OECD/G20 Base Erosion and Profit Shifting Project

Guidance on Transfer Pricing Aspects of Intangibles

ACTION 8: 2014 Deliverable

OECD

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Foreword

Addressing base erosion and profit shifting (BEPS) is a key priority of governments around the globe. In 2013, OECD and G20 countries, working together on an equal footing, adopted a 15-point Action Plan to address BEPS. The Action Plan aims to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. It was agreed that addressing BEPS is critical for countries and must be done in a timely manner, not least to prevent the existing consensus-based international tax framework from unravelling, which would increase uncertainty for businesses at a time when cross-border investments are more necessary than ever. As a result, the Action Plan provides for 15 actions to be delivered by 2015, with a number of actions to be delivered in 2014.

The OECD Committee on Fiscal Affairs (CFA), bringing together 44 countries on an equal footing (all OECD members, OECD accession countries, and G20 countries), has adopted a first set of seven deliverables described in the Action Plan and due in 2014. This report is part of these deliverables and is an output of Action 8.

Developing countries and other non-OECD/non-G20 economies have been extensively consulted through regional and global fora meetings and their input has been fed into the work. Business representatives, trade unions, civil society organisations and academics have also been very involved through opportunities to comment on discussion drafts. These have generated more than 3 500 pages of comments and were discussed at five public consultation meetings and via three webcasts that attracted more than 10 000 viewers.

The first set of reports and recommendations, delivered in 2014, addresses seven of the actions in the BEPS Action Plan published in July 2013. Given the Action Plan's aim of providing comprehensive and coherent solutions to BEPS, the proposed measures, while agreed, are not yet formally finalised. They may be affected by some of the decisions to be taken with respect to the 2015 deliverables with which the 2014 deliverable will interact. They do reflect consensus, as of July 2014, on a number of solutions to put an end to BEPS.

The adoption of this first set of deliverables and the implementation of the relevant measures by national governments mean that: hybrid mismatches will be neutralised; treaty shopping and other forms of treaty abuse will be addressed; abuse of transfer pricing rules in the key area of intangibles will be greatly minimised; and country-by-country reporting will provide governments with information on the global allocation of the profits, economic activity and taxes of MNEs. Equally, OECD and G20 countries have agreed upon a report concluding that it is feasible to implement BEPS measures through a multilateral instrument. They have also advanced the work to fight harmful tax practices, in particular in the area of IP regimes and tax rulings. Finally, they have reached a common understanding of the challenges raised by the digital economy, which will now allow them to deepen their work in this area, one in which BEPS is exacerbated.

By its nature, BEPS requires co-ordinated responses. This is why countries are investing time and resources in developing shared solutions to common problems. At the same time, countries retain their sovereignty over tax matters and measures may be implemented in different countries in different ways, as long as they do not conflict with countries' international legal commitments.

Table of contents

Abbreviations and acronyms 7

Executive summary.....9

Amendments to Chapters I – II of the Transfer Pricing Guidelines 13

D.6. Location savings and other local market features 13
D.7. Assembled workforce 17
D.8. MNE group synergies 18
Example 1 20
Example 2 21
Example 3 21
Example 4 22
Example 5 22

Amendments to Chapter VI of the Transfer Pricing Guidelines.....27

***Chapter VI.* Special considerations for intangibles.....27**

A. Identifying intangibles.....28
[B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles 38
C. Transactions involving the use or transfer of intangibles 57
D. Supplemental guidance for determining arm's length conditions in cases involving intangibles.....64

***Annex to Chapter VI.* Examples to illustrate the guidance on special considerations for intangibles 95**

[Example 1 95
Example 2 96
Example 3 97
Example 4 98
Example 5 98
Example 6 98

Example 7 99
Example 8 100
Example 9 101
Example 10.....103
Example 11.....105
Example 12.....107
Example 13.....108
Example 14.....109
Example 15.....110
[Example 16 111
Example 17.....113
Example 18.....114
Example 19.....115
Example 20.....116
Example 21.....117
Example 22.....118
Example 23.....119
Example 24.....120
Example 25.....121
Example 26.....122
Example 27.....122
Example 28.....124
Example 29.....125
Example 30.....125
[Example 31 127
Example 32.....128
Example 33.....129

Abbreviations and acronyms

BEPS	Base erosion and profit shifting
CFC	Controlled foreign company
CRO	Contract research organisation
CUP	Comparable uncontrolled price
DCF	Discounted cash flow
MNE	Multinational enterprise
OECD	Organisation for Economic Co-operation and Development
R&D	Research and development
TNMM	Transactional net margin method
WACC	Weighted average cost of capital

Executive summary

This document contains guidance on the Transfer Pricing Aspects of Intangibles. It contains final revisions to Chapters I, II and VI of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) which have been developed in connection with Action 8 of the *Action Plan on Base Erosion and Profit Shifting* (OECD, 2013). These changes to the Guidelines clarify the definition of intangibles under the Guidelines, provide guidance on identifying transactions involving intangibles, and provide supplemental guidance for determining arm's length conditions for transactions involving intangibles. These final modifications to the Guidelines also contain guidance on the transfer pricing treatment of local market features and corporate synergies. The guidance is supplemented with numerous examples illustrating the application of the principles contained in the revised text of the Guidelines.

The final guidance contained in this document represents the first instalment of the transfer pricing work mandated by the BEPS Action Plan.

The Action Plan directs the OECD to address a number of transfer pricing issues, as follows:

Action 8 – Intangibles

Develop rules to prevent BEPS by moving intangibles among group members. This will involve (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with (rather than divorced from) value creation; (iii) developing transfer pricing rules or special measures for transfers of hard to value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 9 – Risks and capital

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members. This will involve adopting transfer pricing rules or special measures to ensure that

inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. The rules to be developed will also require alignment of returns with value creation. This work will be co-ordinated with the work on interest expense deductions and other financial payments.

Action 10 – Other high-risk transactions

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: (i) clarify the circumstances in which transactions can be recharacterised; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.

Under the Action Plan, the second phase of the work on these actions is to be completed in 2015.

Inevitably, some transfer pricing issues relating to intangibles are closely related to issues that are to be addressed during 2015 under the Action Plan. Most notably, strong interactions exist between the work on ownership of intangibles under Action 8 and the work on risk, recharacterisation of transactions, and hard to value intangibles. Because of those interactions it is challenging to finalise guidance in one area without also addressing other issues in an integrated manner.

Because the interactions between work on ownership of intangibles, hard to value intangibles, risk and recharacterisation are particularly pronounced, a decision has been made not to finalise the work on some sections of this document at this time. Accordingly, bracketed and shaded portions of this document should be viewed as interim drafts of guidance, not yet fully agreed by delegates, that will be finalised in 2015 in connection with other related BEPS work. The sections setting out interim guidance include (i) Sections B.1 and B.2 of Chapter VI of the Transfer Pricing Guidelines relating to ownership of intangibles, (ii) Section D.3. of Chapter VI relating to intangibles whose valuation is uncertain at the time of the transaction, (iii) paragraph 2.9 of the Guidelines relating to the use of other methods, (iv) guidance on the application of profit split methods contained in paragraphs 6.145 to 6.149, and (v) certain examples relating to the foregoing provisions.

It is the intention of the countries involved in the BEPS project to complete these sections of the revised intangibles guidance during 2015 in

conjunction with the BEPS work on risk, recharacterisation and hard to value intangibles. This 2015 BEPS work will likely include revisions to portions of Chapters I, II, VI, VIII, and IX of the Guidelines and will include finalising the bracketed and shaded portions of this draft. In completing the 2015 BEPS transfer pricing work, issues will be addressed in an integrated manner in order to provide coherent and consistent transfer pricing guidance across issues that involve intangibles and those that do not.

In completing the transfer pricing work required by the BEPS Action Plan, the OECD will, as directed by the Action Plan, consider both the application of the arm's length principle and special measures in order to identify effective responses to the concerns raised in the BEPS Action Plan. Discussions on the special measures required to address the concerns identified in the Action Plan are ongoing. Among the special measures that will be considered during the course of the 2015 work are the following:

- Providing tax administrations with authority in appropriate instances to apply rules based on actual results to price transfers of hard to value intangibles and potentially other assets;
- Limiting the return to entities whose activities are limited to providing funding for the development of intangibles, and potentially other activities, for example by treating such entities as lenders rather than equity investors under some circumstances;
- Requiring contingent payment terms and / or the application of profit split methods for certain transfers of hard to value intangibles; and
- Requiring application of rules analogous to those applied under Article 7 and the Authorised OECD Approach to certain situations involving excessive capitalisation of low function entities.

Work on these transfer pricing measures will be co-ordinated with other BEPS work on the deductibility of interest, the permanent establishment definition, controlled foreign company (CFC) rules, digital economy issues, and work on dispute resolution. In this way delegates will seek to come to a coherent set of rules that will effectively address transfer pricing concerns related to BEPS. It should be emphasised that no decisions have yet been made regarding which special measures will be adopted or whether such measures are consistent with Article 9 of the OECD Model Tax Convention. The foregoing listing is not necessarily comprehensive and other measures may also be considered.

As the topics covered by the transfer pricing measures in the BEPS Action Plan have clear implications for work in other areas of the BEPS

project, it is the intention of the OECD to move forward expeditiously with the work on risk, recharacterisation, hard to value intangibles, and possible special measures.

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Amendments to Chapters I – II of the Transfer Pricing Guidelines

The following language is inserted in Chapter I of the Transfer Pricing Guidelines, immediately following paragraph 1.79.

D.6. Location savings and other local market features

1.80 Paragraphs 1.55, 1.57 and 6.31 indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings.

D.6.1. Location savings

1.81 Paragraphs 9.148 – 9.153 discuss the treatment of location savings in the context of a business restructuring. The principles described in those paragraphs apply generally to all situations where location savings are present, not just in the case of a business restructuring.

1.82 Pursuant to the guidance in paragraphs 9.148 – 9.153, in determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.

1.83 Where the functional analysis shows that location savings exist that are not passed on to customers or suppliers, and where comparable entities and transactions in the local market can be identified, those local

market comparables will provide the most reliable indication regarding how the net location savings should be allocated amongst two or more associated enterprises. Thus, where reliable local market comparables are available and can be used to identify arm's length prices, specific comparability adjustments for location savings should not be required.

1.84 When reliable local market comparables are not present, determinations regarding the existence and allocation of location savings among members of an MNE group, and any comparability adjustments required to take into account location savings, should be based on an analysis of all of the relevant facts and circumstances, including the functions performed, risks assumed, and assets used of the relevant associated enterprises, in the manner described in paragraphs 9.148 – 9.153.

D.6.2. Other local market features

1.85 Features of the local market in which business operations occur may affect the arm's length price with respect to transactions between associated enterprises. While some such features may give rise to location savings, others may give rise to comparability concerns not directly related to such savings. For example, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relevant characteristics of the geographic market in which products are manufactured or sold, the purchasing power and product preferences of households in that market, whether the market is expanding or contracting, the degree of competition in the market and other similar factors affect prices and margins that can be realised in the market. Similarly, the comparability and functional analysis conducted in connection with a particular matter may suggest that the relative availability of local country infrastructure, the relative availability of a pool of trained or educated workers, proximity to profitable markets, and similar features in a geographic market where business operations occur create market advantages or disadvantages that should be taken into account. Appropriate comparability adjustments should be made to account for such factors where reliable adjustments that will improve comparability can be identified.

1.86 In assessing whether comparability adjustments for such local market features are required, the most reliable approach will be to refer to data regarding comparable uncontrolled transactions in that geographic market between independent enterprises performing similar functions, assuming similar risks, and using similar assets. Such transactions are carried out under the same market conditions as the controlled transaction, and, accordingly, where comparable transactions in the local market can be identified, specific adjustments for features of the local market should not be required.

1.87 In situations where reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should consider all of the relevant facts and circumstances. As with location savings, in each case where reliable local market comparables cannot be identified, it is necessary to consider (i) whether a market advantage or disadvantage exists, (ii) the amount of any increase or decrease in revenues, costs or profits, *vis-à-vis* those of identified comparables from other markets, that are attributable to the local market advantage or disadvantage, (iii) the degree to which benefits or burdens of local market features are passed on to independent customers or suppliers, and (iv) where benefits or burdens attributable to local market features exist and are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate such net benefits or burdens between them.

1.88 The need for comparability adjustments related to features of the local market in cases where reasonably reliable local market comparables cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm's length prices of goods transferred or services provided between associated enterprises.

1.89 In other circumstances, a business restructuring or the transfer of intangibles between associated enterprises may make it possible for one party to the transaction to gain the benefit of local market advantages or require that party to assume the burden of local market disadvantages in a manner that would not have been possible in the absence of the business restructuring or transfer of the intangibles. In such circumstances, the anticipated existence of local market advantages and disadvantages may affect the arm's length price paid in connection with the business restructuring or intangible transfer.

1.90 In conducting a transfer pricing analysis it is important to distinguish between features of the local market, which are not intangibles, and any contractual rights, government licences, or know-how necessary to exploit that market, which may be intangibles. Depending on the circumstances, these types of intangibles may have substantial value that should be taken into account in a transfer pricing analysis in the manner described in Chapter VI, including the guidance on rewarding entities for functions, assets and risks associated with the development of intangibles contained in Section VI. B. In some circumstances, contractual rights and government licences may limit access of competitors to a particular market and may therefore affect the manner in which the economic consequences of local market features are shared between parties to a particular transaction.

In other circumstances, contractual rights or government licences to access a market may be available to many or all potential market entrants with little restriction.

1.91 For example, a country may require a regulatory licence to be issued as a pre-condition for conducting an investment management business in the country and may restrict the number of foreign-owned firms to which such licences are granted. The comparability and functional analysis may indicate that qualifying for such a licence requires demonstrating to appropriate government authorities that the service provider has appropriate levels of experience and capital to conduct such a business in a reputable fashion. The market to which such a licence relates may also be one with unique features. It may, for example be a market where the structure of pension and insurance arrangements gives rise to large cash pools, a need to diversify investments internationally, and a resulting high demand for quality investment management services and knowledge of foreign financial markets that can make the provision of such services highly lucrative. The comparability analysis may further suggest that those features of the local market may affect the price that can be charged for certain types of investment management services and the profit margins that may be earned from providing such services. Under these circumstances, the intangible in question (*i.e.* the regulatory licence to provide investment management services) may allow the party or parties holding the licence to extract a greater share of the benefits of operating in the local market, including the benefits provided by unique features of that market, than would be the case in the absence of the licensing requirement. However, in assessing the impact of the regulatory licence, it may be important in a particular case to consider the contributions of both the local group member in the local market and other group members outside the local market in supplying the capabilities necessary to obtain the licence, as described in Chapter VI. B.

1.92 In a different circumstance, the comparability and functional analysis may suggest that a government issued business licence is necessary as a pre-condition for providing a particular service in a geographic market. However, it may be the case that such licences are readily available to any qualified applicant and do not have the effect of restricting the number of competitors in the market. Under such circumstances, the licence requirement may not present a material barrier to entry, and possession of such a licence may not have any discernible impact on the manner in which the benefits of operating in the local market are shared between independent enterprises.

D.7. Assembled workforce

1.93 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 produced by the enterprise. Such factors should ordinarily be taken into account in a transfer pricing comparability analysis. Where it is possible to determine the benefits or detriments of a unique assembled workforce *vis-à-vis* the workforce of enterprises engaging in potentially comparable transactions, comparability adjustments may be made to reflect the impact of the assembled workforce on arm's length prices for goods or services.

1.94 In some business restructuring and similar transactions, it may be the case that an assembled workforce is transferred from one associated enterprise to another as part of the transaction. In such circumstances, it may well be that the transfer of the assembled workforce along with other transferred assets of the business will save the transferee the time and expense of hiring and training a new workforce. Depending on the transfer pricing methods used to evaluate the overall transaction, it may be appropriate in such cases to reflect such time and expense savings in the form of comparability adjustments to the arm's length price otherwise charged with respect to the transferred assets. In other situations, the transfer of the assembled workforce may result in limitations on the transferee's flexibility in structuring business operations and create potential liabilities if workers are terminated. In such cases it may be appropriate for the compensation paid in connection with the restructuring to reflect the potential future liabilities and limitations.

1.95 The foregoing paragraph is not intended to suggest that transfers or secondments of individual employees between members of an MNE group should be separately compensated as a general matter. In many instances the transfer of individual employees between associated enterprises will not give rise to a need for compensation. Where employees are seconded (*i.e.* they remain on the transferor's payroll but work for the transferee), in many cases the appropriate arm's length compensation for the services of the seconded employees in question will be the only payment required.

1.96 It should be noted, however, that in some situations, the transfer or secondment of one or more employees may, depending on the facts and circumstances, result in the transfer of valuable know-how or other intangibles from one associated enterprise to another. For example, an employee of Company A seconded to Company B may have knowledge of a secret formula owned by Company A and may make that secret formula

available to Company B for use in its commercial operations. Similarly, employees of Company A seconded to Company B to assist with a factory start-up may make Company A manufacturing know-how available to Company B for use in its commercial operations. Where such a provision of know-how or other intangibles results from the transfer or secondment of employees, it should be separately analysed under the provisions of Chapter VI and an appropriate price should be paid for the right to use the intangibles.

1.97 Moreover, it should also be noted that access to an assembled workforce with particular skills and experience may, in some circumstances, enhance the value of transferred intangibles or other assets, even where the employees making up the workforce are not transferred. Example 24 in the Annex to Chapter VI illustrates one fact pattern where the interaction between intangibles and access to an assembled workforce may be important in a transfer pricing analysis.

D.8. MNE group synergies

1.98 Comparability issues, and the need for comparability adjustments, can also arise because of the existence of MNE group synergies. In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises. Such group synergies can arise, for example, as a result of combined purchasing power or economies of scale, combined and integrated computer and communication systems, integrated management, elimination of duplication, increased borrowing capacity, and numerous similar factors. Such group synergies are often favourable to the group as a whole and therefore may heighten the aggregate profits earned by group members, depending on whether expected cost savings are, in fact, realised, and on competitive conditions. In other circumstances such synergies may be negative, as when the size and scope of corporate operations create bureaucratic barriers not faced by smaller and more nimble enterprises, or when one portion of the business is forced to work with computer or communication systems that are not the most efficient for its business because of group wide standards established by the MNE group.

1.99 Paragraph 7.13 of these Guidelines suggests that an associated enterprise should not be considered to receive an intra-group service or be required to make any payment when it obtains incidental benefits attributable solely to its being part of a larger MNE group. In this context, the term incidental refers to benefits arising solely by virtue of group

affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant. Consistent with this general view of benefits incidental to group membership, when synergistic benefits or burdens of group membership arise purely as a result of membership in an MNE group and without the deliberate concerted action of group members or the performance of any service or other function by group members, such synergistic benefits of group membership need not be separately compensated or specifically allocated among members of the MNE group.

1.100 In some circumstances, however, synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions. Whether such a structural advantage or disadvantage exists, what the nature and source of the synergistic benefit or burden may be, and whether the synergistic benefit or burden arises through deliberate concerted group actions can only be determined through a thorough functional and comparability analysis.[1]

1.101 For example, if a group takes affirmative steps to centralise purchasing in a single group company to take advantage of volume discounts, and that group company resells the items it purchases to other group members, a deliberate concerted group action occurs to take advantage of group purchasing power. Similarly, if a central purchasing manager at the parent company or regional management centre performs a service by negotiating a group wide discount with a supplier on the condition of achieving minimum group wide purchasing levels, and group members then purchase from that supplier and obtain the discount, deliberate concerted group action has occurred notwithstanding the absence of specific purchase and sale transactions among group members. Where a supplier unilaterally offers one member of a group a favourable price in the hope of attracting business from other group members, however, no deliberate concerted group action would have occurred.

1.102 Where corporate synergies arising from deliberate concerted group actions do provide a member of an MNE group with material advantages or burdens not typical of comparable independent companies, it is necessary to determine (i) the nature of the advantage or disadvantage, (ii) the amount of the benefit or detriment provided, and (iii) how that benefit or detriment should be divided among members of the MNE group.

1.103 If important group synergies exist and can be attributed to deliberate concerted group actions, the benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy. For example, where members of the group take deliberate concerted actions to consolidate purchasing activities to take advantage of economies of scale resulting from high volume purchasing, the benefits of those large scale purchasing synergies, if any exist after an appropriate reward to the party co-ordinating the purchasing activities, should typically be shared by the members of the group in proportion to their purchase volumes.

1.104 Comparability adjustments may be warranted to account for group synergies.

Example 1

1.105 P is the parent company of an MNE group engaging in a financial services business. The strength of the group's consolidated balance sheet makes it possible for P to maintain an AAA credit rating on a consistent basis. S is a member of the MNE group engaged in providing the same type of financial services as other group members and does so on a large scale in an important market. On a stand-alone basis, however, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating, *i.e*. a lower interest rate than would be charged if S were an independent entity with its same balance sheet, but a higher interest rate than would be available to the parent company of the MNE group.

1.106 Assume that S borrows Euro 50 million from an independent lender at the market rate of interest for borrowers with an A credit rating. Assume further that S simultaneously borrows Euro 50 million from T, another subsidiary of P, with similar characteristics as the independent lender, on the same terms and conditions and at the same interest rate charged by the independent lender, (*i.e.* an interest rate premised on the existence of an A credit rating). Assume further that the independent lender, in setting its terms and conditions, was aware of S's other borrowings including the simultaneous loan to S from T.

1.107 Under these circumstances the interest rate charged on the loan by T to S is an arm's length interest rate because (i) it is the same rate charged to S by an independent lender in a comparable transaction; and (ii) no payment or comparability adjustment is required for the group synergy benefit that gives rise to the ability of S to borrow from independent

enterprises at an interest rate lower than it could were it not a member of the group because the synergistic benefit of being able to borrow arises from S's group membership alone and not from any deliberate concerted action of members of the MNE group.

Example 2[2]

1.108 The facts relating to S's credit standing and borrowing power are identical to those in the preceding example. S borrows Euro 50 million from Bank A. The functional analysis suggests that Bank A would lend to S at an interest rate applicable to A rated borrowers without any formal guarantee. However, P agrees to guarantee the loan from Bank A in order to induce Bank A to lend at the interest rate that would be available to AAA rated borrowers. Under these circumstances, S should be required to pay a guarantee fee to P for providing the express guarantee. In calculating an arm's length guarantee fee, the fee should reflect the benefit of raising S's credit standing from A to AAA, not the benefit of raising S's credit standing from Baa to AAA. The enhancement of S's credit standing from Baa to A is attributable to the group synergy derived purely from passive association in the group which need not be compensated under the provisions of this section. The enhancement of S's credit standing from A to AAA is attributable to a deliberate concerted action, namely the provision of the guarantee by P, and should therefore give rise to compensation.

Example 3

1.109 Assume that Company A is assigned the role of central purchasing manager on behalf of the entire group. It purchases from independent suppliers and resells to associated enterprises. Company A, based solely on the negotiating leverage provided by the purchasing power of the entire group is able to negotiate with a supplier to reduce the price of widgets from $200 to $110. Under these circumstances, the arm's length price for the resale of widgets by Company A to other members of the group would not be at or near $200. Instead, the arm's length price would remunerate Company A for its services of coordinating purchasing activity. If the comparability and functional analysis suggests in this case that in comparable uncontrolled transactions involving a comparable volume of purchases, comparable coordination services resulted in a service fee based on Company A's costs incurred plus a mark-up equating to a total service fee of $6 per widget, then the intercompany price for the resale of the widgets by Company A would be approximately $116. Under these circumstances, each member of the group would derive benefits attributable to the group purchasing power of approximately $84 per widget. In addition,

Company A would earn $6 per widget purchased by members of the group for its service functions.

Example 4

1.110 Assume facts similar to those in Example 3, except that instead of actually purchasing and reselling the widgets, Company A negotiates the discount on behalf of the group and group members subsequently purchase the widgets directly from the independent supplier. Under these circumstances, assume that the comparability analysis suggests that Company A would be entitled to a service fee of $5 per widget for the coordinating services that it performed on behalf of other group members. (The lower assumed service fee in Example 4 as compared to Example 3 may reflect a lower level of risk in the service provider following from the fact that it does not take title to the widgets or hold any inventory.) Group members purchasing widgets would retain the benefit of the group purchasing discount attributable to their individual purchases after payment of the service fee.

Example 5

1.111 Assume a multinational group based in Country A, has manufacturing subsidiaries in Country B and Country C. Country B has a tax rate of 30 percent and Country C has a tax rate of 10 percent. The group also maintains a shared services centre in Country D. Assume that the manufacturing subsidiaries in Country B and Country C each have need of 5 000 widgets produced by an independent supplier as an input to their manufacturing processes. Assume further that the Country D shared services company is consistently compensated for its aggregate activities by other group members, including the Country B and Country C manufacturing affiliates, on a cost plus basis, which, for purposes of this example, is assumed to be arm's length compensation for the level and nature of services it provides.

1.112 The independent supplier sells widgets for $10 apiece and follows a policy of providing a 5 percent price discount for bulk purchases of widgets in excess of 7 500 units. A purchasing employee in the Country D shared services centre approaches the independent supplier and confirms that if the Country B and Country C manufacturing affiliates simultaneously purchase 5 000 widgets each, a total group purchase of 10 000 widgets, the purchase discount will be available with respect to all of the group purchases. The independent supplier confirms that it will sell an aggregate of 10 000 widgets to the MNE group at a total price of $95 000, a discount

of 5 percent from the price at which either of the two manufacturing affiliates could purchase independently from the supplier.

1.113 The purchasing employee at the shared services centre then places orders for the required widgets and requests that the supplier invoice the Country B manufacturing affiliate for 5 000 widgets at a total price of $50 000 and invoice the Country C manufacturing affiliate for 5 000 widgets at a total price of $45 000. The supplier complies with this request as it will result in the supplier being paid the agreed price of $95 000 for the total of the 10 000 widgets supplied.

1.114 Under these circumstances, Country B would be entitled to make a transfer pricing adjustment reducing the expenses of the Country B manufacturing affiliate by $2 500. The transfer pricing adjustment is appropriate because the pricing arrangements misallocate the benefit of the group synergy associated with volume purchasing of the widgets. The adjustment is appropriate notwithstanding the fact that the Country B manufacturing affiliate acting alone could not purchase widgets for a price less than the $50 000 it paid. The deliberate concerted group action in arranging the purchase discount provides a basis for the allocation of part of the discount to the Country B manufacturing affiliate notwithstanding the fact that there is no explicit transaction between the Country B and Country C manufacturing affiliates.

The language contained in paragraph 2.9 below is the existing language of paragraph 2.9 of the 2010 OECD Transfer Pricing Guidelines. That language will be revised and updated as part of the 2015 transfer pricing work on BEPS. Changes will take account of the guidance on the application of valuation techniques in Section D of Chapter VI and in Chapter IX. Consideration will also be given to whether paragraph 2.9 should be modified to reflect other guidance on transfer pricing methods and/or special measures that may be adopted in connection with the 2015 work on BEPS.

2.9 [Moreover, MNE groups retain the freedom to apply methods not described in these Guidelines (hereafter "other methods") to establish prices provided those 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.]

The following language is inserted following paragraph 2.9 and paragraphs in Chapter II following 2.9 are renumbered accordingly.

2.10 The application of a general rule of thumb does not provide an adequate substitute for a complete functional and comparability analysis conducted under the principles of Chapters I – III. Accordingly, a rule of thumb cannot be used to evidence that a price or an apportionment of income is arm's length.

Notes

1. In light of differences in local law, some countries consider a deliberate concerted action to always constitute a transaction, while others do not. However, the consensus view is that, in either scenario, a deliberate concerted action involves one associated enterprise performing functions, using assets, or assuming risks for the benefit of one or more other associated enterprises, such that arm's length compensation is required. See, *e.g.* Example 5.

2. Action 4 of the BEPS Action Plan calls for additional work on transfer pricing aspects of financial transactions. Example 2 should not be viewed as providing comprehensive transfer pricing guidance on guarantee fees. Additional consideration will be given in the course of the BEPS project to the determination of arm's length conditions for guarantees and particularly to situations where guarantees between associated enterprises can give rise to BEPS.

Amendments to Chapter VI of the Transfer Pricing Guidelines

The current provisions of Chapter VI of the Transfer Pricing Guidelines are deleted in their entirety, and are replaced by the following language.

Chapter VI

Special considerations for intangibles

6.1 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.

6.2 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. An item or activity can convey economic value notwithstanding the fact that it may not be specifically addressed in Chapter VI. To the extent that an item or activity conveys economic value, it should be taken into account in the determination of arm's length prices whether or not it constitutes an intangible within the meaning of paragraph 6.6.

6.3 The principles of Chapters I – III of these Guidelines apply equally to transactions involving intangibles and those transactions which do not. Under those principles, 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. In cases involving the use or transfer of intangibles, it is especially important to ground the comparability and functional 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 across the entire supply chain. Where necessary, the analysis should consider, within the framework of paragraphs 1.64 – 1.69, whether independent parties would have entered into the arrangement and if so, the conditions that would have been agreed.

6.4 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 legal ownership of intangibles; (iii) the contributions of MNE group members to their development, enhancement, maintenance, protection and exploitation; and (iv) the nature of the controlled transactions involving intangibles including the manner in which such transactions contribute to the creation of value. On that foundation, it is then necessary to consider the remuneration that would be paid between independent parties in transactions involving intangibles. These topics are addressed in the following sections.

A. Identifying intangibles

A.1. In general

6.5 Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.

6.6 In these Guidelines, therefore, the word "intangible" is intended to address something which is not a physical asset or a financial asset,[1]

which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

6.7 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 be used to generate 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.

6.8 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.

6.9 It is important to distinguish intangibles from market conditions or local market circumstances. 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 are not capable of being owned or controlled. While in some circumstances they 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 intangibles for the purposes of Chapter VI. See Section D.6. of Chapter I.

6.10 The identification of an item as an intangible is separate and distinct from the process for determining the price for the use or transfer of the item under the facts and circumstances of a given case. Depending on the industry sector and other facts specific to a particular case, exploitation of intangibles can account for either a large or small part of the MNE's value creation. It should be emphasised that not all intangibles deserve compensation separate from the required payment for goods or services in all circumstances, and not all intangibles give rise to premium returns in all circumstances. 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 that the know-how does not justify allocating a premium return to the enterprise, over and above normal returns earned by comparable independent providers of similar services that use comparable non-unique know-how. See paragraph 1.39. See also paragraph 6.17 for a definition of "unique" intangibles.

6.11 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.

6.12 In a transfer pricing analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant 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 the purpose 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 relevant 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

6.13 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 to which the principles of this Chapter may 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.

6.14 The guidance in this Chapter is also not relevant to recognition of income, capitalisation of intangible development costs, amortisation, or similar matters. Thus, for example, a country may choose not to impose tax on the transfer of particular types of intangibles under specified circumstances. Similarly, a country may not permit amortisation of the cost of certain acquired items that would be considered intangibles under the definitions in this Chapter and whose transfer may be subjected to tax at the time of the transfer in the transferor's country. It is recognised that inconsistencies between individual country laws regarding such matters can sometimes give rise to either double taxation or double non-taxation.

A.3. Categories of intangibles

6.15 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 with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories.

6.16 Certain categories of intangibles are, however, commonly referred to in discussions of transfer pricing matters. To facilitate discussions, definitions of two such commonly used terms, "marketing intangibles" and "trade intangibles" are contained in the Glossary and referred to from time to time in the discussion in these Guidelines. It should be emphasised that generic references to marketing or trade intangibles do not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify relevant intangibles with specificity, nor does the use of those terms suggest that a different approach should be applied in determining arm's length conditions for transactions that involve either marketing intangibles or trade intangibles.

The Glossary of these Guidelines is amended by deleting the definition of the term "marketing intangible" and replacing that definition with the following language:

"Marketing intangible"

"An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers."

6.17 In certain instances these Guidelines refer to "unique and valuable" intangibles. "Unique and valuable" intangibles are those intangibles (i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and (ii) whose use in business operations (*e.g.* 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.

A.4. Illustrations

6.18 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., but this listing should not be used as a substitute for a detailed analysis. 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, the illustrations in this section should be considered and evaluated in the context of the comparability analysis (including the functional analysis) of the controlled transaction with the objective of better understanding how specific intangibles and items not treated as intangibles contribute to the creation of value in the context of the MNE's global business. It should be emphasised that a generic reference to an item included in the list of illustrations does not relieve taxpayers or tax administrations from their obligation in a transfer pricing analysis to identify relevant intangibles with specificity based on the guidance of Section A.1.

(i) Patents

6.19 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. In still other situations, patents may not provide a significant commercial advantage. Patents are intangibles within the meaning of Section A.1.

(ii) Know-how and trade secrets

6.20 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. Know-how and trade secrets may relate to manufacturing, marketing, research and development, or any other commercial activity. 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. In certain industries the disclosure of information necessary to obtain patent protection could assist

competitors in developing alternative solutions. Accordingly, an enterprise may, for sound business reasons, choose not to register patentable know-how, which may nonetheless contribute substantially to the success of the enterprise. The confidential nature of know-how and trade secrets may be protected to some degree by (i) unfair competition or similar laws, (ii) employment contracts, and (iii) 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

6.21 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 often confirmed 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.

6.22 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.

6.23 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 and/or other items, 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 items 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) Rights under contracts and government licences

6.24 Government licences and concessions may be important to a particular business and can cover a wide range of business relationships.

They may include, among others, a government grant of rights to exploit specific natural resources or public goods (*e.g.* a licence of bandwidth spectrum), or to carry on a specific business activity. Government licences and concessions are intangibles within the meaning of Section A.1. However, government licences and concessions should be distinguished from company registration obligations that are preconditions for doing business in a particular jurisdiction. Such obligations are not intangibles within the meaning of Section A.1.

6.25 Rights under contracts may also be important to a particular business and can cover a wide range of business relationships. They may include, among others, contracts with suppliers and key customers, and agreements to make available the services of one or more employees. Rights under contracts are intangibles within the meaning of Section A.1.

(v) Licences and similar limited rights in intangibles

6.26 Limited rights in intangibles are commonly transferred by means of a licence or other similar contractual arrangement, whether written, oral or implied. Such licensed 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.

(vi) Goodwill and ongoing concern value

6.27 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 recognised. 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 recognised that goodwill and ongoing concern value cannot be segregated or transferred separately from other business assets. See 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.

6.28 It is not necessary for purposes of this Chapter to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes or to define when goodwill or ongoing concern value may or may

not constitute an intangible. It is important to recognise, however, that an important and monetarily significant part of the compensation paid between independent enterprises when some or all of the assets of an operating business are transferred may represent compensation for something referred to in one or another of the alternative descriptions of goodwill or ongoing concern value. When similar transactions occur between associated enterprises, such value should be taken into account in determining an arm's length price for the transaction. When the reputational value sometimes referred to by the term goodwill is transferred to or shared with an associated enterprise in connection with a transfer or licence of a trademark or other intangible that reputational value should be taken into account in determining appropriate compensation. If features of a business such as a reputation for producing high quality products or providing high quality service allow that business to charge higher prices for goods or services than an entity lacking such reputation, and such features might be characterised as goodwill or ongoing concern value under one or another definition of such terms, such features should be taken into account in establishing arm's length prices for sales of goods or the provision of services between associated enterprises whether or not they are characterised as goodwill. In other words, labelling a contribution of value from one party to another as goodwill or ongoing concern value does not render such contribution non-compensable. See paragraph 6.2.

6.29 The requirement that goodwill and ongoing concern value be taken into account in pricing transactions in no way implies 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 licence rights, together with their associated goodwill and ongoing concern value, by independent parties. Accounting and business valuation measures of goodwill and ongoing concern value do not, as a general rule, correspond to the arm's length price of transferred goodwill or ongoing concern value in a transfer pricing analysis. Depending on the facts and circumstances, however, accounting valuations and the information supporting such valuations can provide a useful starting point in conducting a transfer pricing analysis. The absence of a single precise definition of goodwill makes it essential for taxpayers and tax administrations to describe specifically relevant intangibles in connection with a transfer pricing analysis, and to consider whether independent enterprises would provide compensation for such intangibles in comparable circumstances.

(vii) Group synergies

6.30 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 or borrowing power, *etc.* Such features may have an effect on the determination of arm's length conditions for controlled transactions and should be addressed for transfer pricing purposes as comparability factors. As they are not owned or controlled by an enterprise, they are not intangibles within the meaning of Section A.1. See paragraphs 1.98 – 1.114 for a discussion of the transfer pricing treatment of group synergies.

(viii) Market specific characteristics

6.31 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 labour 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 are not capable, however, of being owned or controlled, and are therefore 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 paragraphs 1.80 – 1.92 and paragraphs 9.148 – 9.153 for guidance regarding the transfer pricing treatment of market specific characteristics.

[B. Ownership of intangibles and transactions involving the development, enhancement, maintenance, protection and exploitation of intangibles

6.32 In transfer pricing cases involving intangibles, the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial.[2] A related issue is which entity or entities within the group should ultimately bear the costs, investments and other burdens associated with the development, enhancement, maintenance, protection and exploitation of intangibles. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets[3], or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle. This Section B confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters I – III.

6.33 Applying the provisions of Chapters I – III to address these questions can be highly challenging for a number of reasons. Depending on the facts of any given case involving intangibles the following factors, among others, can create challenges:

(i) a lack of comparability between the intangible related transactions undertaken between associated enterprises and those transactions that can be identified between independent enterprises

(ii) a lack of comparability between the intangibles in question;

(iii) the ownership and/or use of different intangibles by different associated enterprises within the MNE group;

(iv) the difficulty of isolating the impact of any particular intangible on the MNE group's income;

(v) the fact that various members of an MNE group may perform activities relating to the development, enhancement, maintenance, protection and exploitation of an intangible, often in a way and

with a level of integration that is not observed between independent enterprises;

(vi) the fact that contributions of various members of the MNE group to intangible value may take place in years different than the years in which any associated returns are realised; and

(vii) the fact that taxpayer structures may be based on contractual terms between associated enterprises that separate ownership, the assumption of risk, and/or funding of investments in intangibles from performance of important functions, control over risk, and decisions related to investment in ways that are not observed in transactions between independent enterprises and that may contribute to base erosion and profit shifting.

Notwithstanding these potential challenges, applying the arm's length principle and the provisions of Chapters I – III within an established framework can, in many cases, yield an appropriate allocation of the returns derived by the MNE group from the exploitation of intangibles.

6.34 The framework for analysing transactions involving intangibles requires the following steps:

(i) identifying the legal owner of intangibles based on the terms and conditions of legal arrangements, including relevant registrations, licence agreements, other relevant contracts, and other indicia of legal ownership;

(ii) identifying the parties performing functions (including specifically the important functions described in paragraph 6.56), using assets, and assuming risks related to developing, enhancing, maintaining, protecting, and exploiting the intangibles by means of the functional analysis;

(iii) confirming the consistency between the conduct of the parties and the terms of the relevant legal arrangements regarding intangible ownership through a detailed functional analysis;

(iv) identifying the controlled transactions related to the development, enhancement, maintenance, protection, and exploitation of intangibles in light of the legal ownership of the intangibles under relevant registrations and contracts, and the conduct of the parties, including their relevant contributions of functions, assets, risks and other factors contributing to the creation of value;

(v) where possible, determining arm's length prices for these transactions consistent with each party's contributions of functions performed, assets used, and risks assumed; and

(vi) in the circumstances described in paragraphs 1.64 – 1.69, recharacterising transactions as necessary to reflect arm's length conditions.

B.1. Intangible ownership and contractual terms relating to intangibles

6.35 Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles. The terms of a transaction may be found in written contracts, public records such as patent or trademark registrations, or in correspondence and/or other communications among the parties. Contracts may describe the roles, responsibilities and rights of associated enterprises with respect to intangibles. They may describe which entity or entities provide funding, undertake research and development, maintain and protect intangibles, and perform functions necessary to exploit the intangibles, such as manufacturing, marketing and distribution. They may describe how receipts and expenses of the MNE associated with intangibles are to be allocated and may specify the form and amount of payment to all members of the group for their contributions. The prices and other conditions contained in such contracts may or may not be consistent with the arm's length principle.

6.36 When no written terms exist, where the contractual terms are ambiguous or incomplete, or where the factual substance of the transaction reflected in the conduct of the parties is inconsistent with the written contracts, the terms of a transaction must be inferred from the conduct of the parties and the economic principles that generally govern relationships between independent enterprises. It is, therefore, good practice for associated enterprises to record in writing their decisions and intentions regarding the allocation of significant rights in intangibles. Written records of such decisions and intentions, including written agreements, should generally be in place at or before the time that associated enterprises enter into transactions leading to the development, enhancement, maintenance, protection, or exploitation of intangibles.

6.37 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. Generally, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible, as well as the right to prevent others from using or otherwise infringing the intangible. These rights may be granted for a specific geographic area and/or for a specific period of time.

6.38 There are also intangibles that are not protectable under specific intellectual property registration systems, but that are protected against

unauthorised appropriation or imitation under unfair competition legislation or other enforceable laws, or by contract. Trade dress, trade secrets, and know-how may fall under this category of intangibles.

6.39 The extent and nature of the available protection under applicable law may vary from country to country, as may the conditions on which such protection is provided. Such differences can arise either from differences in substantive intellectual property law between countries, or from practical differences in local enforcement of such laws. For example, the availability of legal protection for some intangibles may be subject to conditions such as continued commercial use of the intangible or timely renewal of registrations. This means that in some circumstances or jurisdictions, the degree of protection for an intangible may be extremely limited either legally or in practice.

6.40 The legal owner, determined under the principles of paragraphs 1.52 and 1.53, will be considered to be the owner of the intangible for transfer pricing purposes. If no legal owner of the intangible is identified under applicable law or governing contracts, then the member of the MNE group that, based on the facts and circumstances, controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible will be considered the legal owner of the intangible for transfer pricing purposes.

6.41 In identifying the legal owner of intangibles, an intangible and any licence relating to that intangible are considered to be different intangibles for transfer pricing purposes, each having a different owner. See paragraph 6.26. For example, Company A, the legal owner of a trademark, may provide an exclusive licence to Company B to manufacture, market, and sell goods using the trademark. One intangible, the trademark, is legally owned by Company A. Another intangible, the licence to use the trademark in connection with manufacturing, marketing and distribution of trademarked products, is legally owned by Company B. Depending on the facts and circumstances, marketing activities undertaken by Company B pursuant to its licence may potentially affect the value of the underlying intangible legally owned by Company A, the value of Company B's licence, or both.

6.42 While determining legal ownership is an important first step in the analysis, that determination is separate and distinct from the question of remuneration under the arm's length principle. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible. The return

ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed. For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm's length compensation, if any, for holding title.

6.43 Legal ownership and contractual relationships serve simply as reference points for identifying and analysing controlled transactions relating to the intangible and for determining the appropriate remuneration to members of a controlled group with respect to those transactions Identification of legal ownership, combined with the identification and compensation of relevant functions performed, assets used, and risks assumed by all contributing members, provides the analytical framework for identifying arm's length prices and other conditions for transactions involving intangibles. As with any other type of transaction, the analysis must take into account all of the relevant facts and circumstances present in a particular case and price determinations must reflect the realistic alternatives of the relevant group members. The principles of this paragraph are illustrated by Examples 1 – 7 in the Chapter VI Annex.

6.44 Because the actual outcomes and manner in which risks associated with the development or acquisition of an intangible will play out over time are not known with certainty at the time members of the MNE group make decisions regarding intangibles, it is important to distinguish between (a) anticipated (or *ex ante*) remuneration, which refers to the future income expected to be derived by a member of the MNE group at the time of a transaction; and (b) actual (or *ex post*) remuneration, which refers to the income actually earned by a member of the group through the exploitation of the intangible.

6.45 The compensation that must be paid to members of the MNE group that contribute to the development, enhancement, maintenance, protection and exploitation of intangibles is generally determined on an *ex ante* basis. That is, it is determined at the time transactions are entered into and before risks associated with the intangible play out. Such compensation may be fixed or contingent. The allocation of actual *ex post* profit or loss will depend on the facts and circumstances of the case.

6.46 An important question is how to determine the appropriate arm's length remuneration to members of a group for their functions, assets, and

risks within the framework established by the taxpayer's contractual arrangements, the legal ownership of intangibles, and the conduct of the parties. Section B.2. discusses the application of the arm's length principle to situations involving intangibles. It focuses on the functions, assets and risks related to the intangibles. Unless stated otherwise, references to arm's length returns and arm's length remuneration in Section B.2. refer to anticipated (*ex ante*) returns and remuneration.

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

6.47 As stated above, a determination that a particular group member is the legal owner of intangibles does not, in and of itself, imply that the member has the right ultimately to retain or have attributed to it the receipts that may accrue in the first instance to that member as a result of its commercial right to exploit the intangible, nor does it necessarily imply that the legal owner is entitled to any income of the business after compensating other members of the MNE group for their contributions in the form of functions performed, assets used, and risks assumed. That is, after appropriately rewarding other members of the MNE group for their functions performed, for assets used, and for risks assumed, the income of the legal owner related to the intangible may be positive, negative or zero depending on the facts of the case.

6.48 In identifying arm's length prices for transactions among associated enterprises, the contributions of members of the group related to the creation of intangible value should be considered and appropriately rewarded. The arm's length principle and the principles of Chapters I – III require that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles. It is therefore necessary to determine, by means of a functional analysis, which member(s) perform and exercise control over development, enhancement, maintenance, protection, and exploitation functions, which member(s) provide necessary funding and other assets, and which member(s) control and bear the various risks associated with the intangible. Of course, in each of these areas, this may or may not be the legal owner of the intangible**.** As noted in paragraph 6.130, it is also important in determining arm's length compensation for functions performed, assets used, and risks assumed to consider comparability factors that may contribute to the creation of value or the generation of returns derived by the MNE group from the exploitation of intangibles in determining prices for relevant transactions.

6.49 The relative importance of contributions to the creation of intangible value by members of the group in the form of functions

performed, assets used and risks assumed will vary depending on the circumstances. For example, assume that a fully developed and currently exploitable intangible is purchased from a third party by a member of a group and exploited through manufacturing and distribution functions performed by other group members while being actively managed and controlled by the entity purchasing the intangible. It is assumed that this intangible would require no development, may require little or no maintenance or protection, and may have limited usefulness outside the area of exploitation intended at the time of the acquisition. There would be no development risk associated with the intangible, although there may be other risks associated with exploiting the intangible. The key functions performed by the purchaser are those necessary to select the most appropriate intangible on the market, to analyse its potential benefits if used by the MNE group, and the decision to purchase the intangible. The key asset used is the funding required to purchase the intangible. If the purchaser has the capacity and actually performs all the key functions described, it may be reasonable to conclude that, after making arm's length payment for the manufacturing and distribution functions of other associated enterprises, the owner would be entitled to retain or have attributed to it any income or loss derived from the post-acquisition exploitation of the intangible. While the application of Chapters I – III may be fairly straightforward in such a simple fact pattern, the analysis may be more difficult in situations in which:

(i) intangibles are self-developed by a multinational group, especially when such intangibles are transferred between associated enterprises while still under development;

(ii) acquired or self-developed intangibles serve as a platform for further development; or

(iii) other aspects, such as marketing or manufacturing are particularly important to value creation.

The generally applicable guidance below is particularly relevant for, and is primarily concerned with, these more difficult cases.

(a) Performance and Control of Functions

6.50 Under the principles of Chapters I – III, each member of the MNE group should receive arm's length compensation for the functions it performs. In cases involving intangibles, this includes functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles. The identity of the member or members of the group performing functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles, therefore, is one key consideration in determining prices for controlled transactions and in determining which

entity or entities ultimately will be entitled to returns derived by the MNE group from the exploitation of intangibles.

6.51 The need to ensure that all members of the MNE group are appropriately compensated for the functions they perform implies that if the legal owner of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles it must perform all of the functions, contribute all assets used and assume all risks related to the development, enhancement, maintenance, protection and exploitation of the intangible. This does not imply, however, that the associated enterprises constituting an MNE group must structure their operations regarding the development, enhancement, maintenance, protection or exploitation of intangibles in any particular way. It is not essential that the legal owner physically perform all of the functions related to the development, enhancement, maintenance, protection and exploitation of an intangible through its own employees in order to be entitled ultimately to retain or be attributed a portion of the return derived by the MNE group from exploitation of the intangibles. In transactions between independent enterprises, certain functions are sometimes outsourced to other entities. A member of an MNE group that is the legal owner of intangibles could similarly outsource functions related to the development, enhancement, maintenance, protection or exploitation of intangibles to either independent enterprises or associated enterprises.

6.52 Where associated enterprises other than the legal owner perform relevant functions that are anticipated to contribute to the value of the intangibles, they should be compensated on an arm's length basis for the functions they perform under the principles set out in Chapters I – III. The determination of arm's length compensation for functional contributions should consider the availability of comparable uncontrolled transactions, the importance of the functions performed to the creation of intangible value, and the realistically available options of the parties. The specific considerations described in paragraphs 6.53 – 6.58 should also be taken into account.

6.53 In outsourcing transactions between independent enterprises, it is usually the case that an entity performing functions on behalf of the legal owner of the intangible that relate to the development, enhancement, maintenance, protection, and exploitation of the intangible will operate under the direction or control of such legal owner. Because of the nature of the relationships between associated enterprises that are members of an MNE group, however, it may be the case that outsourced functions performed by associated enterprises will be controlled by an entity other than the legal owner of the intangibles. In such cases, the legal owner of the intangible should also compensate the entity performing control functions

related to the development, enhancement, maintenance, protection, and exploitation of intangibles on an arm's length basis. In assessing what member of the MNE group in fact controls the performance of the relevant functions, principles analogous to those of paragraphs 9.22 – 9.28 apply. Assessing the capacity of a particular entity to exert control and perform control functions will be an important part of the analysis.

6.54 If the legal owner neither controls nor performs the functions related to the development, enhancement, maintenance, protection or exploitation of the intangible, the legal owner would not be entitled to any ongoing benefit attributable to the outsourced functions. Except where transactions or structures are appropriately recharacterised or disregarded under paragraphs 1.64 – 1.69, a legal owner not performing any relevant function may nevertheless be entitled to share in the return derived by the MNE group from the exploitation of intangibles as compensation for any assets it uses and risks it assumes. See paragraphs 6.59 – 6.65. It will not, however, be entitled to any portion of such returns related to the performance or control of functions. Depending on the facts, the arm's length compensation required to be provided by the legal owner to other associated enterprises performing or controlling functions related to the development, enhancement, maintenance, protection, or exploitation of intangibles may comprise any share of the total return derived from exploitation of the intangibles.

6.55 The relative value of contributions to development, enhancement, maintenance, protection, and exploitation of intangibles varies depending on the particular facts of the case. The MNE group member(s) making the more significant contributions in a particular case should receive relatively greater remuneration. For example, a company that merely funds research and development should have a lower anticipated return than if it both funds and controls research and development. Other things being equal, a still higher anticipated return should be provided if the entity funds, controls, and physically performs the research and development.

6.56 In considering the arm's length compensation for functional contributions of various members of the MNE group, certain important functions will have special significance. The nature of these important functions in any specific case will depend on the facts and circumstances. For self-developed intangibles, or for self-developed or acquired intangibles that serve as a platform for further development activities, these more important functions may include, among others, design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research, control over strategic decisions regarding intangible development programmes, and management and control of budgets. For any intangible

(*i.e.* for either self-developed or acquired intangibles) other important functions may also include 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. Those important functions usually make a significant contribution to intangible value and, if those important functions are outsourced by the legal owner in transactions between associated enterprises, the performance of those functions should be compensated with an appropriate share of the returns derived by the MNE group from the exploitation of intangibles.

6.57 Because it may be difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions. Where the legal owner outsources most or all of such important functions to other group members, the entitlement of the legal owner to be attributed any material portion of the return derived from the exploitation of the intangibles after compensating other group members for their functions is highly doubtful. In some circumstances it may also be determined that the outsourcing of such important functions would not have been undertaken by independent enterprises behaving in a commercially rational manner, and that the actual structure adopted impedes the determination of an appropriate transfer price, thereby necessitating the disregarding of the actual structure adopted in accordance with the principles described in paragraph 1.65. Examples 17 and 18 in the Chapter VI Annex illustrate the principles contained in this paragraph.

6.58 Because the important functions described in paragraph 6.56 are often instrumental in managing the different functions performed, assets used, and risks assumed that are key to the successful development, enhancement, maintenance, protection, or exploitation of intangibles, and are therefore essential to the creation of intangible value, it is necessary to carefully evaluate transactions between parties performing these important functions and other associated enterprises. In particular, the reliability of a one-sided transfer pricing method will be substantially reduced if the party or parties performing significant portions of the important functions are treated as the tested party or parties. See Example 7.

(b) Use of assets

6.59 Group members that use assets in the development, enhancement, maintenance, protection, and exploitation of an intangible should receive appropriate compensation for doing so. Such assets may include, without

limitation, intangibles used in research, development or marketing, (*e.g.* know-how, customer relationships, *etc.*), physical assets, or funding. One member of an MNE group may fund some or all of the development, enhancement, maintenance, and protection of an intangible, while one or more other members perform all of the relevant functions. When assessing the appropriate anticipated return to funding in such circumstances, it should be recognised that in arm's length transactions, a party that provides funding, but does not control the risks or perform other functions associated with the funded activity, generally does not receive anticipated returns equivalent to those received by an otherwise similarly-situated investor who also performs and controls important functions and bears and controls important risks associated with the funded activity. The nature and amount of compensation attributable to an entity that bears intangible-related costs, without more, must be determined on the basis of all the relevant facts, and should be consistent with similar funding arrangements among independent entities where such arrangements can be identified.

6.60 Funding and risk-taking are integrally related in the sense that funding often coincides with the taking of certain risks (*e.g.*, a funding party often bears the risk of loss of the funds). Nonetheless, they can and should be analysed separately because there is no standard set of risks assumed in the funding of intangible development, enhancement, maintenance, protection, or exploitation. Rather, the risks assumed will vary based on contractual terms, the conduct and solvency of the relevant group members, and the nature of their control over the risks assumed among other factors. The timing of the funding in the course of an intangible development undertaking may also affect the level of risk. For example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk. The nature and extent of the risk assumed must, therefore, be determined considering all of the facts and circumstances of the relationship among such group members. It cannot simply be assumed or asserted that the party funding intangible development bears all of the risks associated with such development.

6.61 Bearing a funding risk, without the assumption of any further risk generally would entitle the funder to a risk-adjusted rate of anticipated return on its funding, but not more. The key questions in each case are: (i) what is the financial risk assumed by the funding entity, (ii) does it have the financial capacity to bear the risk, (iii) how and by whom is that financial risk controlled (within the meaning of paragraphs 9.22 – 9.28), (iv) what are the financing options realistically available to the parties; and (v) what is the arm's length anticipated compensation for assuming the financial risk in question?

(c) Assumption of risks

6.62 In assessing the allocation of risks related to intangibles among members of an MNE group, the principles of paragraphs 9.10 – 9.46 apply. In particular, the provisions of paragraph 9.18 regarding the importance of data evidencing similar allocations of risk in comparable uncontrolled transactions, the discussions of control of risk in paragraphs 9.23 – 9.28, the discussion of financial capacity to assume risk in paragraphs 9.29 – 9.32, and the provisions of paragraph 9.38 should be considered in assessing the incidence of risk related to the development, enhancement, maintenance, protection, and exploitation of intangibles.

6.63 The identity of the member or members of the group bearing and controlling risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles is also an important consideration in determining prices for controlled transactions and in determining which entity or entities will be entitled to share in returns derived from the exploitation of the intangibles. The legal owner may bear and control those risks. If instead other members of the group bear or control such risks, such members must be compensated for their contributions, including the risks they assume. This may mean, for example, that these parties are attributed the anticipated returns remaining after the legal owner is remunerated for the anticipated value of its own functions performed, assets used, and risks assumed (if any), and other members of the MNE group are similarly remunerated for their respective contributions.

6.64 Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles 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, costly and/or unavailing; and (iv) product liability and similar risks related to products and services based on the intangibles. The existence and level of such risks will depend on the facts and circumstances of each individual case and the nature of the intangible in question.

6.65 It is especially important to ensure that the group member(s) asserting entitlement under contractual arrangements to returns from assuming risk actually bear responsibility for costs that may be incurred if the relevant risk materialises. Where one party to a transaction is both contractually allocated risk and performs the functions controlling those risks while the other party bears the costs that arise from the risks, then a

transfer pricing adjustment may be necessary to reflect actual sharing of risks and the appropriate attribution of relevant costs. Example 8 in the Chapter VI Annex illustrates this principle.

(d) Unanticipated *ex post* returns

6.66 It is quite common that unanticipated events will lead to an increase or decrease in the returns derived from exploiting an intangible such that actual (*ex post*) profitability is different than anticipated (*ex ante)* profitability. For example, it may happen that a competitive product is removed from the market, a natural disaster takes place in a key market, a key asset malfunctions for unanticipated reasons, or that a breakthrough technological development by a competitor will have the effect of making products based on the intangible in question obsolete or less desirable. It may also happen that financial projections, on which calculations of *ex ante* returns and compensation arrangements are based, simply prove to be inaccurate. The question arises in such circumstances whether, and if so how, the profits or losses related to such unanticipated events should be shared among members of an MNE group that have contributed to the development, enhancement, maintenance, protection, and exploitation of the intangible in question.

6.67 Resolution of this question requires a careful analysis of whether returns are in fact attributable to unanticipated events and which entity or entities in the MNE group in fact bear the risks of such unanticipated events. The entity or entities entitled to the benefits or required to bear the burdens of such unanticipated events may or may not be the legal owner of the intangible, and may or may not be the entity or entities providing funding for the development, enhancement, maintenance, protection, or exploitation of the intangible. Terms and conditions of contracts form the starting point for this analysis. However, a careful analysis of two additional issues is also required. First, consideration must be given to whether the *ex ante* remuneration paid to members of the MNE group for their functions performed, assets used, and risks assumed is consistent with the conduct of the parties and with the arm's length principle. Care should be taken to ascertain, for example, whether the group in fact understated anticipated profits, thereby giving rise to underpayments (determined on an *ex ante* basis) to some group members for their contributions. Second, consideration must be given to which entity or entities within the group bear the risk of such unanticipated developments. Such consideration should include analysis of which entity or entities perform functions related to the risk of unanticipated events. In particular, functions relating to the control and management of the relevant risks, including the development and execution of risk mitigation strategies, need to be considered. Such functions include

those relating to monitoring and managing (if possible) the circumstances giving rise to such unanticipated events, management and control of specific functions and assets if risks relate to such specific functions and assets, as well as the control and management of the financial and reputational consequences of unanticipated events. Evaluation of the financial capacity of various entities to bear risk related to unanticipated events is also important. In some situations it may be determined, given the facts of the particular case, that the contractual allocation of the risk is not aligned with the conduct of the parties or that the taxpayer's arrangements should be disregarded or recharacterised in accordance with the principles in paragraphs 1.64 – 1.69. The principles of Chapters I – III, Chapter IX and this Chapter should be applied to resolve these issues.

Interaction with continuing work on BEPS

In theory, if *ex ante* remuneration to all members of an MNE group for their contributions is truly determined on an arm's length basis and the provisions of paragraph 6.67 are applied, then unanticipated profits would tend to follow a 'random walk' – that is sometimes there would be unanticipated profits, sometimes there would be unanticipated shortfalls from anticipated profits or even losses, and the contractual allocation of unanticipated profits or losses to any member of the MNE group would not offer a systematic risk-adjusted anticipated advantage. Unfortunately, in some circumstances, actual returns may consistently exceed anticipated returns in a way that suggests that taxpayers systematically understate anticipated returns, resulting in consistently greater than anticipated returns to the legal owner of intangibles. Clearly, taxpayers in some situations have an incentive to overstate anticipated risk and understate the appropriate remuneration by the legal owner to other members of the group. Taxpayers also have the practical opportunity to undertake such mispricing through exploitation of the information asymmetries between the taxpayer and tax administrations, and the passage of time between when prices are initially determined and when audits take place. Section D.3. provides guidance for situations, such as those discussed above, when valuation may be highly uncertain at the time of the transaction. It has been the experience of G20 / OECD countries that these situations and fact patterns are particularly susceptible to base erosion and profit shifting.

(e) Summary of Sections B.1 and B.2

6.68 If the legal owner of an intangible in substance:

- Performs and controls all of the functions (including the important functions described in paragraph 6.56) related to the development, enhancement, maintenance, protection and exploitation of the intangible;
- Provides all assets, including funding, necessary to the development, enhancement, maintenance, protection, and exploitation of the intangibles; and
- Bears and controls all of the risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible,

then it will be entitled to all of the anticipated, *ex ante,* returns derived from the MNE group's exploitation of the intangible. To the extent that one or more members of the MNE group other than the legal owner performs functions, uses assets, or assumes risks related to the development, enhancement, maintenance, protection, and exploitation of the intangible, such associated enterprises must share in the anticipated returns derived from exploitation of the intangible by receiving arm's length compensation for their functions, assets and risks. This compensation may, depending on the facts and circumstances, constitute all or a substantial part of the return anticipated to be derived from the exploitation of the intangible.

6.69 The entitlement of any member of the MNE group to profit or loss relating to unanticipated events (*ex post*, income or loss) will depend on the terms and conditions of relevant contracts and on the functions performed, assets used and risks assumed in connection with these unanticipated events.**]**

B.3. Identifying and determining the prices and other conditions for the controlled transactions

6.70 Undertaking the comparability analysis described in Chapters I – III, as supplemented by this Chapter, should facilitate a clear assessment of legal ownership, functions, assets and risks associated with intangibles, and an accurate identification of the transactions whose prices and other conditions require determination. In general, the transactions identified by the MNE group in the relevant registrations and contracts are those whose prices and other conditions are to be determined under the arm's length principle. However, the comparability analysis may reveal that transactions in addition to, or different from, the transactions described in the

registrations and contracts actually occurred. Consistent with paragraph 1.53, the transactions (and the true terms thereof) to be analysed are those determined to have occurred consistent with the actual conduct of the parties and other relevant facts.

6.71 Arm's length prices and other conditions for transactions should be determined according to the guidance in Chapters I - III, taking into account the contributions to anticipated intangible value of functions performed, assets used, and risks assumed at the time such functions are performed, assets are used, or risks are assumed as discussed in this Section B. Section D provides supplemental guidance on transfer pricing methods and other matters applicable in determining arm's length prices and other conditions for transactions involving intangibles.

B.4. Application of the foregoing principles in specific fact patterns.

6.72 The principles set out in this Section B must be applied in a variety of situations involving the development, enhancement, maintenance, protection, and exploitation of intangibles. A key consideration in each case is that associated enterprises that contribute to the development, enhancement, maintenance, protection, or exploitation of intangibles legally owned by another member of the group must receive arm's length compensation for the functions they perform, the risks they assume, and the assets they use. In evaluating whether associated enterprises that perform functions or assume risks related to the development, enhancement, maintenance, protection, and exploitation of intangibles have been compensated on an arm's length basis, it is necessary to consider (i) the level and nature of the activity undertaken; and (ii) the amount and form of compensation paid. In assessing whether the compensation provided in the controlled transaction is consistent with the arm's length principle, reference should be made to the level and nature of activity of comparable uncontrolled entities performing similar functions, the compensation received by comparable uncontrolled entities performing similar functions, and the anticipated creation of intangible value by comparable uncontrolled entities performing similar functions. This section describes the application of these principles in commonly occurring fact patterns.

(a) Development and enhancement of marketing intangibles

6.73 A common situation where these principles must be applied arises when an enterprise associated with the legal owner of trademarks performs marketing or sales functions that benefit the legal owner of the trademark, for example through a marketing arrangement or through a distribution/marketing arrangement. In such cases, it is necessary to

determine how the marketer or distributor should be compensated for its activities. One important issue is whether the marketer/distributor should be compensated only for providing promotion and distribution services, or whether the marketer/distributor should also be compensated for enhancing the value of the trademarks and other marketing intangibles by virtue of its functions performed, assets used, and risks assumed.

6.74 The analysis of this issue requires an assessment of (i) the obligations and rights implied by the legal registrations and agreements between the parties; (ii) the functions performed, the assets used, and the risks assumed by the parties; (iii) the intangible value anticipated to be created through the marketer/distributor's activities; and (iv) the compensation provided for the functions performed by the marketer/distributor (taking account of the assets used and risks assumed). 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 owner of the trademarks and other marketing 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 further development of the trademark and other marketing intangibles, and would therefore not be entitled to additional remuneration in that regard.

6.75 When the distributor actually bears the cost of its marketing activities (for example, when there is no arrangement for the legal owner to reimburse the expenditures), the analysis should focus on the extent to which the distributor is able to share in the potential benefits deriving from its functions performed, assets used, and risks assumed currently or in the future. In general, in arm's length transactions the ability of a party that is not the legal owner of trademarks and other marketing intangibles to obtain the benefits of marketing activities that enhance 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, and risks assumed in developing the value of a trademark and other marketing intangibles from its turnover and market share when it has a long-term contract providing for sole distribution rights for the trademarked product. In such a situation the distributor's efforts may have enhanced the value of its own intangibles, namely its distribution rights. In such cases, the distributor's share of benefits should be determined based on what an independent distributor would receive in comparable circumstances. In some cases, a distributor may perform functions, use assets or assume risks that exceed those an independent distributor with similar rights might incur or perform for the benefit of its own distribution activities and that create value beyond that created by other

similarly situated marketers/distributors. An independent distributor in such a case would typically require additional remuneration from the owner of the trademark or other intangibles. Such remuneration could take the form of higher distribution profits (resulting from a decrease in the purchase price of the product), a reduction in royalty rate, or a share of the profits associated with the enhanced value of the trademark or other marketing intangibles, in order to compensate the distributor for its functions, assets, risks, and anticipated value creation. Examples 9 – 14 in the Annex to Chapter VI illustrate in greater detail the application of this Section B in the context of marketing and distribution arrangements.

(b) Research, development and process improvement arrangements

6.76 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 is the legal owner of any resulting intangibles. Appropriate compensation for research services will depend on all the facts and circumstances, such as whether the research team possesses unique skills and experience relevant to the research, bears risks (*e.g.* where "blue sky" research is undertaken), uses its own intangibles, or is controlled and managed by another party. Compensation based on a reimbursement of costs plus a modest mark-up will not reflect the anticipated value of or the arm's length price for the contributions of the research team in all cases.

6.77 The principles set out in this section similarly apply in situations where a member of an MNE group provides manufacturing services that may lead to process or product improvements on behalf of an associated enterprise that will assume legal ownership of such process or product improvements. Examples 15 – 18 in the Annex to Chapter VI illustrate in greater detail the application of this Section B in the context of research and development arrangements.

(c) Payments for use of the company name

6.78 Questions often arise regarding the arm's length compensation for the use of group names, trade names and similar intangibles. Resolution of such questions should be based on the principles of this Section B and on the commercial and legal factors involved. As a general rule, no payment should be recognised for transfer pricing purposes for simple recognition of group membership or the use of the group name merely to reflect the fact of group membership. See paragraph 7.13.

6.79 Where one member of the group is the owner of a trademark or other intangible for the group name, and where use of the name provides a financial benefit to members of the group other than the member legally owning such intangible, it is reasonable to conclude that a payment for use would have been made in arm's length transactions. Similarly, such payments may be appropriate where a group member owns goodwill in respect of the business represented by an unregistered trademark, use of that trademark by another party would constitute misrepresentation, and the use of the trademark provides a clear financial benefit to a group member other than that owning the goodwill and unregistered trademark.

6.80 In determining the amount of payment with respect to a group name, it is important to consider the amount of the financial benefit to the user of the name attributable to use of that name, the costs and benefits associated with other alternatives, and the relative contributions to the value of the name made by the legal owner, and the entity using the name in the form of functions performed, assets used and risks assumed. Careful consideration should be given to the functions performed, assets used, and risks assumed by the user of the name in creating or enhancing the value of the name in its jurisdiction. Factors that would be important in a licence of the name to an independent enterprise under comparable circumstances applying the principles of Chapters I – III should be taken into account.

6.81 Where an existing successful business is acquired by another successful business and the acquired business begins to use a name, trademark or other branding indicative of the acquiring business, there should be no automatic assumption that a payment should be made in respect of such use. If there is a reasonable expectation of financial benefit to the acquired company from using the acquiring company's branding, then the amount of any payment should be informed by the level of that anticipated benefit.

6.82 It may also be the case that the acquiring business will leverage the existing position of the acquired business to expand the business of the acquirer in the territory of operation of the acquired business by causing the acquired business to use the acquirer's branding. In that case, consideration should be given to whether the acquirer should make a payment to or otherwise compensate the acquired business for the functions performed, risks assumed and assets used (including its market position) in connection with expanded use of the acquirer's name.

C. Transactions involving the use or transfer of intangibles

6.83 In addition to identifying with specificity the intangibles involved in a particular transfer pricing issue, and identifying the owner of such intangibles, it is necessary to identify and properly characterise, at the beginning of any transfer pricing analysis involving intangibles, the specific controlled transactions involving intangibles. The principles of Chapter I apply in identifying and characterising transactions involving the use or transfer of intangibles. In addition to the guidance on contractual terms (paragraph 1.53) and on business restructurings (Chapter IX, especially Part II), Section C outlines some typical scenarios that may be useful in ascertaining whether intangibles or rights in intangibles are involved in a transaction. See Example 20. The characterisation of a transaction for transfer pricing purposes has no relevance for determinations under Article 12 of the OECD Model Tax Convention. See, *e.g.* paragraphs 8 – 19 of the Commentary to Article 12 of the OECD Model Tax Convention.

6.84 There are two general types of transactions where the identification and examination of intangibles will be relevant for transfer pricing purposes. These are: (i) transactions involving transfers of intangibles or rights in intangibles; and (ii) transactions involving the use of intangibles in connection with the sale of goods or the provision of services.

C.1. Transactions involving transfers of intangibles or rights in intangibles

(i) Transfers of intangibles or rights in intangibles

6.85 Rights in intangibles themselves may be transferred in controlled transactions. Such transactions may involve a transfer of all rights in the intangibles in question (*e.g.* a sale of the intangible or a perpetual, exclusive licence of the intangible) or only limited rights (*e.g.* a licence or similar transfer of limited rights to use an intangible which may be subject to geographical restrictions, limited duration, or restrictions with respect to the right to use, exploit, reproduce, further transfer, or further develop). The principles of Chapters I – III apply to transactions involving the transfer of intangibles or rights in intangibles. Supplemental guidance regarding the determination of arm's length conditions for such transactions is also contained in Sections D.1., D.2. and D.3. of this Chapter.

6.86 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. It should be noted in this regard that the labels applied to transactions do not control the transfer pricing analysis. For example, in the case of a transfer of the exclusive right to exploit a patent in Country X, the taxpayer's decision to characterise the transaction either as a sale of all of the Country X patent rights, or as a perpetual exclusive licence of a portion of the worldwide patent rights, does not affect the determination of the arm's length price if, in either case, the transaction being priced is a transfer of exclusive rights to exploit the patent in Country X over its remaining useful life. Thus, the functional analysis should identify the nature of the transferred rights in intangibles with specificity.

6.87 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 research and development. In transactions between independent enterprises, 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 independent enterprises are also observed where the transferee/licensee retains the right to any enhancements it may develop, either for the term of its licence 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. Such limitations must be evaluated in light of both the written terms of agreements and the actual conduct of the affected parties.

6.88 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 or rights in 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 administration if such specification is not consistent with the conduct of the parties. Example 19 in the Chapter VI Annex illustrates the provisions of this paragraph.

(ii) Transfers of combinations of intangibles

6.89 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.

6.90 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.

6.91 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 performed functions, bore the risks and incurred the 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 value creation where different associated enterprises hold rights in the intangibles used.

6.92 A second and related issue involves the importance of ensuring 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. For example, the transfer of rights to

use a trademark under a licence agreement will usually also imply the licensing of the reputational value, sometimes referred to as goodwill, associated with that trademark, where it is the licensor who has built up such goodwill. Any licence fee required should consider both the trademark and the associated reputational value. Example 21 in the Chapter VI Annex illustrates the principles of this paragraph.

6.93 It is important to identify situations where taxpayers or tax administrations may seek to artificially separate intangibles that, as a matter of substance, independent parties would not separate in comparable circumstances. For example, attempts to artificially separate trademarks or trade names from the goodwill or reputational value that is factually associated with the trademark or trade name should be identified and critically analysed. Example 22 in the Chapter VI Annex illustrates the principles of this paragraph.

6.94 It should be recognised that the process of identifying all of the intangibles transferred in a particular transaction is an exercise of identifying, by reference to written agreements and the actual conduct of the parties, the actual transactions that have been undertaken, applying the principles of paragraphs 1.52 – 1.54.

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

6.95 In some situations intangibles or rights in 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. Examples 24 – 26 in the Chapter VI Annex illustrate the principles of this paragraph.

6.96 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 or rights in intangibles. Reliability of available comparables will be an important factor in considering whether transactions should be combined or segregated. In

particular, it is important to consider whether available comparables permit accurate evaluation of interactions between transactions.

6.97 One situation where transactions involving transfers of intangibles or rights in intangibles may be combined with other transactions involves a 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 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.

6.98 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.

6.99 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 independent enterprises in comparable transactions.

6.100 Moreover, it should also be emphasised that determinations as to whether transactions should be aggregated or segregated for analysis usually involve the determination of the actual transaction undertaken, by reference to written agreements and the actual conduct of the parties. Such determinations do not involve the recharacterisation of transactions within the meaning of paragraphs 1.64 – 1.69. Determinations regarding the actual

transaction undertaken constitute one necessary element in determining the most appropriate transfer pricing method in the particular case.

C.2. Transactions involving the use of intangibles in connection with sales of goods or performance of services

6.101 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 relevant intangibles used by either 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, 2.110 and 3.18. Supplemental guidance regarding the determination of arm's length conditions for transactions involving the use of intangibles in connection with the sale of goods or the provision of services is contained in Sections D.1. and D.4. of this Chapter.

6.102 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.

6.103 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 and may affect the value of services, but are not transferred.

D. Supplemental guidance for determining arm's length conditions in cases involving intangibles

6.104 After identifying the relevant transactions involving intangibles, specifically identifying the intangibles involved in those transactions, identifying which entity or entities legally own the intangibles as well as those that contribute to the value of the intangibles, it should be possible to identify arm's length conditions for the relevant transactions. The principles set out in Chapters I – III of these Guidelines should be applied in determining arm's length conditions for transactions involving 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 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., and C. of this Chapter VI should be considered.

6.105 However, the principles of Chapters I – III can sometimes be difficult to apply to controlled transactions involving intangibles. Intangibles may have special characteristics that complicate the search for comparables, and in some cases make pricing 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. The use or transfer of intangibles may raise challenging issues regarding comparability, selection of transfer pricing methods, and determination of arm's length conditions for transactions. This Section D. provides supplemental guidance for use in applying the principles of Chapters I – III to determine arm's length conditions for controlled transactions involving intangibles.

6.106 Section D.1. provides general supplemental guidance related to all transactions involving intangibles. Section D.2. provides supplemental guidance specifically related to transactions involving the transfer of intangibles or rights in intangibles. Section D.3. provides supplemental guidance regarding transfers of intangibles or rights in intangibles whose value is highly uncertain at the time of the transfer. Section D.4. provides supplemental guidance applicable to transactions involving the use of intangibles in connection with the sale of goods or the provision of services in situations where there is no transfer of rights in the intangibles.

D.1. General principles applicable in transactions involving intangibles

6.107 Paragraphs 1.33 – 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 all controlled transactions involving intangibles.

6.108 In applying the principles of the Guidelines related to the content and process of a comparability analysis to a transaction involving 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 – 9.64 should be applied.

6.109 In considering the options realistically available to the parties, the perspectives of each of the parties to the transaction must be considered. A comparability analysis focusing only on one side of a transaction generally does not provide a sufficient basis for evaluating a transaction involving intangibles (including in those situations for which a one-sided transfer pricing method is ultimately determined).

6.110 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 either all or part of its rights in an intangible that is less advantageous to the transferor 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 rights in the intangible. Similarly, a transferee should not be expected to accept a price for a transfer of rights in one or more intangibles that would make it impossible for the transferee to anticipate earning a profit using the acquired rights in 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.

6.111 It will often be the case that a price for a transaction involving intangibles 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. 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. Similarly, if situations arise in which there are assertions that either the current use of an intangible, or a proposed realistically available option (*i.e.* an alternative use of the intangible), does not optimise resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case. This discussion highlights the importance of taking all relevant facts and circumstances into account in a comparability analysis involving intangibles.

D.2. Supplemental guidance regarding transfers of intangibles or rights in intangibles

6.112 This section provides supplemental guidance regarding specific issues arising in connection with the transfer between associated enterprises of intangibles or rights in intangibles. Such transactions may include sales of intangibles as well as transactions that are economically equivalent to sales. Such transactions could also include a licence of rights in one or more intangibles or a similar transaction. This section is not intended to provide comprehensive guidance with regard to the transfer pricing treatment of such intangibles transfers. Rather, it supplements the otherwise applicable provisions of Chapters I – III, and the guidance in Sections A., B., C., and D.1. of this Chapter, in the context of transfers of intangibles or rights in intangibles, by providing guidance with regard to certain specific topics commonly arising in connection with such transfers.

(i) Comparability of intangibles or rights in intangibles

6.113 In applying the provisions of Chapters I to III to transactions involving the transfer of intangibles or rights in intangibles, it should be borne in mind that intangibles often have unique characteristics, and as a result have the potential for generating returns and creating future benefits that could differ widely. In conducting a comparability analysis with regard to a transfer of intangibles, it is therefore essential to consider the unique features of the intangibles. This is particularly important where the CUP method is considered to be the most appropriate transfer pricing method, but also has importance in applying other methods that rely on comparables. In the case of a transfer of an intangible or rights in an intangible that provides the enterprise with a unique competitive advantage in the market, purportedly comparable intangibles or transactions should be carefully scrutinised. It is critical to assess whether potential comparables in fact exhibit similar profit potential.

6.114 Set out below is a description of some of the specific features of intangibles that may prove important in a comparability analysis involving transfers of intangibles or rights in intangibles. 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

6.115 Whether the rights in intangibles relevant to a particular transaction involving the transfer of intangibles or rights in intangibles are exclusive or non-exclusive can be an important comparability consideration. Some intangibles allow the legal owner of the intangible 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 enjoy a high 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

6.116 The extent and duration of legal protection of the intangibles relevant to a particular transfer 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 from the exploitation of 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

6.117 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

6.118 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.

6.119 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. The useful life of an intangible that forms a base for ongoing research and development may extend beyond the commercial life of the current generation product line based on that intangible.

(e) Stage of development

6.120 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.

6.121 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 data 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

6.122 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. In some industries, 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.

6.123 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

6.124 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.

(ii) Comparison of risk in cases involving transfers of intangibles or rights in intangibles

6.125 In conducting a comparability analysis involving the transfer of intangibles or rights in intangibles, the existence of risks related to the likelihood of obtaining future economic benefits from the transferred intangibles must be considered, including the allocation of risk between the parties which should be analysed within the framework set out in Section B.2. of Part I of Chapter IX. The following types of risks, among others, should be considered in evaluating whether transfers of intangibles or combinations of intangibles are comparable, and in evaluating whether the intangibles themselves 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 transfers of 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, the risk that counterfeit products could erode the profitability of relevant markets, and the likelihood that substantial damages could be collected in the event of infringement.
- Product liability and similar risks related to the future use of the intangibles.

(iii) Comparability adjustments with regard to transfers of intangibles or rights in intangibles

6.126 The principles of paragraphs 3.47 – 3.54 relating to comparability adjustments apply with respect to transactions involving the transfer of intangibles or rights in 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, depending on the specific facts, 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.

(iv) Use of comparables drawn from data bases

6.127 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 – 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 that may be important in conducting a comparability analysis. In evaluating comparable licence arrangements identified from data bases, the specific facts of the case, including the methodology being applied, should be considered in the context of the provisions of paragraph 3.38.

(v) Selecting the most appropriate transfer pricing method in a matter involving the transfer of intangibles or rights in intangibles

6.128 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 – 2.12. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles. In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to (i) the nature of the relevant intangibles, (ii) the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases, and

(iii) the difficulty of applying certain of the transfer pricing methods described in Chapter II in cases involving the transfer of intangibles. The issues discussed below are particularly important in the selection of transfer pricing methods under the Guidelines.

6.129 In applying the principles of paragraphs 2.1 – 2.12 to matters involving the transfer of intangibles or rights in 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), as either may convey the value of the intangible to the transferee. Accordingly, in selecting the most appropriate transfer pricing method in connection with a transaction involving the transfer of intangibles or rights in intangibles, it is important to consider the economic consequences of the transaction, rather than proceeding on the basis of an arbitrary label.

6.130 This Chapter makes it clear that in matters involving the transfer of intangibles or rights in intangibles it is important not to simply assume that all residual profit, after a limited return to those providing functions, should necessarily be allocated to the owner of intangibles. 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 the transferred intangibles interact with other functions, assets and risks that comprise the global business. The functional analysis should identify all 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 take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions.

6.131 The principles set out in paragraphs 2.12, 3.58 and 3.59 regarding the use of more than one transfer pricing method apply to matters involving the transfer of intangibles or rights in intangibles.

6.132 Paragraphs 3.9 – 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 transfer of intangibles or rights in intangibles and are supplemented by the guidance in Section C. of this Chapter VI. Indeed, it is often the case that intangibles may be transferred in combination with other intangibles, or in combination with transactions involving the sale of goods or the performance of 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) Supplemental guidance on transfer pricing methods in matters involving the transfer of intangibles or rights in intangibles

6.133 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 one or more intangibles. The use of other alternatives may also be appropriate.

6.134 Where the comparability analysis identifies reliable information related to comparable uncontrolled transactions, the determination of arm's length prices for a transfer of intangibles or rights in intangibles can be determined on the basis of such comparables after making any comparability adjustments that may be appropriate and reliable.

6.135 However, it will often be the case in matters involving transfers of intangibles or rights in intangibles 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 and other conditions. This can occur if the intangibles in question have unique characteristics, or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes. Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm's length price and other conditions for the controlled transaction, except in circumstances where paragraph 1.65 applies.

6.136 Where information regarding reliable comparable uncontrolled transactions cannot be identified, the arm's length principle 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 competitive advantages conferred by the intangibles including especially the relative profitability of products and services or potential products and services related to the intangibles.
- The expected future economic benefits from the transaction.
- Other comparability factors such as features of local markets, location savings, assembled workforce, and MNE group synergies.

6.137 In identifying prices and other conditions that would have been agreed between independent enterprises 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 independent enterprises 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.

6.138 Care should be used, in applying certain of the OECD transfer pricing methods in a matter involving the transfer of intangibles or rights in intangibles. One sided methods, including the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles. In some circumstances such mechanisms can be utilised to indirectly value intangibles by determining values for some functions using those methods and deriving a residual value for intangibles. However, the principles of paragraph 6.130 are important when following such approaches and care should be exercised to ensure that all functions, risks, assets and other factors contributing to the generation of income are properly identified and evaluated.

6.139 The use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided.

6.140 However, in some limited circumstances, transfer pricing methods based on the estimated cost of reproducing or replacing the intangible may be utilised. Such approaches may sometimes have valid application with regard to the development of intangibles used for internal business operations (*e.g.* internal software systems), particularly where the

intangibles in question are not unique and valuable intangibles. Where intangibles relating to products sold in the marketplace are at issue, however, 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 arm's length price for partially developed intangibles.

6.141 The provisions of paragraph 2.10 related to the use of rules of thumb apply to determinations of a correct transfer price in any controlled transaction, including cases involving the use or transfer of intangibles. Accordingly, a rule of thumb cannot be used to evidence that a price or apportionment of income is arm's length, including in particular an apportionment of income between a licensor and a licensee of intangibles.

6.142 The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools. Supplemental guidance on the transfer pricing methods most likely to be useful in connection with transfers of intangibles is provided below.

(a) Application of the CUP method

6.143 Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. The general principles contained in paragraphs 2.14 – 2.21 apply when the CUP method is used in connection with transactions involving the transfer of intangibles. Where the CUP method is utilised in connection with the transfer of intangibles, 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 – 1.63 should be considered. The matters described in Section D.2.(i) – (iv) of this Chapter are of particular importance in evaluating the comparability of specific transferred intangibles and in making comparability adjustments, where

possible. It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible.

6.144 In some situations, intangibles acquired by an MNE group from independent enterprises 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 often (after any appropriate adjustments, including 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 facts and 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. Examples 24 and 27 in the Chapter VI Annex illustrate the principles of this paragraph.

[(b) Application of profit split methods

6.145 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 in intangibles where it is not possible to identify reliable comparable uncontrolled transactions for such transfers. Paragraphs 2.109 – 2.146 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. In evaluating the reliability of profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered. See paragraph 2.115.

6.146 Profit split methods may 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 6.160 – 6.165 should be taken into account.

6.147 It is also 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.

6.148 Caution should be exercised in applying profit split approaches to determine estimates of the contributions of the parties to the creation of income in years following the transfer, or an arm's length allocation of future income, with respect to partially developed intangibles. The contribution or value of work undertaken prior to the transfer may bear no relationship to the cost of that work. For example, a chemical compound with potentially blockbuster pharmaceutical indications might be developed in the laboratory at relatively little cost. In addition, a variety of difficult to evaluate factors would need to be taken into account in such a profit split analysis. These would include the relative riskiness and value of research contributions before and after the transfer, the relative risk and its effect on value, for other development activities carried out before and after the transfer, the appropriate amortisation rate for various contributions to the intangible value, assumptions regarding the time at which any potential 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 sometimes be especially speculative. These factors can combine to call the reliability of such an application of a profit split analysis into question.[4]

6.149 Where limited rights in fully developed intangibles are transferred in a licence or similar transaction, and reliable comparable uncontrolled transactions cannot be identified, a transactional profit split method can often 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 contributions of the licensee to enhancements in the value of 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.]

(c) Use of valuation techniques

6.150 In situations where reliable comparable uncontrolled transactions for a transfer of one or more intangibles cannot be identified, it may also be possible to use valuation techniques to estimate the arm's length price for intangibles transferred between associated enterprises. In particular, the application of income based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued, may be particularly useful when properly applied. Depending on the facts and circumstances, valuation techniques may be used as a part of one of the five OECD approved transfer pricing methods described in Chapter II, or as a tool that can be usefully applied in identifying an arm's length price.

6.151 Where valuation techniques are utilised in a transfer pricing analysis involving the transfer of intangibles or rights in intangibles, 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 – III. Principles related to realistically available options (see paragraph 1.34), perspectives of the parties, attribution of risk (see paragraphs 9.10 – 9.46), and aggregation of transactions (see paragraphs 3.9 – 3.12) apply fully to situations where valuation techniques are utilised in a transfer pricing analysis. Furthermore, the rules of these Guidelines on selection of transfer pricing methods apply in determining when such techniques should be used (see paragraphs 2.1 – 2.11). The principles of Sections A., B., C., and D.1. of this Chapter VI also apply where use of valuation techniques is considered.

6.152 It is essential to consider the assumptions and other motivations that underlie particular applications of valuation techniques. For sound accounting purposes, some valuation assumptions may sometimes reflect conservative assumptions and 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 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 determinative for transfer pricing purposes and should be utilised in a transfer pricing analysis with caution and careful consideration of the underlying assumptions.

6.153 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 or specifically endorse one or more specific valuation techniques or methods as being 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 sound valuation principles and 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 6.139 and 6.140 for a discussion of the reliability and application of valuation techniques based on intangible development costs.

6.154 Valuation techniques that estimate the discounted value of projected future cash flows derived from the exploitation of the transferred intangible or intangibles can be particularly useful when properly applied. There are many variations of these valuation techniques. In general terms, such techniques measure the value of an intangible by the estimated value of future cash flows it may generate over its expected remaining lifetime. The value can be calculated by discounting the expected future cash flows to present value.[5] Under this approach valuation requires, among other things, defining realistic and reliable financial projections, growth rates, discount rates, the useful life of intangibles, and the tax effects of the transaction. Moreover it entails consideration of terminal values when appropriate. Depending on the facts and circumstances of the individual case, the calculation of the discounted value of projected cash flows derived from the exploitation of the intangible should be evaluated from the perspectives of both parties to the transaction in arriving at an arm's length price. The arm's length price will fall somewhere within the range of present values evaluated from the perspectives of the transferor and the transferee. Examples 28 - 30 in the Annex to Chapter VI illustrate the provisions of this section.

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

6.155 When applying valuation techniques, including valuation techniques based on projected cash flows, it is important to recognise that the estimates of value based on such techniques can be 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 large differences 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.

6.156 The reliability of the intangible value produced using a valuation model is particularly sensitive to 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.

6.157 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.

6.158 It may be relevant in assessing the reliability of a valuation model to consider the purposes for which the valuation was undertaken and to examine the assumptions and valuation parameters in different valuations undertaken by the taxpayer for non-tax purposes. 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. Such requests would also be appropriate if it is asserted that particular intangibles have short

useful lives but the projections used in other business planning contexts demonstrate that related intangibles produce cash flows in years beyond the 'useful life' that has been claimed for transfer pricing purposes. Valuations used by an MNE group in making operational business decisions may be more reliable than those prepared exclusively for purposes of a transfer pricing analysis.

6.159 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. Notwithstanding the various concerns expressed above and outlined in detail in the following paragraphs, depending on the circumstances, application of such a valuation technique, either as part of one of the five approved OECD methods or as a useful tool, may prove to be more reliable than application of any other transfer pricing method, particularly where reliable comparable uncontrolled transactions do not exist.

(1) Accuracy of financial projections

6.160 The reliability of a valuation of a transferred intangible using discounted cash flow valuation techniques is 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 is contingent on developments in the marketplace that are both unknown and unknowable at the time the valuation is undertaken, and to this extent such projections are speculative, it is essential for taxpayers and tax administrations to examine carefully the assumptions underlying the projections of both future revenue and future expense.

6.161 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.

6.162 The length of time covered by the projections should also be considered in evaluating the reliability of the projections. 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.

6.163 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.

6.164 When deciding whether to include development costs in the cash flow projections it is important to consider the nature of the transferred intangible. Some intangibles may have indefinite useful lives and may be continually developed. In these situations it is appropriate to include future development costs in the cash flow forecasts. Others, for example a specific patent, may already be fully developed and, in addition not provide a platform for the development of other intangibles. In these situations no development costs should be included in the cash flow forecasts for the transferred intangible.

6.165 Where, for the foregoing reasons, or any other reason, there is a basis to believe that the projections behind the valuation are unreliable or speculative, attention should be given to the guidance in Section D.3. regarding situations where valuation is highly uncertain at the time of the transaction.

(2) Assumptions regarding growth rates

6.166 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.

(3) Discount rates

6.167 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 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.

6.168 There is no single measure for a discount rate that is appropriate for transfer pricing purposes in all instances. Neither taxpayers nor tax administrations 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.

6.169 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.

6.170 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.

(4) Useful life of intangibles and terminal values

6.171 Valuation techniques are often premised on the projection of cash flows derived from the exploitation of 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.

6.172 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, and by other factors affecting competition in the relevant economic environment. See paragraphs 6.118 and 6.119.

6.173 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 non-routine returns are attributable to such intangibles in perpetuity.

6.174 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 thoroughly examined, particularly the assumed growth rates.

(5) Assumptions regarding taxes

6.175 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 projected future income taxes on the projected cash flows. Tax effects to be considered include: (i) taxes projected to be imposed on future cash flows, (ii) tax amortisation benefits projected to be available to the transferee, if any, and (iii) taxes projected to be imposed on the transferor as a result of the transfer, if any.

(vii) Form of payment

6.176 Taxpayers 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. The principles of Chapter I (paragraphs 1.48 – 1.69) should be followed in evaluating taxpayer agreements with regard to the form of payment.

6.177 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 or profit will normally 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.3. Arm's length pricing when valuation is highly uncertain at the time of the transaction

The BEPS Action Plan suggests that one area for future BEPS related work involves the transfer pricing treatment of hard to value intangibles. That work will include a detailed review of the language and approach currently outlined in the Transfer Pricing Guidelines on this topic. Accordingly, for the purposes of this draft, the language of the 2010 Guidelines on hard to value intangibles has been retained, including language in Examples 31 - 33. However, it is anticipated that substantial work will be focused on this topic during the coming months.

6.178 As stated at the outset of this section, 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.

6.179 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. 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.

6.180 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.

6.181 Also, independent enterprises may determine to bear the risk of unpredictable subsequent developments to a certain degree, however with the joint understanding that major unforeseen developments changing the fundamental assumptions upon which the pricing was determined would lead to renegotiation of the pricing arrangements by mutual agreement of the parties. For example, each 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 the drug at all, in which case the agreement might be renegotiated (although whether this in fact would happen, would depend upon all the facts and circumstances).

6.182 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 price 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.

6.183 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 rate 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 paid 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.

6.184 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.

6.185 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.]

D.4. Supplemental guidance for transactions involving the use of intangibles in connection with the sale of goods or the provision of services

6.186 This section provides supplemental guidance for applying the rules of Chapters I – III in situations where one or both parties to a controlled transaction uses intangibles in connection with the sale of goods or the provision of services, but where no transfer of intangibles or interests in intangibles occurs. Where intangibles are present, the transfer pricing analysis must carefully consider the effect of the intangibles involved on the prices and other conditions of controlled transactions.

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

6.187 The general rules of paragraphs 1.33 – 1.63 and Chapter III also apply to guide the comparability analysis of transactions involving the use of intangibles in connection with a controlled transaction involving the sale of goods or the provision of services. However, the presence of intangibles may sometimes raise challenging comparability issues.

6.188 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 notwithstanding its relatively less complex operations. 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.

6.189 For example, a tested party engaged in the marketing and distribution of goods purchased in controlled transactions may have developed marketing intangibles in its geographic area of operation, including customer lists, customer relationships, and customer data. 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.

6.190 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, collect customer data, 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.

6.191 Where the tested party and the potential comparable have comparable intangibles, the intangibles will not constitute unique and valuable intangibles within the meaning of paragraph 6.17, and therefore no comparability adjustments will be required with regard to the intangibles. The potential comparable will, in these circumstances, provide the best evidence of the profit contribution of the tested party's intangibles. If, however, either the tested party or the potential comparable has and uses in its business unique and valuable intangibles, it may be necessary either to make appropriate comparability adjustments or to revert to a different transfer pricing method. The principles contained in Section D.2.(i) – (iv) apply in evaluating the comparability of intangibles in such situations.

6.192 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 unique and valuable intangibles.

(ii) Determining arm's length prices for transactions involving the use of intangibles in connection with the sale of goods or the performance of services

6.193 The principles of Chapters I – III apply in determining arm's length prices for transactions involving the use of intangibles in connection with sales of goods or the performance of services. 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 unique and valuable intangibles. Transfer pricing approaches to these two categories of cases are described below.

(a) Situations where reliable comparables exist

6.194 It will often be the case that, notwithstanding the use of intangibles by one or both parties to a controlled sale of goods or provision of 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 provision of services and reliable comparables are present.

6.195 Where the tested party does not use unique and valuable intangibles, and where reliable comparables can be identified, it will often be possible to determine arm's length prices on the basis of one-sided methods including the CUP, resale price, cost plus and TNMM methods. The guidance in Chapters I – III will generally be sufficient to guide the determination of arm's length prices in such situations, without the need for a detailed analysis of the nature of the intangibles used by the other party to the transaction.

6.196 The principles described in Section D.2.(i) – (iv) 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 unique and valuable 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 unique and valuable

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.

6.197 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 a different transfer pricing method that is less dependent on identification of reliable comparables.

6.198 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.

(b) Situations where reliable comparables do not exist

6.199 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 the sale of goods or the provision of 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 2.110.

6.200 Paragraphs 2.109 – 2.146 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 the provision of services in controlled transactions.

6.201 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 performed, risks

assumed and assets used. Vague assertions of the existence and use of unspecified intangibles will not support a reliable application of a profit split method.

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

Notes

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.

2. As used herein, exploitation of an intangible includes both the transfer of the intangible or rights in the intangible and the use of the intangible in commercial operations.

3. As used in this Section B., the use of assets includes the contribution of funding and/or capital to the development, enhancement, maintenance, protection or exploitation of intangibles. See paragraph 6.59.

4. The BEPS Action Plan specifically calls for work to be undertaken on hard to value intangibles and on the application of profit split methods. The provisions of paragraphs 6.145 – 6.149 will be reconsidered in connection with that work.

5. In the case of a financial valuation based on projections, the analysis will often be based on projections of cash flows. Accrual based measures of income, such as those determined for accounting or tax purposes, may not properly reflect the timing of cash flows which can create a difference in outcome between an income and a cash flow based approach. However, in light of a number of considerations, the use of income projections rather than cash flow projections may, in some cases, yield a more reliable result in a transfer pricing context as a practical matter. Care must be taken, however, to ensure that either income or cash flow measures are applied in a consistent manner and in appropriate circumstances. References to cash flow in this document should therefore be read broadly to include both cash flow and income measures, appropriately applied.

The provisions of the Annex to Chapter VI of the Transfer Pricing Guidelines are deleted in their entirety and are replaced by the following language.

Annex to Chapter VI

Examples to illustrate the guidance on special considerations for intangibles

[Example 1

1. 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 funds R&D and 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. All patent registrations are held and maintained in the name of Company S.

2. Company S employs three lawyers to perform its patent administration work and has no other employees. Company S does not 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. Key decisions related to defending the patents are made by Premiere management, after taking advice from employees of Company S. Premiere's management, and not the employees of Company S, controls all decisions regarding licensing of the group's patents to both independent and associated enterprises.

3. At the time of each assignment of rights from Premiere to Company S, Company S makes a nominal 100 Euro payment to Premiere in consideration of the assignment of rights to a patentable invention and, as a specific condition of the assignment, simultaneously grants to Premiere an exclusive, royalty free, patent licence, with full rights to sub-licence, for the full life of the patent to be registered. The nominal payments of Company S

to Premiere are made purely to satisfy technical contract law requirements related to the assignments and, for purposes of this example, it is assumed that they do not reflect arm's length compensation for the assigned rights to patentable inventions. Premiere uses the patented inventions in manufacturing and selling its products throughout the world and from time to time sublicenses patent rights to others. Company S makes no commercial use of the patents nor is it entitled to do so under the terms of the licence agreement with Premiere.

4. Under the agreement, Premiere performs all functions related to the development, enhancement, maintenance, protection and exploitation of the intangibles except for patent administration services. Premiere contributes and uses all assets associated with the development and exploitation of the intangible, and bears all or substantially all of the risks associated with the intangibles. Premiere should be entitled to the bulk of the returns derived from exploitation of the intangibles. Tax administrations could arrive at an appropriate transfer pricing solution by determining the true nature of the arrangements between Premiere and Company S. Depending on the facts, it might be determined that taken together the nominal assignment of rights to Company S and the simultaneous grant of full exploitation rights back to Premiere reflect in substance a patent administration service arrangement between Premiere and Company S. An arm's length price would be determined for the patent administration services and Premiere would retain or be allocated the balance of the returns derived by the MNE group from the exploitation of the patents.

Example 2

5. The facts related to the development and control of patentable inventions are the same as in Example 1. However, instead of granting a perpetual and exclusive licence of its patents back to Premiere, Company S, acting under the direction and control of Premiere, grants licences of its patents to associated and independent enterprises throughout the world in exchange for periodic royalties. For purposes of this example, it is assumed that the royalties paid to Company S by associated enterprises are all arm's length.

6. Company S is the legal owner of the patents. However, its contributions to the development, enhancement, maintenance, protection, and exploitation of the patents are limited to the activities of its three employees in registering the patents and maintaining the patent registrations. The Company S employees do not control or participate in the licensing transactions involving the patents. Under these circumstances, Company S is only entitled to compensation for the functions it performs. Based on an

analysis of the respective functions performed, assets used, and risks assumed by Premiere and Company S in developing, enhancing, maintaining, protecting, and exploiting the intangibles, Company S should not be entitled ultimately to retain or be attributed income from its licensing arrangements over and above the arm's length compensation for its patent registration functions.

7. As in Example 1 the true nature of the arrangement is a patent administration service contract. The appropriate transfer pricing outcome can be achieved by ensuring that the amount paid by Company S in exchange for the assignments of patent rights appropriately reflects the respective functions performed, assets used, and risks assumed by Premiere and by Company S. Under such an approach, the *ex ante* compensation due to Premiere for the patentable inventions is equal to the anticipated licensing revenue of Company S less an appropriate return to the functions Company S performs. This example does not address the allocation of *ex post* returns, if any.

Example 3

8. The facts are the same as in Example 2. However, after licensing the patents to associated and independent enterprises for a few years, Company S, again acting under the direction and control of Premiere, sells the patents to an independent enterprise at a price reflecting appreciation in the value of the patents during the period that Company S was the legal owner. The functions of Company S throughout the period it was the legal owner of the patents were limited to performing the patent registration functions described in Examples 1 and 2.

9. Under these circumstances, the income of Company S should be the same as in Example 2. It should be compensated for the registration functions it performs, but should not otherwise share in the returns derived from the exploitation of the intangibles, including the returns generated from the disposition of the intangibles.

Example 4

10. The facts related to the development of the patents and the initial assignment of the patents to Company S are the same as described in Example 3. However, it should be assumed for purposes of this example that the price paid by Company S in exchange for the patents was an arm's length price that accurately reflected the anticipated returns to be derived from exploitation of the patents as of the time of their assignment to Company S.

11. Following the assignments, Company S licensed the patents to independent enterprises for a few years. In contrast to Example 1, Company S in this example has employees capable of taking all management decisions relating to its patent portfolio. All decisions relating to the licensing programme were taken by Company S employees, all negotiations with licensees were undertaken by Company S employees, and Company S employees monitored compliance of independent licensees with the terms of the licenses. Thereafter the value of the patents increases significantly because of external circumstances unforeseen at the time the patents were assigned to Company S. Company S then sells the patents to an unrelated purchaser at a price exceeding the price initially paid by Company S to Premiere for the patents. Company S employees make all decisions regarding the sale of the patents, negotiate the terms of the sale, and in all respects manage and control the disposition of the patents.

12. Under these circumstances, Company S is entitled to retain the proceeds of the sale, including amounts attributable to the appreciation in the value of the patents resulting from the unanticipated external circumstances.

Example 5

13. The facts are the same as in Example 4 except that instead of appreciating, the value of the patents decreases during the time they are owned by Company S as a result of unanticipated external circumstances. Under these circumstances, Company S is entitled to retain the proceeds of the sale, meaning that it will suffer the loss.

Example 6

14. The facts are the same as in Example 4 except that the appreciation in the value of the patents results from the efforts of Premiere in launching, paying for and managing an intensive and successful marketing campaign in new markets for the products covered by the patents.

This successful marketing campaign results in a significant increase in the amount of royalties received by Company S. Under these circumstances, Company S must compensate Premiere for its contributions to the enhanced value of the patents.

Example 7

15. In Year 1, a multinational group comprised of Company A (a country A corporation) and Company B (a country B corporation) decides to develop an intangible, which is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff. The intangible is expected to take five years to develop before possible commercial exploitation. If successfully developed, the intangible is anticipated to have value for 10 years after initial exploitation. Under the development agreement between Company A and Company B, Company B will perform and control all activities related to the development, maintenance, and exploitation of the intangible. Company A will provide all funding associated with the development of the intangible (the development costs are anticipated to be $100 million per year for 5 years), and will become the legal owner of the intangible. Once developed, the intangible is anticipated to result in profits of $550 million per year (years 6 to 15). Company B will license the intangible from Company A and make contingent payments to Company A for the right to use the intangible, based on returns of purportedly comparable licensees. After the projected contingent payments, Company B will be left with an anticipated return of $200 million per year from selling products based on the intangible.

16. A functional analysis by the country B tax administration of the arrangement assesses the functions performed, assets used and contributed, and risks assumed by Company A and by Company B. The analysis concludes that Company A's contribution to the arrangement is solely R&D funding, including assuming the inherent risk associated with that funding. Company A performs, through its own personnel, all the functions expected from an independent entity providing funding for a research and development project, including the analysis of the intangible at stake and the anticipated profits that can be derived from the investment, the evaluation of the funding risk, including the risk that further investment may be required to complete the project, and of the capacity of Company A to take that risk, and the making of decisions to bear, cover, or mitigate that risk. Taking into account Company A's contributions, as well as the realistic alternatives of Company A and Company B, it is determined that Company A's anticipated remuneration should be a risk-adjusted rate of anticipated return on its funding commitment. Assume that this is determined to be $110 million per

year (for years 6 to 15).[1] Company B, accordingly, would be entitled to all remaining anticipated income after accounting for Company A's anticipated return, or $440 million per year ($550 million minus $110 million), rather than $200 million per year as claimed by the taxpayer. (Based on the detailed functional analysis and application of the most appropriate method, the taxpayer incorrectly chose Company B as the tested party rather than Company A). Thus, Company A would be entitled to 20% of anticipated profits, and Company B would be entitled to 80% of anticipated profits.

17. The anticipated returns to Company A and Company B would then be aligned to the contractual terms of the arrangement. That is, the contingent contractual arrangements (*e.g.,* licensing payments) should be determined such that it leaves Company B with anticipated profits of $440 million per year and leaves Company A with anticipated profits of $110 million per year. Although Company A is the legal owner of the intangible, its contribution of R&D funding and associated risks on that funding entitle it to only 20% of anticipated profits. Company A and Company B's actual profits will likely be higher or lower than their projected anticipated profits. Differences between actual and anticipated profits, if any, would be allocated to Company A and / or Company B based on the principles set out in paragraph 6.66 and 6.67.]

Example 8

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

19. 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. The distribution agreement provides that Primero, and not Company S, is to bear product recall and product liability risk, and provides further that Primero will be entitled to all profit or loss from selling Product X in the territory after providing Company S with the agreed level of compensation for its distribution functions. Operating under the contract, Company S purchases Product X from Primero and resells Product X to independent customers in countries throughout its geographical area of operation. In performing its distribution functions, Company S follows all applicable regulatory requirements.

20. In the first three years of operations, Company S earns returns from its distribution functions that are consistent with its limited risk characterisation and the terms of the distribution contract. Its returns reflect the fact that Primero, and not Company S, is entitled to retain income

derived from exploitation of the intangibles 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.

21. Under these circumstances, there is an inconsistency between Primero's asserted entitlement to returns derived from exploiting the Product X intangibles and its failure to bear the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the inconsistency. In determining the appropriate adjustment, it would be necessary to determine the true transaction between the parties by applying the provisions of paragraph 1.53. In doing so, it would be appropriate to consider the risks borne by each of the parties on the basis of the course of conduct followed by the parties over the term of the agreement, the control over risk exercised by Primero and Company S, their respective capacity to bear risk, and other relevant facts. If it is determined that the true nature of the relationship between the parties is that of a limited risk distribution arrangement, then the most appropriate adjustment would likely take the form of an allocation of the recall and product liability related costs from Company S to Primero. Alternatively, if it is determined on the basis of all the relevant facts that the true nature of the relationship between the parties includes the assumption of product liability and recall risk by Company S, and if an arm's length price can be identified on the basis of the comparability analysis, an increase in the distribution margins of Company S for all years might be made to reflect the true risk allocation between the parties. As risk and the functions related to control of risk should generally be aligned, this second alternative may be unlikely.

Example 9

22. 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.

23. 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 R 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.

24. 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. 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 service fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

25. 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, the assets it uses and the risks it assumes.

26. 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, and is paid a mark-up 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.

27. Under these circumstances, Primair is entitled to retain any income derived from exploiting the R trademark and trade name in the country Y market that exceeds the arm's length compensation to Company S for its functions and no transfer pricing adjustment is warranted under the circumstances.

Example 10

28. The facts in this example are the same as in Example 9, 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 direct 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 than in Example 9 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 9. The contractual arrangements between Primair and Company S are different and the risks assumed by Company S are greater in Example 10 than in Example 9. Company S does not receive direct cost reimbursements or a separate fee for marketing activities. The only controlled transaction between Primair and

Company S in Example 10 is the transfer of the branded watches. As a result, Company S can obtain its reward for its marketing activities 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 10 than the price for watches determined for purposes of Example 9. 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 9. This results in Company S having a greater anticipated total profit in Example 10 than in Example 9 because of its higher level of risk and its more extensive functions.

29. 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, performs marketing functions and 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 administrations conclude, based on a review of comparable distributors, that Company S would have been expected to have performed the functions it performed and incurred its actual level of marketing expense if it were independent from Primair.

30. Given that Company S performs the functions and 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.

31. Based on the foregoing assumptions, Company S's return is arm's length and its marketing activities, including its marketing expenses, are not significantly different than those performed by independent marketers and distributors in comparable uncontrolled transactions. The information on comparable uncontrolled arrangements provides the best

measure of the arm's length return earned by Company S for the contribution to intangible value provided by its functions, risks, and costs. That return therefore reflects arm's length compensation for Company S's contributions and accurately measures its share of the income derived from exploitation of the trademark and trade name in country Y. No separate or additional compensation is required to be provided to Company S.

Example 11

32. The facts in this example are the same as in Example 10, except that the market development functions undertaken by Company S in this Example 11 are far more extensive than those undertaken by Company S in Example 10.

33. 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 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. Assume further that the high level of expense incurred by Company S reflects its performance of additional or more intensive functions than those performed by the potential comparables and that Primair and Company S expect those additional functions to generate higher margins or increased sales volume for the products. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has made a larger functional contribution to development of the market and the marketing intangibles and has assumed significantly greater costs and risks than identified potentially comparable independent enterprises (and substantially higher costs and risks than in Example 10). There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profit margins of the identified potentially comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

34. As in Example 10, 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 expects to have an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case Company S has performed functions and borne marketing expenditures beyond what

independent enterprises in potentially comparable transactions with similar rights incur for their own benefit, resulting in significantly lower profit margins for Company S than are made by such enterprises.

35. Based on these facts, it is evident that by performing functions and incurring marketing expenditure substantially in excess of the levels of function and expenditure of independent marketer/distributors in comparable transactions, Company S has not been adequately compensated by the margins it earns on the resale of R watches. Under such circumstances it would be appropriate for the country Y tax administration to propose a transfer pricing adjustment based on compensating Company S for the marketing activities performed (taking account of the risks assumed and expenditure incurred) on a basis that is consistent with what independent enterprises would have earned in comparable transactions. Depending on the facts and circumstances reflected in a detailed comparability analysis, 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 if such comparables can be identified.

- 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 contributions of both Company S and Primair to the generation of income and 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.

36. In this example, the proposed adjustment is based on Company S's having performed functions, incurred risks, and incurred costs that contributed to the development of the marketing intangibles for which it was 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 12

37. The facts in this example are the same as in Example 10, 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.

38. 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, the assets used, and the risks assumed within the time period of the contract. 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.

39. The risks assumed by Company S are substantially higher than in Example 10 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 profit margins 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 compensation for its at risk contribution to the value of the R trademark and trade name during the term of its arrangement with Primair.

40. Such compensation could take the form of direct compensation from Primair to Company S for the anticipated value created through 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 13

41. The facts in this example are the same as in Example 10 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 profit margins declining substantially.

42. Assume that there is no evidence that independent marketers/distributors of similar branded products have agreed to pay royalties under similar arrangements. Company S's level of marketing expenditure and activity, from Year 4 on, is consistent with that of independent enterprises.

43. For transfer pricing purposes, it would not generally be expected that a royalty would be paid in arm's length transactions 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 income derived from exploiting such intangibles. Furthermore, the royalty causes Company S's profit margins to be consistently lower than those of independent enterprises with comparable functions performed, assets used and risks assumed during the corresponding years of similar long-term marketing and distribution arrangements. Accordingly, a transfer pricing adjustment disallowing the royalties paid would be appropriate based on the facts of this example.

Example 14

44. The facts in this example are the same as those set out in Example 11 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 11.
- 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.

45. In connection with a tax audit conducted by country Y tax administrations 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 and intensity of marketing activity undertaken by Company S exceeded that of independent marketers and distributors, and that the relatively greater activity has been successful in expanding volumes and/or increasing the Primair group's overall margins from sales in country Y. Given the extent of the market development activities undertaken by Company S, including its strategic control over such activities, 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 individual entity profit margins realised by Company S are significantly

lower than the profit margins of comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

46. 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, Company S may have an opportunity to benefit (or suffer a loss) from its 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 anticipated profit margins for Company S than those of comparable enterprises.

47. Based on these facts, Company S should be compensated with an additional return for the market development functions it performs, the assets it uses and the risks it assumes. For Years 1 through 3, the possible bases for such an adjustment would be as described in Example 11. 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 received compensation in connection with the renegotiation of the arrangement at the end of Year 3 in accordance with the guidance in Part II of Chapter IX.

Example 15

48. 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.

49. 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.

50. The transfer pricing analysis of these facts would begin by recognising that Shuyona is the legal owner of the intangibles. Shuyona controls and manages both its own R&D work and that of Company S. It performs the important functions related to that work such as budgeting, establishing research programmes, designing projects and funding and controlling expenditures. Under these circumstances, Shuyona is entitled to returns derived from the exploitation of the intangibles developed through the R&D efforts of Company S. Company S is entitled to compensation for its functions performed, assets used, and risks assumed. In determining the amount of compensation due Company S, the relative skill and efficiency of the Company S R&D personnel, the nature of the research being undertaken, and other factors contributing to value should be considered as comparability factors. 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 would generally relate to the year the service is provided and would not affect the entitlement of Shuyona to future returns derived from exploiting intangibles derived from the Company S R&D activities.

[Example 16

51. 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.

52. 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 through Company S research efforts are registered by Shuyona. Shuyona makes no or only a nominal payment to Company S in relation to the patentable inventions developed by the Company S R&D centre.

53. 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 Company S 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.

54. The transfer pricing analysis of this fact pattern would begin by recognising that Shuyona is the legal owner / registrant of intangibles developed by Company S. Unlike the situation in Example 15, however, Shuyona neither performs nor exercises control over the research functions carried out by Company S, including the important functions related to management, design, budgeting and funding that research. Accordingly, Shuyona's legal ownership of the intangibles does not entitle it to retain or be attributed any income related to the product line B intangibles. Tax administrations could arrive at an appropriate transfer pricing outcome by recognising Shuyona's legal ownership of the intangibles but by noting that, because of the contributions of Company S in the form of functions, assets, and risks, appropriate compensation to Company S for its contributions could be ensured by confirming that Company S should make no royalty or other payment to Shuyona for the right to use any successfully developed Company S intangibles, so that the future income derived from the exploitation of those intangibles by Company S would be allocated to Company S and not to Shuyona.

55. If Shuyona exploits the product line B intangibles by itself, Shuyona should provide appropriate compensation to Company S for its functions performed, assets used and risks assumed related to intangible development. In determining the appropriate level of compensation for Company S, the fact that Company S performs all of the important functions

related to intangible development would likely make it inappropriate to treat Company S as the tested party in an R&D service arrangement.

Example 17

56. 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 15.

57. In Year 1, Shuyona sells all rights to patents and other technology related intangibles, including rights to use those intangibles in ongoing research, to a new subsidiary, Company T, organised 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 at the time of the transfer.

58. 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 contractually agrees to bear the financial risk associated with possible failure of future R&D projects, agrees to assume the cost of all future R&D activity, and agrees to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a mark-up equivalent to the profit mark-up over cost earned by certain identified independent companies engaged in providing research services.

59. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design the R&D programme related to further development of the transferred intangibles, to establish its own R&D budgets, to determine its own levels of R&D staffing, and to make decisions regarding whether to pursue or terminate particular R&D projects. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 15.

60. The transfer pricing analysis of these facts begins by recognising that Company T is the legal owner of the intangibles following the transfer. Shuyona is entitled to compensation for the research functions it performs and for the functions it undertakes in managing and controlling that research. Company S should also be compensated for its research functions. Company T would be entitled to compensation for its manufacturing functions and for its investment in the acquired intangibles. Company T should also be compensated for funding ongoing R&D. It may be extremely difficult or impossible to identify comparable transactions with such a structure and use of profit split methods, valuation techniques, or other methods may be necessary to identify the appropriate level of compensation to Shuyona for its functions, assets and risks.

Example 18

61. Company A is a fully integrated pharmaceutical company engaged in the discovery, development, production and sale of pharmaceutical preparations. Company A conducts its operations in country X. In conducting its research activities, Company A regularly retains independent Contract Research Organisations to perform various R&D activities, including designing and conducting clinical trials with regard to products under development by Company A. However, such CROs do not engage in the blue sky research required to identify new pharmaceutical compounds. Where Company A does retain a CRO to engage in clinical research activities, research personnel at Company A actively participate in designing the CRO's research studies, provide to the CRO results and information derived from earlier research, establish budgets and timelines for CRO projects, and conduct ongoing quality control with respect to the CRO's activities. In such arrangements, CROs are paid a negotiated fee for services and do not have an ongoing interest in the profits derived from sales of products developed through their research.

62. Company A transfers patents and related intangibles related to Product M, an early stage pharmaceutical preparation believed to have potential as a treatment for Alzheimer's disease to Company S, a subsidiary of Company A operating in country Y (the transaction relates strictly to the existing intangibles and does not include compensation for future R & D services of Company A). It is assumed for purposes of this example that the payment of Company S for the transfer of intangibles related to Product M is arm's length. Company S has no technical personnel capable of designing, conducting or supervising required ongoing research activities related to Product M. Company S therefore contracts with Company A to carry on the research programme related to Product M in the same manner as before the transfer of intangibles to Company S. Company S agrees to fund all of the

ongoing Product M research, assume the financial risk of potential failure of such research, and to pay for Company A's services based on the cost plus margins earned by CROs like those with which Company A regularly transacts.

63. The transfer pricing analysis of these facts begins by recognising that, following the transfer, Company S is the legal owner of the Product M intangibles under relevant contracts and registrations. However, Company A continues to perform and control functions and to manage risks related to the intangibles owned by Company S, including the important functions described in paragraph 6.56, and is entitled to compensation for those contributions. Under these circumstances, Company A's transactions with CRO's are not comparable to the arrangements between Company S and Company A related to Product M and may not be used as a benchmark for the arm's length compensation required to be provided to Company A for its ongoing R&D activity with respect to the Product M intangibles. Company S does not perform or control the same functions or control the same risks in its transactions with Company A, as does Company A in its transactions with the CROs.

64. While Company S is the owner of the intangibles, it should not be entitled to all of the returns derived from the exploitation of the intangibles. Because Company S lacks the capability to control research related risks, Company A should be treated as bearing a substantial portion of the relevant risk and Company A should also be compensated for its functions, including the important functions described in paragraph 6.56. Company A should be entitled to larger returns than the CROs under these circumstances and if, as is likely, appropriate comparables cannot be identified, it may be necessary to apply profit split methods, valuation techniques, or other methods that do not directly rely on comparables to identify the appropriate compensation of Company A.[2]]

Example 19

65. 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. It obtains valid patents in all countries relevant to this example. Primarni and Company S enter into a written licence 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 Asia, Africa, and in country A.

66. Assume Company S uses the patents and know-how to manufacture Product X in country B. It sells Product X to both independent and associated customers in country B. Additionally, it sells Product X to associated distribution entities based throughout Asia and Africa. The distribution entities resell the units of Product X to customers throughout Asia and Africa. Primarni does not exercise its retained patent rights for Asia and Africa to prevent the sale of Product X by Company S to the distribution entities operating in Asia and Africa.

67. Under these circumstances, the conduct of the parties suggests that the transaction between Primarni and Company S is actually a licence of the Product X patents and know-how for country B, plus Asia and Africa. In a transfer pricing analysis of the transactions between Company S and Primarni, Company S's licence should be treated as extending to Asia and Africa, and should not be limited to country B, based on the conduct of the parties. The royalty rate should be recalculated to take into account the total projected sales by Company S in all territories including those to the Asian and African entities.

Example 20

68. Company P, a resident of country A conducts a retailing business, operating several department stores in country A. Over the years, Company P has developed special know-how and a unique marketing concept for the operation of its department stores. It is assumed that the know-how and unique marketing concept constitute intangibles within the meaning of Section A of Chapter VI. After years of successfully conducting business in country A, Company P establishes a new subsidiary, Company S, in country B. Company S opens and operates new department stores in country B, obtaining profit margins substantially higher than those of otherwise comparable retailers in country B.

69. A detailed functional analysis reveals that Company S uses in its operations in country B, the same know-how and unique marketing concept as the ones used by Company P in its operations in country A. Under these circumstances, the conduct of the parties reveals that a transaction has taken place consisting in the transfer from Company P to Company S of the right to use the know-how and unique marketing concept. Under comparable circumstances, independent parties would have concluded a license agreement granting Company S the right to use in country B, the know-how and unique marketing concept developed by Company P. Accordingly, one possible remedy available to the tax administration is a transfer pricing adjustment imputing a royalty payment from Company S to Company P for the use of these intangibles.

Example 21

70. Ilcha is organised in country A. The Ilcha group of companies has for many years manufactured and sold Product Q in countries B and C through a wholly owned subsidiary, Company S1, which is organised in country B. Ilcha owns patents related to the design of Product Q and has developed a unique trademark and other marketing intangibles. The patents and trademarks are registered by Ilcha in countries B and C.

71. For sound business reasons, Ilcha determines that the group's business in countries B and C would be enhanced if those businesses were operated through separate subsidiaries in each country. Ilcha therefore organises in country C a wholly owned subsidiary, Company S2. With regard to the business in country C:

- Company S1 transfers to Company S2 the tangible manufacturing and marketing assets previously used by Company S1 in country C.
- Ilcha and Company S1 agree to terminate the agreement granting Company S1 the following rights with relation to Product Q: the right to manufacture and distribute Product Q in country C; the right to use the patents and trademark in carrying out its manufacturing and distribution activities in country C; and, the right to use customer relationships, customer lists, goodwill and other items in country C (hereinafter, "the Rights")
- Ilcha enters into new, long-term licence agreements with Company S2 granting it the Rights in country C.

The newly formed subsidiary thereafter conducts the Product Q business in country C, while Company S1 continues to conduct the Product Q business in Country B.

72. Assume that over the years of its operation, Company S1 developed substantial business value in country C and an independent enterprise would be willing to pay for that business value in an acquisition. Further assume that, for accounting and business valuation purposes, a portion of such business value would be treated as goodwill in a purchase price allocation conducted with regard to a sale of Company S1's country C business to an independent party.

73. Under the facts and circumstances of the case, there is value being transferred to Company S2 through the combination of (i) the transfer of part of Company S1's tangible business assets to Company S2 in country C, and, (ii) the surrendering by Company S1 of the Rights and the

subsequent granting of the Rights by Ilcha to Company S2. There are three separate transactions:

- the transfer of part of Company S1's tangible business assets to Company S2 in country C;
- the surrendering by Company S1 of its rights under the licence back to Ilcha; and
- the subsequent granting of a licence by Ilcha to Company S2.

For transfer pricing purposes, the prices paid by Ilcha and by Company S2 in connection with these transactions should reflect the value of the business which would include amounts that may be treated as the value of goodwill for accounting purposes.

Example 22

74. 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. Product Y is well recognised and attracts a premium compared to its competitors, to which Första is entitled as the legal owner and developer of the trademark and related goodwill giving rise to that premium.

75. In Year 2, Första organises Company S, a wholly owned subsidiary, in country B. Company S acts as a super distributor 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.

76. Beginning in Year 2, Company S undertakes to reimburse the distribution affiliates for a portion of their advertising costs. Prices for Product Y from Company S to the distribution affiliates are adjusted upward so that the distribution affiliate operating profit margins remain constant notwithstanding the shift of advertising cost to Company S. Assume that the operating profit margins earned by the distribution affiliates are arm's length both before and after Year 2 given the concurrent changes in product pricing and the reimbursement of advertising costs. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

77. 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 now entitled to income related to intangibles. It

asserts that such income is attributable to intangibles in respect of Product Y created through the advertising costs it has borne.

78. In substance, Company S has no claim to income derived from the exploitation of intangibles with respect to Product Y. It performs no functions, bears and controls no risk, and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles. Transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate.

Example 23

79. Company A owns a government licence for a mining activity and a government licence for the exploitation of a railway. The mining licence has a standalone market value of 20. The railway licence has a standalone market value of 10. Company A has no other net assets.

80. Birincil, an entity which is independent of Company A, acquires 100 percent of the equity interests in Company A for 100. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to the mining licence; 10 to the railway licence; and 70 to goodwill based on the synergies created between the mining and railway licences.

81. Immediately following the acquisition, Birincil causes Company A to transfer its mining and railway licences to Company S, a subsidiary of Birincil.

82. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for the transaction with Company A, it is important to identify with specificity the intangibles transferred. As was the case with Birincil's arm's length acquisition of Company A, the goodwill associated with the licences transferred to Company S would need to be considered, as it should generally be assumed that value does not disappear, nor is it destroyed as part of an internal business restructuring.

83. As such, the arm's length price for the transaction between Companies A and S should take account of the mining licence, the railway licence, and the value ascribed to goodwill for accounting purposes. The 100 paid by Birincil for the shares of Company A represents an arm's length price for those shares and provides useful information regarding the combined value of the intangibles.

Example 24

84. Birincil acquires 100 percent of the equity interests in an independent enterprise, 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.

85. 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.

86. 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 not determinative for transfer pricing purposes. The 100 paid by Birincil for the shares of

Company T represents an arm's length price for shares of the company and provides useful information regarding the value of 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. If the transfer of intangibles to Company S had been separated in time from the acquisition, a separate inquiry would be required regarding any intervening appreciation or depreciation in the value of the transferred intangibles.

Example 25

87. 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 copyrighted software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customisation.

88. 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 licence 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. The code developed in the Bank A engagement and embedded in the Bank B software would be sufficiently

extensive to justify a claim of copyright infringement if copied on an unauthorised basis by a third party.

89. 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 26

90. 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.

91. 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.

92. 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.

Example 27

93. Osnovni is the parent company of an MNE Group engaged in the development and sale of software products. Osnovni acquires 100 percent of

the equity interests in 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.

94. 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.

95. Company T is a wholly owned subsidiary of Osnovni. Osnovni has traditionally licensed exclusive rights in all of its intangibles related to the European and Asian markets to Company T. For purposes of this example it is assumed that all arrangements related to the historic licences of European and Asian rights to Company T prior to the acquisition of Company S are arm's length.

96. Immediately following the acquisition of Company S, Osnovni liquidates Company S, and thereafter grants an exclusive and perpetual licence to Company T for intangible rights related to the Company S products in European and Asian markets.

97. In determining an arm's length price for the Company S intangibles licensed 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 licensed to Company T, Company T should pay an amount for the transferred Company S intangibles and rights in intangibles that reflects 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 not determinative for transfer pricing purposes.

Example 28

98. Company A is the parent of an MNE group with operations in country X. Company A owns patents, trademarks and know-how with regard to several products produced and sold by the MNE group. Company B is a wholly owned subsidiary of Company A. All of Company B's operations are conducted in country Y. Company B also owns patents, trademarks and know-how related to Product M.

99. For sound business reasons related to the coordination of the group's patent protection and anti-counterfeiting activities, the MNE group decides to centralise ownership of its patents in Company A. Accordingly, Company B sells the Product M patents to Company A for a lump-sum price. Company A assumes responsibility to perform all ongoing functions and it assumes and controls all risks related to the Product M patents following the sale. Based on a detailed comparability and functional analysis, the MNE group concludes that it is not able to identify any comparable uncontrolled transactions that can be used to determine the arm's length price. Company A and Company B reasonably conclude that the application of valuation techniques represents the most appropriate transfer pricing method to use in determining whether the agreed price is consistent with arm's length dealings.

100. Valuation personnel apply a valuation method that directly values property and patents to arrive at an after-tax net present value for the Product M patent of 80. The analysis is based on royalty rates, discount rates and useful lives typical in the industry in which Product M competes. However, there are material differences between Product M and the relevant patent rights related to Product M, and those typical in the industry. The royalty arrangements used in the analysis would therefore not satisfy the comparability standards required for a CUP method analysis. The valuation seeks to make adjustments for these differences.

101. In conducting its analysis, Company A also conducts a DCF based analysis of the Product M business in its entirety. That analysis, based on valuation parameters typically used by Company A in evaluating potential acquisitions, suggests that the entire Product M business has a net present value of 100. The 20 difference between the 100 valuation of the entire Product M business and the 80 valuation of the patent on its own appears to be inadequate to reflect the net present value of routine functional returns for functions performed by Company B and to recognise any value for the trademarks and know-how retained by Company B. Under these circumstances further review of the reliability of the 80 value ascribed to the patent would be called for.

Example 29

102. Company A is the parent company of an MNE group with operations in country S. Company B is a member of the MNE group with operations in country T, and Company C is also a member of the MNE group with operations in country U. For valid business reasons the MNE group decides to centralise all of its intangibles related to business conducted outside of country S in a single location. Accordingly, intangibles owned by Company B are sold to Company C for a lump sum, including patents, trademarks, know-how, and customer relationships. At the same time, Company C retains Company B to act as a contract manufacturer of products previously produced and sold by Company B on a full-risk basis. Company C has the personnel and resources required to manage the acquired lines of business, including the further development of intangibles necessary to the Company B business.

103. The MNE group is unable to identify comparable uncontrolled transactions that can be used in a transfer pricing analysis of the arm's length price to be paid by Company C to Company B. Based on a detailed comparability and functional analysis, the MNE group concludes that the most appropriate transfer pricing method involves the application of valuation techniques to determine the value of the transferred intangibles. In conducting its valuation, the MNE group is unable to reliably segregate particular cash flows associated with all of the specific intangibles.

104. Under these circumstances, in determining the arm's length compensation to be paid by Company C for the intangibles sold by Company B, it may be appropriate to value the transferred intangibles in the aggregate rather than to attempt a valuation on an asset by asset basis. This would particularly be the case if there is a significant difference between the sum of the best available estimates of the value of individually identified intangible and other assets when valued separately and the value of the business as a whole.

Example 30

105. 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.

106. At the beginning of Year 1, Pervichnyi organises 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. 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.

107. According to this valuation analysis, Pervichnyi could have generated after tax residual cash flows (after rewarding all functional activities of other members of the MNE group on an arm's length basis) having a present value of 600 by continuing to manufacture Product F in Country X. The valuation from the buyer's perspective shows that Company S could generate after tax residual cash flows having a present value of 1100 if it owned the intangibles and manufactured the product in country Y. The difference in the present value of Pervichnyi's after tax residual cash flow and the present value of Company S's after tax residual cash flow is attributable to several factors.

108. 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 in country Y. In this scenario, Pervichnyi calculates it would be able to generate after tax cash flow with a present value of 875.

109. In defining arm's length compensation for the intangibles transferred by Pervichnyi to Company S, it is important to take into account the perspectives of both parties, the options realistically available to each of them, and the particular facts and circumstances of the case. Pervichnyi would certainly not sell the intangibles at a price that would yield an after tax residual cash flow with a present value lower than 600 , the residual cash flow it could generate by retaining the intangible and continuing to operate in the manner it had done historically. Moreover there is no reason to believe Pervichnyi would sell the intangible for a price that would yield an after tax residual cash flow with a present value lower than 875. If Pervichnyi could capture the production cost savings by retaining another entity to manufacture on its behalf in a low cost environment, one realistically available option open to it would be to establish such a contract manufacturing operation. That realistically available option should be taken into account in determining the selling price of the intangible.

110. Company S, would not be expected to pay a price that would, after taking into account all relevant facts and circumstances, leave it with an after tax return lower than it could achieve by not engaging in the

transaction. According to the discounted cash flow valuation, the net present value of the after tax residual cash flow it could generate using the intangible in its business would be 1100. A price might be negotiated that would give Pervichnyi a return equal to or greater than its other available options, and give Company S a positive return on its investment considering all of the relevant facts, including the manner in which the transaction itself would be taxed.

111. A transfer pricing analysis utilising a discounted cash flow approach would have to consider how independent enterprises dealing at arm's length would take into account the cost savings and projected tax effects in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield Pervichnyi after tax residual cash flow equivalent to that of the options realistically available, and a price that would yield Company S a positive return to its investments and risks, considering the manner in which the transaction itself would be taxed.

112. The facts of this example and the foregoing analysis are obviously greatly oversimplified by comparison to the analysis that would be required in an actual transaction. The analysis nevertheless reflects the importance of considering all of the relevant facts and circumstances in performing a DCF analysis, evaluating the perspectives of each of the parties in such an analysis, and taking into consideration the options realistically available to each of the parties in performing the transfer pricing analysis.

[Example 31

113. 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 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.

114. 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.

115. 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.

116. 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 6.179. 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 6.180 and 6.181.

Example 32

117. 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.

118. 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.

119. 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 6.183.

Example 33

120. 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.

121. 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 and comparable conditions of uncertainty 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%

122. 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 6.180, 6.182, and 6.183.]

Notes

1. For purposes of this example, it is not necessary to derive these results. The example assumes that making a funding 'investment' of $100 million per year for 5 years in a project with this level of risk should earn at arm's length anticipated profits of $110 million per year for the following 10 years.

2. Some country delegates believe that fact patterns like those reflected in Examples 17 and 18 could be appropriately addressed by disregarding or recharacterising transactions under paragraph 1.65 in some instances because such transactions would not normally occur between independent enterprises. The BEPS action plan calls for additional consideration to be given to the circumstances in which it is appropriate to disregard or recharacterise transactions. The analysis of these Examples will accordingly be discussed further in the context of the 2015 work on BEPS.

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Contents

Executive summary

Amendments to Chapters I – II of the Transfer Pricing Guidelines

Amendments to Chapter VI of the Transfer Pricing Guidelines

Chapter VI. Special considerations for intangibles

Annex to Chapter VI. Examples to illustrate the guidance on special considerations for intangibles

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