INTERNATIONAL TAXATION

TRANSFER PRICING

SPECIAL CONSIDERATION FOR INTANGIBLES

INTRODUCTION

- Intangibles are increasingly critical to MNE's value creation and account for a significant proposition of added value
- 90% of enterprise value of the largest companies in the world are derived from intangibles
- Transactions involving intangible property can be extremely difficult to evaluate from a transfer pricing perspective
- IP transactions are often a source of complex disputes involving substantial sums of money

INTRODUCTION

- ‘Key value drivers’ within an MNE group.
- Value of intangible assets may exceed the combined value of all tangible assets held by a company.
- Intangibles are very easy to move across an MNE group; hence they give opportunities for tax planning.

What are Intangibles

- The term “intangible” refers to;

1. something that belongs to a company but is not a physical asset or a financial asset;
2. capable of being owned or controlled for use in commercial activities; and
3. whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances due to expected commercial benefits.

Intangibles

- Intangibles are characterised as;

1. Hard Intangibles – eligible for legal protection
2. Soft Intangibles – generally don't require specific legal protection

- OECD guidelines distinguish between;

i. Routine intangibles
ii. Unique & valuable intangibles

Identification of Intangible Assets

- Intangibles specifically for transfer pricing:-

1. Patents;
2. Trademarks;
3. Trade names;
4. Brands;
5. Know-how and trade secrets;
6. Customer list;
7. Rights under contract and Government licenses;
8. License and limited rights in intangibles;
9. Goodwill (Reputational value)

Identification of Intangible Assets

1. Patents

- 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.
- Patentable inventions are often developed through risky and costly research and development activities.
- The developer of a patent may try to recover its development costs (and earn a return) through:-
- sale of products covered by the patent,
- licensing others to use the patented invention, or
- outright sale of the patent.

Identification of Intangible Assets

2. Trademarks, trade names and brands

- 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.
- A trade name may have the same force of market penetration as a trademark and may indeed be registered in some specific form as a trademark.
- A brand may, in fact, represent a combination of intangibles including, among others, trademarks, trade names, customer relationships, reputational characteristics, and goodwill.
- It may sometimes be difficult or impossible to segregate or separately transfer the various intangibles contributing to brand value.

Identification of Intangible Assets

3. Know-how and trade secrets

- 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.
- Generally consist of undisclosed information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise.
- The value of know-how and trade secrets is often dependent on the ability of the enterprise to preserve the confidentiality of the know-how or trade secret.

Identification of Intangible Assets

4. Rights under contracts and government licenses

- Contract rights and licenses can cover a wide range of business relationships.
- They may include, among others:-
  - contracts with key customers or suppliers
  - a government grant of rights to exploit specific natural resources or public goods to carry on a specific business activity

Question: *Are government mining or exploration licenses intangibles?*

Identification of Intangible Assets

5. Goodwill and Going concern value

- The term goodwill can be used to refer to a number of different concepts:-

- In accounting, it's the difference between the fair value of separately identifiable assets and the value of the operating business (acquisition value).

- Economic value of the business assets;

- Expected future trade from existing customers.

- Whichever the definition, goodwill and going concern value are now considered as intangibles.
- However measurement for TP purpose is not consistent with that of accounting.

Types of Intangibles

1. Marketing Intangibles

- Assets used by a business that are customer facing and relate to marketing activities.
- These intangibles aid in the commercial exploitation of a product or service and have important promotional value on the product.
- They include trademarks and trade names, customer lists, distribution channels, and unique names, symbols, or pictures.

Types of Intangibles

2. Trade Intangibles

- Are all other assets other than marketing intangibles
- They are product or service related.
- Usually relate to manufacturing process and provision of services
- They are often created through risky and costly research and development (R&D) activities.
- Examples; Patents, Know-how, trade secrets, licences, rights under contract.

Identification of Intangibles

- OECD guidelines identify several economic categories that are not intangibles from a transfer pricing point of view

1. Market features
2. Group synergies

Market Features

- Market specific characteristics may affect the prices paid for specific goods and services in a particular market.
- These may include:-

i. the high purchasing power of households in a particular market
ii. low prevailing labour costs
iii. proximity to markets
iv. favourable weather conditions.

Group Synergies

Group synergy may include:

i. streamlined management
ii. elimination of costly duplication of effort
iii. integrated systems
iv. purchasing or borrowing power
v. Assembled workforce- Team of well-skilled and experienced staff.

Intangibles Ownership

- From a transfer pricing perspective it is vital to distinguish between **legal** and **economic** ownership

1. **Legal Owner** – person/entity in whose name the IP is registered
2. **Economic Owner** – entity that contributes to the development, enhancement, maintenance or exploitation (DEMPE) of an IP.

- Multiple entities in an MNE may contribute to the creation of an IP.

Intangibles Ownership

- Entities performing and/or controlling the DEMPE functions, bearing related risks, using relevant assets should be compensated for their contributions
- Entity contributing to DEMPE functions is an economic owner and is therefore entitled to a return generated by the asset.
- DEMPE analysis identifies the DEMPE functions and evaluates each function's contribution to the value creation and should follow the general OECD guidelines

Intangibles Ownership

- In general, the registered legal owner of such intangibles has the exclusive legal and commercial right to use the intangible.
- for transfer pricing purposes the legal owner is considered to be the owner of the intangible.
- **All members of the MNE group are entitled to return** based on their functions, assets and risks in relation to DEMPE transactions.

Transfer Pricing of Intangibles

- The TP approach depends on the type of transaction;

1. **Transfer (sale) of an intangible**

- Price to be analysed is the actual price paid for the IA

2. **Licensing**

- Licenser expects to receive compensation from the licensee for use of the IA

Arm's Length Compensation – DEMPE Transactions

- There are **two types of returns** from exploitation of intangibles :

1. ***Ex ante*** - Anticipated/expected future income/cash flows;
2. ***Ex post*** – Income actually earned from the intangibles.

- Generally, intangible returns are determined based on *ex ante* approach.

- The arm's length compensation should be done based on the most appropriate TP method in line with the facts and circumstances of the case.
- Comparability analysis should be conducted in order to identity comparable uncontrolled transactions.

Comparability analysis for intangibles

- Factors that affect IA price and are important in a comparability analysis;

1. Exclusivity
2. Extent and duration of legal protection.
3. Geographic scope
4. Useful life.
5. Stage in development.
6. Rights to enhancements, revisions, and updates

- These factors affect the anticipated future benefit

Transfer Pricing Methods

- The selection of the most appropriate transfer pricing method should be based on a functional analysis.
- One sided TP methods, (CPM, RPM, TNMM), are generally not applicable where intangibles are involved.
- OECD discourages use of cost-based methods for valuing IA as development costs rarely determine the value of an IP.
- CUP method may be considered if there are reliable comparable uncontrolled transactions that can be used as a reference for setting the price

Transfer Pricing Methods

- In practice, identification of reliable comparables is difficult if not impossible.
- Where CUP fails, profit split method should be used to determine the arms' length price

Questions?