM operations for another bank, Bank B. Zhu agrees to support its associated enterprise by providing employees who worked on the Bank A engagement to work on Company S's Bank B engagement. Those employees have access to software designs and know-how developed in the Bank A engagement, including proprietary software code. That code and the services of the Zhu employees are utilised by Company S in executing its Bank B engagement. Ultimately, Bank B is provided by Company S with a software system for managing its ATM network, including the necessary license to utilise the software developed in the project. Portions of the proprietary code developed by Zhu in its Bank A engagement are embedded in the software provided by Company S to Bank B.

241. A transfer pricing analysis of these transactions should recognise that Company S received two benefits from Zhu which require compensation. First, it received services from the Zhu employees that were made available to work on the Bank B engagement. Second, it received rights in Zhu's proprietary software which was utilised as the foundation for the software system delivered to Bank B. The compensation to be paid by Company S to Zhu should include compensation for both the services and the rights in the software.

Example 17

242. Prathamika is the parent company of an MNE group. Prathamika has been engaged in several large litigation matters and its internal legal department has become adept at managing large scale

litigation on behalf of Prathamika. In the course of working on such litigation, Prathamika has developed proprietary document management software tools unique to its industry.

243. Company S is an associated enterprise of Prathamika. Company S becomes involved in a complex litigation similar to those with which the legal department of Prathamika has experience. Prathamika agrees to make two individuals from its legal team available to Company S to work on the Company S litigation. The individuals from Prathamika assume responsibility for managing documents related to the litigation. In undertaking this responsibility they make use of the document management software of Prathamika. They do not, however, provide Company S the right to use the document management software in other litigation matters or to make it available to Company S customers.

244. Under these circumstances, it would not be appropriate to treat Prathamika as having transferred rights in intangibles to Company S as part of the service arrangement. However, the fact that the Prathamika employees had experience and available software tools that allowed them to more effectively and efficiently perform their services should be considered in a comparability analysis related to the amount of any service fee to be charged for the services of the Prathamika employees.

Examples Illustrating the Provisions of Chapter VI.D.

Example 18

245. Osnovni is the parent company of an MNE Group engaged in the development and sale of software products. Osnovni acquires Company S, a publicly traded company organised in the same country as Osnovni, for a price equal to 160. At the time of the acquisition, Company S shares had an aggregate trading value of 100. Competitive bidders for the Company S business offered amounts ranging from 120 to 130 for Company S.

246. Company S had only a nominal amount of fixed assets at the time of the acquisition. Its value consisted primarily of rights in developed and partially developed intangibles related to software products and its skilled workforce. The purchase price allocation performed for accounting purposes by Osnovni allocated 10 to tangible assets, 60 to intangibles, and 90 to goodwill. Osnovni justified the 160 purchase price in presentations to its Board of Directors by reference to the complementary nature of the existing products of the Osnovni group and the products and potential products of Company S.

247. Company T is a wholly owned subsidiary of Osnovni. Osnovni and Company T are parties to a research and development cost contribution arrangement. By virtue of that cost contribution arrangement, Company T holds the exclusive right to produce and sell all software products of the Osnovni group in European and Asian markets. For purposes of this example it is assumed that all arrangements related to the cost contribution arrangement as regards products and intangibles in existence in the Osnovni group prior to the acquisition of Company S are arm’s length. Historically 50 percent of MNE group sales and profits have been derived from markets allocated to Company T under the cost contribution arrangement.

248. Immediately following the acquisition of Company S, Osnovni liquidates Company S in a transaction that is not taxable in Osnovni’s country, and thereafter grants an exclusive and perpetual license to Company T for intangible rights related to the Company S products. The cost contribution arrangement is amended to include the products and potential products acquired in the Company S acquisition, and the developed and partially developed intangibles related to the Company S products.

249. In determining an arm’s length price for the Company S intangibles made available to Company T under the foregoing arrangements, the premium over the original trading value of the Company S shares included in the acquisition price should be considered. To the extent that premium reflects the complementary nature of Osnovni group products with the acquired products in the European and Asian

markets allocated to Company T under the cost contribution agreement, Company T should pay an amount for the transferred Company S intangibles and rights in intangibles that includes an appropriate share of the purchase price premium. To the extent the purchase price premium is attributable exclusively to product complementarities outside of Company T's markets, the purchase price premium should not be taken into account in determining the arm's length price paid by Company T for Company S intangibles related to Company T's geographic market. The value attributed to intangibles in the purchase price allocation performed for accounting purposes is irrelevant for transfer pricing purposes.

Example 19

250. Pervichnyi is the parent of an MNE group organised and doing business in country X. Prior to Year 1, Pervichnyi developed patents and trademarks related to Product F. It manufactured Product F in country X and supplied the product to distribution affiliates throughout the world. For purposes of this example assume the prices charged to distribution affiliates were consistently arm's length.

251. At the beginning of Year 1, Pervichnyi organised a wholly owned subsidiary, Company S, in country Y. In order to save costs, Pervichnyi transfers all of its production of Product F to Company S. At the time of the organisation of Company S, Pervichnyi sells the patents and trademarks related to Product F to Company S for a lump sum.

252. Assume the following facts:

- Pervichnyi's distribution affiliates consistently sell 1000 of Product F annually and expect to do so each year for the next five years. However, if production cost savings would support a price reduction, the distribution affiliates believe it would be in their interest to avoid long-term erosion of Pervichnyi's market position to reduce prices by 5 percent so that total sales of the same quantity would generate 950 of revenue.

- Prior to Year 1, Pervichnyi's cost of goods sold for Product F is consistently 600 annually and would be expected to remain at that level if production remains in country X. If production is moved to Company S in country Y, cost of goods sold for the same production volume would fall to 500 annually.

- The selling expenses of the distribution affiliates are consistently 100 annually.

- Country X imposes corporate income tax at a 30 percent rate. Country Y imposes corporate tax at a 10 percent rate.

- The distribution affiliates are subject to tax on their income at a rate of 10%.

- The transferred intangibles have a 5 year useful life.

- An appropriate return for manufacturing activities is 5 percent of COGS. An appropriate return for distribution activities is 2 percent of sales.

- An appropriate discount rate for a DCF type analysis, taking into account the risks of the Product F business, is 14 percent.

253. Under these circumstances, Pervichnyi and Company S seek to identify an arm's length price for the transferred intangibles by utilising a discounted cash flow valuation technique. As shown in Table 1 below, viewed from the point of view of Pervichnyi, and assuming that Pervichnyi itself continues to

manufacture Product F, the residual after tax cash flows notionally attributable to the transferred intangibles have a present value of 594.

Table 1
From the Seller's Viewpoint – Pervichnyi owns the intangible
Pervichnyi manufactures and sells to distributors

Pervichnyi		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(1)	**Revenues**	880	880	880	880	880	
(2)	**COGS**	600	600	600	600	600	
(3)	**Selling Expenses**	0	0	0	0	0	
(4)	**Operating Income**	280	280	280	280	280	
(5)	**Tax Rate**	30%	30%	30%	30%	30%	
(6)	**Taxes**	84	84	84	84	84	
(7)	**Income after tax (14% DR)**	196	196	196	196	196	**673**
(7A)	**Value of intangible (14% DR)**	173	173	173	173	173	**594**

Distributors		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(8)	**Revenues**	1000	1000	1000	1000	1000	
(9)	**COGS**	880	880	880	880	880	
(10)	**Selling Expenses**	100	100	100	100	100	
(11)	**Operating Income**	20	20	20	20	20	
(12)	**Tax Rate**	10%	10%	10%	10%	10%	
(13)	**Taxes**	2	2	2	2	2	
(14)	**Income after tax**	18	18	18	18	18	

Company S	**DOES NOT EXIST**

Global (Consolidated) Results		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(15)	**Revenues**	1000	1000	1000	1000	1000	
(16)	**COGS**	600	600	600	600	600	
(17)	**Selling Expenses**	100	100	100	100	100	
(18)	**Operating Income**	300	300	300	300	300	
(19)	**Tax Rate**						
(20)	**Taxes**	86	86	86	86	86	
(21)	**Income after tax**	214	214	214	214	214	**735**

254. If the intangibles are transferred to Company S, the residual after tax cash flows notionally attributable to intangibles would have a higher present value of 941, as reflected in Table 2. This difference results from the lower manufacturing costs at Company S and from the lower tax rate at Company S, partially offset by the lower revenue attributable to a price reduction made possible by the production cost savings.

Table 2
From the Buyer's Viewpoint – Company S owns the intangible
Company S manufactures and sells to distributors

Pervichnyi	HAS NO ROLE

Distributors		Year 1	Year 2	Year 3	Year 4	Year 5	Total PV
(29)	Revenues	950	950	950	950	950	
(30)	COGS	830	830	830	830	830	
(31)	Selling Expenses	100	100	100	100	100	
(32)	Operating Income	20	20	20	20	20	
(33)	Tax Rate	10%	10%	10%	10%	10%	
(34)	Taxes	2	2	2	2	2	
(35)	Income after tax	18	18	18	18	18	

Company S		Year 1	Year 2	Year 3	Year 4	Year 5	Total PV
(36)	Revenues	830	830	830	830	830	
(37)	COGS	500	500	500	500	500	
(38)	Selling Expenses	0	0	0	0	0	
(39)	Operating Income	330	330	330	330	330	
(40)	Tax Rate	10%	10%	10%	10%	10%	
(41)	Taxes	33	33	33	33	33	
(42)	Income after tax (14% DR)	297	297	297	297	297	**1020**
(42A)	Value of Intangible (14% DR)	274	274	274	274	274	**941**

Global (Consolidated) Results		Year 1	Year 2	Year 3	Year 4	Year 5	Total PV
(43)	Revenues	950	950	950	950	950	
(44)	COGS	500	500	500	500	500	
(45)	Selling Expenses	100	100	100	100	100	
(46)	Operating Income	350	350	350	350	350	
(47)	Tax Rate						
(48)	Taxes	35	35	35	35	35	
(49)	Income after tax	315	315	315	315	315	**1081**

255. Another option open to Pervichnyi would be for Pervichnyi to retain ownership of the intangible, and to retain Company S or an alternative supplier to manufacture products on its behalf. The consequences of following such an option are reflected in Table 3. In this scenario, Pervichnyi would be able to capture the benefit of manufacturing Product F in a lower cost environment without transferring the intangibles to Company S. As reflected in the Table 3, the cash flows attributable to the intangible would have a present value of 735.

Table 3
From the Seller's Viewpoint – Pervichnyi owns the intangible
Pervichnyi contracts manufactures through Company S and sells to distributors

Pervichnyi		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(22)	**Revenues**	830	830	830	830	830	
(23)	**COGS**	525	525	525	525	525	
(24)	**Selling Expenses**	0	0	0	0	0	
(25)	**Operating Income**	305	305	305	305	305	
(26)	**Tax Rate**	30%	30%	30%	30%	30%	
(27)	**Taxes**	92	92	92	92	92	
(28)	**Income after tax (14% DR)**	214	214	214	214	214	**735**

Distributors		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(29)	**Revenues**	950	950	950	950	950	
(30)	**COGS**	830	830	830	830	830	
(31)	**Selling Expenses**	100	100	100	100	100	
(32)	**Operating Income**	20	20	20	20	20	
(33)	**Tax Rate**	10%	10%	10%	10%	10%	
(34)	**Taxes**	2	2	2	2	2	
(35)	**Income after tax**	18	18	18	18	18	

Company S		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(36)	**Revenues**	525	525	525	525	525	
(37)	**COGS**	500	500	500	500	500	
(38)	**Selling Expenses**	0	0	0	0	0	
(39)	**Operating Income**	25	25	25	25	25	
(40)	**Tax Rate**	10%	10%	10%	10%	10%	
(41)	**Taxes**	3	3	3	3	3	
(42)	**Income after tax**	23	23	23	23	23	

Global (Consolidated) Results		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total PV**
(43)	**Revenues**	950	950	950	950	950	
(44)	**COGS**	500	500	500	500	500	
(45)	**Selling Expenses**	100	100	100	100	100	
(46)	**Operating Income**	350	350	350	350	350	
(47)	**Tax Rate**						
(48)	**Taxes**	96	96	96	96	96	
(49)	**Income after tax**	254	254	254	254	254	**872**

256. In defining arm's length compensation for the intangibles it is important to take into account the perspectives of both parties and the options realistically available to each of them. Pervichnyi would certainly not sell the intangibles at a price that would yield an after tax return lower than 594, the present value of intangible related cash flows reflected in Table 1, because it could generate after tax income with a present value of that amount by continuing to operate the business as it has in the past. Moreover, there is no reason to believe Pervichnyi would sell the intangible for a price that would yield an after tax return lower than the 735 reflected in Table 3, because it could achieve such a value by outsourcing the manufacturing to a lower cost provider on an arm's length basis.

257. Company S would not pay more than 941 for the intangibles, since if it did it would derive no return from the risks associated with intangible ownership, as reflected in Table 2. A higher price would be inconsistent with the reasonably available option to Company S of not entering into the transaction.

258. A transfer pricing analysis utilising a discounted cash flow approach would have to consider how unrelated parties dealing at arm's length would take into account the cost savings and tax rate benefits in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield Pervichnyi an after tax return equivalent to that reflected in Table 3, and a price that would yield Company S a positive return to its investments and risks, which would be a price lower than the present value of the intangible related cash flow calculated in Table 2.

Example 20

259. Manufacturing and distribution rights for an established drug are licensed between associated enterprises under an agreement that fixes the rate of royalty for the three year term of the agreement. Those terms are found to be in accordance with industry practice and equivalent arm's length agreements for comparable products, and the rate is accepted as being equivalent to that agreed in uncontrolled transactions based on the benefits reasonably anticipated by both parties at the time the agreement is executed.

260. In the third year of the agreement, it is discovered that the drug has capabilities in another therapeutic category in combination with another drug, and the discovery leads to a considerable increase in sales and profits for the licensee. Had the agreement been negotiated at arm's length in year three with this knowledge, there is no doubt that a higher royalty rate would have been agreed to reflect the increased value of the intangible.

261. There is evidence to support the view (and the evidence is made available to the tax administration) that the new capabilities of the drug were unanticipated at the time the agreement was executed and that the royalty rate established in year one was adequately based on the benefits reasonably anticipated by both parties at that time. The lack of price adjustment clauses or other protection against the risk of uncertainty of valuation also is consistent with the terms of comparable uncontrolled transactions. Based on analysis of the behaviour of independent enterprises in similar circumstances, there is no reason to believe that the development in year three was so fundamental that it would have led at arm's length to a renegotiation of the pricing of the transaction.

262. Taking all these circumstances into account, there is no reason to adjust the royalty rate in year three. Such an adjustment would be contrary to the principles set out in Chapter VI because it would represent an inappropriate use of hindsight in this case. See paragraph 173. There is no reason to consider that the valuation was sufficiently uncertain at the outset and that the parties at arm's length would have required a price adjustment clause, or that the change in value was so fundamental a development that it would have led to a re-negotiation of the transaction. See paragraphs 174 and 175.

Example 21

263. The facts are the same as in the previous example. Assume that at the end of the three-year period the agreement was re-negotiated between the parties. At this stage it is known that the rights to the drug are considerably more valuable than they had at first appeared. However, the unexpected development of the previous year is still recent, and it cannot reliably be predicted whether sales will continue to rise, whether further beneficial effects will be discovered, and what developments in the market may affect sales as competitors piggyback on the discovery. All these considerations make the re-evaluation of the intangible rights a highly uncertain process. Nevertheless, the associated enterprises enter into a new licensing agreement for a term of ten years that significantly increases the fixed royalty rate based on speculative expectations of continuing and increasing demand.

264. It is not industry practice to enter into long-term agreements with fixed royalty rates when the intangible involved potentially has a high value, but that value has not been established by a track record. Nor is there evidence that, given the uncertainty in valuation, any projections made by the associated enterprises would have been considered adequate by independent enterprises to justify an agreement with a fixed royalty rate. Assume that there is evidence that independent enterprises would have insisted on protection in the form of prospective price adjustment clauses based on reviews undertaken annually.

265. Assume that in year 4 sales increased and the royalty rate established under the ten-year agreement is regarded as appropriate under the arm's length principle. However, at the beginning of year 5, a competitor introduces a drug that has greater benefit than the first drug in the therapeutic category in which the first drug, in combination, unexpectedly had provided benefits, and sales of the first drug for that use rapidly decline. The royalty rate fixed at the outset of the ten-years agreement cannot be regarded as arm's length beyond year 5, and it is justifiable for the tax administration to make a transfer price adjustment from the beginning of year 6. This adjustment is appropriate because of the evidence, mentioned in the preceding paragraph that in comparable circumstances independent enterprises would have provided in the agreement for a price adjustment based on annual review. See paragraph 177.

Example 22

266. Assume that Company X licenses the rights to produce and market a microchip to Company Y, a newly established subsidiary, for a period of five years. The royalty rate is fixed at 2 percent. This royalty rate is based on a projection of benefits to be derived from the exploitation of the intangible, which shows expected product sales of 50 to 100 million in each of the first five years.

267. It is established that contracts between independent enterprises dealing with comparable intangibles in comparable circumstances would not consider the projections sufficiently reliable to justify a fixed royalty rate, and so would normally agree upon a price adjustment clause to account for differences between actual and projected benefits. An agreement made by Company X with an independent manufacturer for a comparable intangible under comparable circumstances provides for the following adjustments to the rate:

Sales	Royalty
Up to 100 million	2.00 %
Next 50 million	2,25 %
Next 50 million	2.50%
In excess of 200 million	2.75%

268. In fact, although sales by Y in year 1 are 50 million, in subsequent years sales are three times greater than the projected figures. In accordance with the principles of this section, for these subsequent years the tax administration would be justified in determining the royalty rate on the basis of the adjustment clause that would be provided in a comparable uncontrolled transaction such as that between Company X and the independent manufacturer. See paragraphs 174, 176, and 177.

COLLATERAL CHANGES TO THE GUIDELINES

It is proposed that paragraph 2.9 of Chapter II of the existing Transfer Pricing Guidelines be modified in the manner indicated below:

2.9 Moreover, MNE groups and tax administrations retain the freedom to apply methods not described in Chapter II of these Guidelines (hereafter "other methods") to establish prices or to demonstrate that the prices charged either do or do not ~~provided thoses prices~~ satisfy the arm's length principle in accordance with these Guidelines. Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established. For a discussion of documentation, see Chapter V.