Transfer Pricing of Intangibles

A comparison between The Netherlands and the United States

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Introduction

In 2006, a high-profile transfer pricing settlement reached world headlines. It involved a dispute between a pharmaceutical giant, GlaxoSmithKline, and the U.S. tax authorities, the IRS. The dispute was reported not only in the tax literature, but also in major newspapers like The Wall Street Journal\(^1\) and The Washington Post.\(^2\) The amount involved in the settlement was certainly large enough to justify broad coverage: USD 3.4 billion. The information that was made public revealed that the settlement involved an allocation of drug profits from the country where the drug, Tagamet, was developed (the U.K.) to the country where the drug was marketed (the U.S.) at the cost of a significant amount of double taxation. The IRS has held that the U.S. company was entitled to valuable intangible income.

Depending on one’s perspective, the case raised different questions. The Chief Financial Officer of a major company, operating in the United States might wonder whether he should expect the IRS to target his company as well. A lawyer, educated in international taxation, would probably think: wait a minute, isn’t there something like a mutual agreement procedure to deal with these matters? A pharmacist might be left questioning why the IRS is saying that the R&D work performed by his colleagues is less valuable than the smooth talking by savvy salesmen. And the transfer pricing specialist would think, well…

In 2006, an article in The Independent\(^3\) and in 2007, an article in the International Herald Tribune\(^4\) contained headlines that illustrated the other side of the coin. The articles revealed that the Rolling Stones, a very British band according to most people, used Dutch holding companies in a very successful tax-planning strategy. The Stones paid only 1.6% taxes on GBP 240 million of royalties for their songs and trademarks. “You can’t always get what you want”, the group sang in 1969. Or can you?

The articles left the author questioning: why are intangible assets in one case the reason behind a settlement that resulted in an almost absurd amount of double taxation, whereas in another case they are so successfully (apparently almost tax-exempt) used in holding companies? After all, both cases involve taxpayers seeking to exploit their intangibles.

This thesis will take the exploitation of intangible rights as a starting point. One will learn that the exploitation of intangibles can take place in many different ways. For instance, the transfer of an intangible can take place through an outright sale (A sells its patent to company B), but also through the sale of a physical good that contains an intangible element (A sells a machine with special technology to B). A transfer of an intangible might even take place when Mick Jagger and Co. perform in a football stadium. From the perspective of a transfer of intangibles: what is the difference between buying the latest album (for which royalties are due) and buying a ticket to see the concert where the band performs its new songs?

The subject will be analysed from a transfer pricing perspective. Transfer pricing seeks to price transactions between related companies in a way that independent companies dealing in comparable circumstances would have done. This reference to third parties is called the arm’s length principle. It thus requires comparing intercompany transactions to third-party transactions. For instance, it tells us to consider: what would a pharmaceutical company agree

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\(^1\) http://online.wsj.com/article/SB1115798715531459461.html?mod=health_home_stories.
\(^3\) http://news.independent.co.uk/uk/this_britain/article1209751.ece.
upon with an independent distributor if it wants to have its drugs distributed in the United States? If the transfer price is determined correctly, it should give rise to neither double taxation nor to tax avoidance.

Since the transfer pricing of intangibles will eventually result in an allocation of the intangible’s profits, one will have to understand what drives the value of the intangibles. Let us, for example, consider this from the perspective of the Taxman: why should he accept royalty payments to a low-tax country? The answer he will get from the taxpayer would be: because an enterprise in his country is licensing a highly valuable brand. The Taxman will reply to that answer by asking: but why is this brand so valuable? Back to the Rolling Stones example: why shouldn’t the U.K. instead of the Netherlands be entitled to tax Stones profits? After all, it was the U.K. where the band members lived when they became famous and where they recorded their albums. In order to answer these questions, this thesis will explain how intangibles are developed, how their value fluctuates, and it will explain which functions enhance the intangible’s value.

The perceived difference between the U.S. (tough on transfer pricing) and the Netherlands (a tax-haven) as one would conclude from the newspaper headlines, was the main reason for a comparison between the Netherlands and the United States. The other reasons to study the United States transfer pricing regime include: the widespread availability of literature on U.S. transfer pricing and the historic role of the U.S. as a catalyst of transfer pricing developments. The Netherlands was chosen because of its sophisticated and worldwide renowned tax regime and for being the country where the author resides and studies.

The comparison between the U.S. and the Netherlands consists of two questions:

1. How is an arm’s length royalty determined in country A?
2. Does this differ from the calculation of an arm’s length royalty in country B?

Since both countries adhere to the arm’s length principle, the outcome of a royalty determination should theoretically be the same in both the U.S. and the Netherlands. After all, reference is made to what comparable independent parties in similar circumstances would have done, and this should not lead to different results. It will therefore also be examined whether the results reached under U.S. and Dutch regulations are in accordance with actual arm’s length evidence. To understand why this is necessary, one should imagine a situation where the U.S. imposes a remuneration for the U.S. distributor that is higher than is usually observed in arm’s length transactions. If the U.K. wants the U.K. R&D provider to be correctly compensated with an arm’s length return, worldwide profits are partly taxed twice. Therefore, only after reference has been made to actual arm’s length evidence it is possible to see whether the abovementioned perceptions of the U.S. and the Netherlands are correct.

In this process of comparing, the author will apply a three-step method. The first step will be to determine the ownership of the intangibles. The second step will be to identify the arrangements made between the parties involved. The third step will be to choose a methodology to determine the arm’s length royalty.
1 Transfer pricing and intangibles

1.1 INTRODUCTION
This chapter will provide an introduction to the issues discussed in this thesis. It will first provide a general introduction to what transfer pricing is and why it is relevant. It will then discuss what intangibles are and how they can be defined. Finally it will address double taxation and the solutions to it.

1.2 TRANSFER PRICING
It will first be described what transfer pricing is. This chapter underscores the importance of transfer pricing in today’s economy and explains why transfer pricing is under review by tax authorities in many countries. Next, the term transfer pricing will be explained. Subsequently this subchapter examines the principles behind transfer pricing and the methods used in transfer pricing. Furthermore it will examine the role of the OECD in transfer pricing. Finally it provides an overview of how transfer pricing has been implemented in both Dutch and U.S. laws.

According to Ernst & Young’s 2005 Global Transfer Pricing Survey, “transfer pricing dominates the agenda”. In response to what they consider the most import tax issue they faced, 38% of the tax directors surveyed answered: “transfer pricing”. Nearly 77% of the companies surveyed believe that transfer pricing will be important or absolutely critical in the next two years. Companies are more and more seeking to avoid transfer pricing penalties and are instead looking to have their transfer pricing policies approved in advance. This trend can for instance be deduced from the 55% increase in the number of executed APAs (from 53 to 82) in the US.

1.2.1 Business restructuring
Prior to answering what transfer pricing is, it is illustrative to look at a trend in global business from the last decades. Multinational enterprises (MNEs) earn their profits worldwide. Originally, MNEs would create subsidiaries in new countries, where they would perform all functions. The subdivision was thus based on territorial grounds. Over the years this has changed into a system where a MNE’s subdivision was to be based on functionality. The report of the Second CTPA Roundtable describes a common pattern clearly emerging in cross border restructuring: “businesses, regardless of their products or sectors, are increasingly reorganizing their structures to provide more centralized control and management of manufacturing, research and distribution functions. The changes in the business model typically consisted of “stripping out” functions, intangible assets and risks which were previously integrated in local operations and transferring them to more centralized and specialized regional or global units.” These waves of restructurings give rise to numerous questions relating to transfer pricing. The most basic question would be: should company A in country A pay to affiliated company B in country B for a certain product or service? And if so, to what extent? A conceptually more difficult issue, recognised at the CTPA roundtable is he following: “in the case of a change from full fledged to contract or toll

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5 For instance Turkey (Tropin 2007), China (Coronado 2007) and Russia (O’Donoghue 2007).
8 For instance the Japanese Honda corporation which, around 2004 transformed its European business model from a decentralized model with fully-fledged distributors to a centralized model with distributors with limited functions.
manufacturing, there might be a transfer of process intangibles developed locally. (..) In these cases, it will be necessary to identify whether in effect an intangible is being transferred and where this is the case, what is the transferred value to quantify its appropriate remuneration.” These questions are all questions of transfer pricing.

Transfer pricing can thus be described as the area that deals with pricing of transfers of goods and services between associated enterprises.

1.2.2 Arm’s length standard
The Organisation for Economic Co-operation and Development (OECD) has always played a significant role in transfer pricing. It published reports on transfer pricing in 1979, 1984 and 1995. The 1995 report was titled “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (OECD Guidelines). The views in this report have been implemented/adopted in many countries as the applicable transfer pricing rules. The OECD adopted the arm’s length approach as the authoritative international standard for determining transfer prices for tax purposes. Art. 9 of the OECD Model Tax Convention reads as follows:

“where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Thus, in plain English, the arm’s length standard seeks to reward a transaction between associated enterprises with a price that a third party, engaged in a similar transaction, under similar circumstances, would pay.

1.2.3 Associated enterprises
A definition of associated enterprises is provided in the OECD Guidelines. Enterprises are associated when either an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or when the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.11 A transaction that involves a dealing between associated enterprises is called an controlled transaction. A dealing between non-associated enterprises (third parties) is called an uncontrolled transaction.

1.2.4 Separate entity approach
In order to compare a controlled transaction with an uncontrolled transaction, the OECD Guidelines treat the members of an MNE as separate entities: “By seeking to adjust profits by reference to the conditions which would have obtained between independent enterprises in comparable transactions and comparable circumstances, the arm’s length approach follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable parts of a single unified business.”12 A flaw this approach is that “it may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses.”13

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10 The OECD Model Tax Convention aims to eliminate international double taxation.
11 Art. 9 (1) OECD Model Tax Convention.
12 OECD Guidelines par. 1.6.
13 Id. par 1.9.
1.2.5 Comparability analysis  
The OECD Guidelines provide guidance on applying the arm’s length principle. One should compare the conditions in controlled transactions to the conditions in transactions between independent parties. In order to be able to compare the transactions, the economically relevant characteristics of the situations being compared must be sufficiently comparable. According to the Guidelines, the factors determining comparability are:

- Characteristics of property or services,
- Functional analysis,
- Contractual terms,
- Economic circumstances, and
- Business strategies.  

Below, an explanation of “functional analysis” is provided. For coverage of the other four factors, reference is made to the OECD Guidelines.

1.2.5.1 Functional analysis  
“In general dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed).” In transfer pricing the functional analysis is of great importance. A functional analysis consists of investigating the functions performed (e.g. sales, marketing or distribution), the assets employed and the risks assumed. The aim of the functional analysis is to determine the values of the functions performed so the arm’s length price can reflect this value.

1.2.6 Methodology  
There are different methods to determine an arm’s length rate. There are transactional methods, which compare the prices charged in controlled transactions to prices charged in uncontrolled transactions. There are also transactional profit methods, which examine the profits that arise from particular controlled transactions. Below is a discussion of both the transactional methods and the profit-based methods.

1.2.6.1 Traditional transaction methods  
According to the Guidelines, “Traditional transaction methods are preferable to other methods.” The three methods traditional methods recognised by the Guidelines are the comparable uncontrolled price method, the resale price method and the cost plus method.

1.2.6.1.1 Comparable uncontrolled price method  
The comparable uncontrolled price method (CUP) “compares the price charged for property or services transferred in a controlled transaction to the price charged for property transferred or services provided in a comparable uncontrolled transaction in comparable circumstances.” The CUP method is the OECD’s preferred method since it is the most direct and reliable. However, finding transactions that are similar enough to a controlled transaction is often very difficult.

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14 Id. par 1.19-1.35.  
15 Id. par. 1.20.  
16 Id. par. 2.49.  
17 Id. par. 2.6-2.13.  
18 http://www.ibfd.org
1.2.6.1.2  Resale price method\textsuperscript{19}

The resale price method (RPM) begins with the price of a product purchased from an associated enterprise which is then resold to an independent enterprise. After subtracting a ‘resale price margin’, which represents the amount out of which the reseller would seek to cover its selling and operating expenses in a comparable uncontrolled transaction, an arm’s length price is arrived at. The RPM is mostly used in case of marketing efforts and in situations where a product is bought from an associated enterprise and sold to an independent party.

1.2.6.1.3  Cost plus method\textsuperscript{20}

The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. A cost plus mark up is then added to this cost. The mark up can be based on either a functional analysis or by reference to a comparable transaction. The method is commonly used for the supply of services and for transfers of semi-finished goods between associated enterprises.

1.2.6.2  Transactional profit methods

The “other methods” are the transactional profit methods and the global formulary apportionment. Transactional profit methods examine the profits that arise from particular controlled transactions. They are mostly used in situations where no comparable transactions can be identified. The global formulary apportionment method “cannot reliably approximate arm’s length conditions” and was therefore rejected by the OECD.\textsuperscript{21}

1.2.6.2.1  Profit split method\textsuperscript{22}

The profit split method first identifies the profit (or loss) to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises in a manner that would have been expected in an arm’s length arrangement. The division of profits reflects each party’s contribution, to be determined by analysis of the functions performed, risks assumed and resources employed.

1.2.6.2.2  Transactional net margin method\textsuperscript{23}

The transactional net margin method (TNMM) examines the profits relative to a controlled base (e.g. cost, sales, assets) from controlled transactions engaged in by associated enterprises.

1.2.7  Transfer pricing under national law

Not only has the OECD adopted transfer pricing regulations, more countries have begun to adopt transfer pricing regulations in their national laws. Below is a brief overview of the legal framework of transfer pricing legislation in the Netherlands and the U.S.

1.2.7.1  Dutch transfer pricing legislation

Prior to January 1, 2002, Dutch tax legislation did not contain any transfer pricing regulations. However, the arm’s length principle was recognised through the applicability of provisions in

\textsuperscript{19} OECD Guidelines par. 2.14-2.31.
\textsuperscript{20} Id. par. 2.32-2.48.
\textsuperscript{21} Id. par. 3.1.
\textsuperscript{22} Id. par. 3.5-3.25.
\textsuperscript{23} Id. par. 3.26-3.48.
the Income Tax Act 2001 (ITA). As of 2002, the Corporate Income Tax Act (CITA) contains a specific transfer pricing provision, art. 8b CITA. Furthermore, there are two important decrees, issued by the Ministry of Finance, which address transfer pricing: the 2001 Transfer Pricing Decree and the 2004 Adjusted Decree. The 2001 Decree clarifies the relationship between the OECD Guidelines and Dutch transfer pricing regulations. In principle, the OECD Guidelines are directly applicable in the Netherlands. The Decree provides clarity where necessary and, when possible, comes with an interpretation of the Guidelines.

1.2.7.2 U.S. transfer pricing legislation
U.S. rules on transfer pricing have a history of spurring the worldwide debate on transfer pricing and have catalysed the development of global OECD Guidelines for years. For instance, the introduction of the ‘commensurate with income’ standard, which is discussed in Chapter 3, triggered reactions that this was a political decision and that it did not reflect the arm’s length standard. Section 482 of the Internal Revenue Code (IRC) contains the US transfer pricing provisions. The provisions of this section are illustrated and clarified in the U.S. Federal Treasury Regulations. In 2006, new Final and Temporary Regulations were released which replace the 1994 versions. The OECD Guidelines do not apply directly in the U.S.

1.3 INTANGIBLES
The term ‘intangibles’ is used for a large variety of assets, e.g. trademarks and patents. This subchapter will first examine the general definition of intangibles in tax literature. Subsequently it addresses the definition of intangibles under Dutch and U.S. tax legislation and under the OECD Guidelines. Finally, this subchapter explains the increasing importance of intangibles for transfer pricing matters and explains why this has triggered the tax authorities’ attention.

Intangibles have no ‘physical dimensions or coordinates in space’. Lev and Przysuski give an overview of the differences between tangibles and intangibles by looking at the different economic characteristics. From a transfer pricing perspective, this is a relevant approach, since it gives an overview of the special characteristics to take into account when determining an intangible’s value. Below is a chart that summarizes their comparison.

<table>
<thead>
<tr>
<th>Intangibles</th>
<th>Tangibles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrival</td>
<td>Rival</td>
</tr>
<tr>
<td>Increasing returns to scale</td>
<td>Decreasing returns to scale</td>
</tr>
<tr>
<td>Difficult to manage</td>
<td>Easy to manage</td>
</tr>
<tr>
<td>Partial excludability, spillover effects</td>
<td>Full excludability, spillover effects</td>
</tr>
<tr>
<td>High risk</td>
<td>Low risk</td>
</tr>
</tbody>
</table>

Table 1: economic characteristics of intangibles and tangibles

26 Besluit verrekenprijzen, IFZ2001/295.
27 Aanpassing besluit verrekenprijzen, IFZ2004/680M.
28 Transfer Pricing Decree: “In principle, this means that the OECD Guidelines apply directly in the Netherlands under Section 3.8 of the Income Tax Act 2001.”
29 In tax literature the terms ‘intangibles’, ‘intangible assets’ and ‘intangible property are used interchangeably.
31 Lev 2005.
1.3.1 Defining intangibles

1.3.1.1 Literature

In tax literature, no clear definition of intangibles has been provided. Jie-a-Joen states that an intangible, in general, has the following 5 features:

“1) non-physical in nature (no physical substance). However there should be tangible documentation of the intangible existence (e.g. a contract or trademark registration); 2) future economic benefits are expected to flow to the owner; 3) the value of the intangible arises from its intangible nature and not from its tangible nature. (for instance the literary or scientific works included in a book, and not the material carrier itself); 4) subject to property rights, legal existence and protection, and private ownership; and 5) separable and identifiable in order to determine value of specific intangible.”

Verlinden uses another approach. Firstly, she distinguishes between intellectual property rights (IP rights) and intangibles. The term intangible is used for tax and accounting purposes, IP rights is a legal term. As ‘creations or realisations’ of the mind IP rights are intangible in nature. However, not all intangibles are IP rights. IP rights, according to Verlinden have a number of common, basic features, which can be summarised as follows:

- They are intangible by nature, as they protect certain ‘creations of the mind or intellect’,
- in so far and to the extent such creations meet certain legal conditions,
- by attributing territorially limited,
- exclusive (or monopoly) rights,
- which can be assigned or licensed to third parties, and
- can be used by the owner or licensee to prohibit third parties from commercially exploiting such creations.

There seems to be a broad view and a narrow view. The broad view considers all creations or realisations of the mind or intellect to be intangibles. The narrow view also requires these intangibles to possess certain qualities, for instance the possibility of legal protection. In most cases, the consequences of having differing views are rather limited. For instance, patents and trademarks will be considered an intangible under both views. However, to answer a controversial question as whether an efficient management system (EMS) can be considered to be an intangible, it is obvious that one standard that defines an intangible should be used.

1.3.1.2 Dutch Tax Law

A definition of intangibles is not provided for under the CITA and the ITA. There is no general definition under the trade law, however for accounting purposes one should divide intangibles into five categories:

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33 This thesis does not discuss goodwill (favourable attitudes toward the firm), which is a broader and less identifiable concept than intangibles.
34 Jie-a-Joen 2007.
35 Verlinden 2005.
36 Which includes the administration of corporate and financial matters, purchasing, production planning, inventory control systems and sale techniques: Miyatake 2007.
a) costs that relate to the foundation and the issuing of shares;
b) costs of research and development;
c) costs of the acquisition of concessions, licenses and intellectual property rights;
d) costs of goodwill acquired from third parties;
e) prepayments on intangible assets.\(^{37}\)

1.3.1.3 OECD Guidelines

According to the Guidelines, “Particular attention to intangible property is appropriate because the transactions are often difficult to evaluate for tax purposes”\(^{38}\). Intangibles include “rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property, such as know-how and trade secrets”\(^{39}\). Thus the OECD Guidelines provide for examples of intangibles only, they do not clearly define them. The OECD restricts itself to business rights, \textit{i.e.} intangible property associated with commercial activities, including marketing activities.

The Guidelines recognise that it may be difficult to determine whether one is dealing with an intangible or a product. An example is a software program. The distinction has significant consequences how the payment in case of a ‘sale’ of the software program should be regarded.\(^{40}\) In case the software program is considered to be an intangible, the payment is deemed a royalty. In case the software program is considered to be a product, the payment is merely an ordinary business profit for the software producer. In international tax law, the difference is important, for royalties are usually treated differently than ordinary business profits. Royalties might be liable to withholding taxes and both their deductibility (in the hands of the payer) and their taxation (in the hands of the recipient) are often subject to special rules.\(^{41}\) For a definition of royalties, see article 12 OECD Model Tax Convention, which defines it as “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific works including cinematographic films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”.

Regarding business rights, the OECD Guidelines distinguish between trade intangibles and marketing intangibles.\(^{42}\) Trade intangibles are often created through risky and costly research and development activities (R&D). The developer will seek to recoup these R&D expenditures through product sales, service contracts or license agreements.\(^{43}\) Marketing intangibles include trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned. They are mostly the result of extensive marketing campaigns and other efforts that are made to promote and sell products or services.\(^{44}\) Some marketing intangibles may be legally protected, but this is not a requirement. Intellectual property such as know-how and trade secrets can be either trade intangibles or marketing intangibles. Know-how and trade secrets are proprietary information or knowledge that assists or improves a commercial activity, but that is not

\(^{37}\) Art. 365, Book 2 Civil Code (\textit{Burgerlijk Wetboek}).
\(^{38}\) OECD Guidelines par. 6.1.
\(^{39}\) \textit{Id.} par. 6.2.
\(^{40}\) Verlinden 2005, D.2. provide for a more detailed analysis.
\(^{41}\) \textit{Id.}, see also OECD Guidelines par. 6.19.
\(^{42}\) OECD Guidelines par. 6.5.
\(^{43}\) The different ways in which a developer will try to get a return on its investments are discussed in Chapter 2.
\(^{44}\) Verlinden 2005.
registered for protection in the manner of a patent or a trademark. For a definition of know-how the Guidelines refer to the OECD Model Tax Convention. In recent years know-how has become a highly controversial matter, especially where high-value (often unique) services are provided. For instance, the IRS seeks to identify a transfer of valuable intangibles when a U.S. plant manager is seconded to a foreign country to set up an engineering plant.

Although the division between trade intangibles and marketing intangibles may seem clear, in some cases it is not. The reputation of a company can be a result of the fact that the company has been producing very good products for a number of years. In that case, this reputation is not a marketing intangible but a trade intangible. On the other hand, if a company’s reputation is the result of years of marketing campaigns, then this reputation is indeed a marketing intangible. A combination of both trade intangibles and marketing intangibles can produce a valuable combination. An example is what Bayer AG has done with Aspirin. Its first patent expired at the beginning of last century but the company still earns enormous revenues as a result of the strong brand value.

1.3.1.4 U.S. Tax Law
The IRC and supporting Regulations contain a number of different definitions of the term intangible. Section 482, which is the U.S. transfer pricing provision, and section 936(h)(3)(b), which determines the tax treatment of intangible income, use the broad definition below:

“For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual:

1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
2) Copyrights and literary, musical, or artistic compositions;
3) Trademarks, trade names, or brand names;
4) Franchises, licenses, or contracts;
5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.”

Section 197(d), which discusses amortisation of acquired goodwill and certain other intangibles, uses a different definition, tailored to the specific rules in the article. The language from Merck & Co., which required the intangible to be “commercially transferable”, was included in the 1993 Proposed Regulations but omitted in the 1994 Final Regulations. However, this requirement probably still has value as precedent.

45 Par. 11 of the commentary on Article 12 OECD Model Tax Convention.
46 It was one of the main controversies at the IFA Congress 2007 in Kyoto which addressed the transfer pricing of intangibles. Aritake 2007.
47 According to Deloris R. Wright, Managing Principal of the Analysis Group in Denver, Colorado.
48 See Glaxo’s Chairman Sir Paul Girolami’s view however, “any product which makes money doesn’t sell itself… you’ve got to sell it and sell it hard, because if you don’t it won’t be sold, however good it is”. Fris 2006.
49 Section 1.482-4 (b) Regulations.
51 See Bonano 1999: Despite the omission of this language, Merck probably still has value as precedent as the final regulation definition of intangible property does not materially differ from the 1968 regulation definition.
1.3.1.5 Conclusion
As discussed above, definitions of intangibles vary greatly: “There is no global definition of intangibles, so problems can arise when intangibles are defined differently in different jurisdictions. The lack of clarity is exacerbated by a wider recognition of less traditional forms of intangibles, including human capital intangibles, advertising slogans, business models and strategies, and unique business cultures and philosophies.”

1.3.1.6 IFRS
Given the lack of a common definition in the tax world, it may be interesting to see how the accounting world tries to solve this puzzle. The International Financial Reporting Standards (IFRS) are set by the International Accounting Standards Board (IASB). The IFRS include both old standards (International Accounting Standards, IAS) and new standards. IFRS are worldwide standards except for the United States, which have their own accounting system (United States Generally Accepted Accounting Principles, US GAAP). Most countries have their own GAAP for non-publicly listed companies. In 2003, the European Commission accepted the IAS-regulation. The result was that as of January 1, 2005, the IFRS are the compulsory standards for publicly listed companies in the European Union. In the Netherlands, non-publicly listed companies have the option of applying the IFRS.

According to IAS 38, which is the standard for intangibles, an intangible asset is an identifiable nonmonetary asset without physical substance. An asset is a resource that is controlled by the enterprise as a result of past events (for example, purchase or self-creating) and from which future economic benefits (inflow of cash or other assets) are expected. An intangible is identifiable when it is separable or when it arises from contractual or other legal rights.

1.3.2 Growing importance of intangibles
In the economy of the 21st Century, rapid developments in communication, infrastructure and technology have made the world one large marketplace. Multinational Enterprises (MNEs), who through their scale, financial resources and worldwide presence have the ability to fully exploit the new possibilities, have set a new course in which intangibles have a more significant share than ever before. Companies who used to invest in tangible assets such as machinery and factories are now investing in their intangible assets such as management systems, trademarks and R&D. As Markham notes: “many successful MNEs such as Coca-Cola and Ford are divesting themselves of their physical assets to concentrate on intangible assets. Pharmaceutical giants such as Merck and Co. and Pfizer Inc. have prospered not because they have built new factories for manufacturing and packaging pills, but because they have been technological leaders, spending substantial amounts on research and development to develop new pharmaceuticals.”

The annual investment of the U.S. corporate sector in intangible assets during 2000 amounted to 1 trillion dollars, according to Nakamura, a senior economist with the Philadelphia Federal Reserve. This was about the same amount the U.S. manufacturing sector invested in physical assets. Another perspective to consider the large role of intangibles in MNEs is by comparing the market value of publicly listed companies with their balance sheet value. According to a

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52 Markham 2005.
54 According to Titel 9 Boek 2 BW.
55 IAS 38.8.
56 IAS 38.12.
57 Markham 2005.
2003 survey by Lev the market value (stock price times number of shares outstanding) was a staggering 5 times larger than their balance sheet value, which reflects primarily the net worth of physical and financial assets.\(^{58}\) A large part of this difference was attributable to the company’s intangible assets.

1.3.3 Increased focus by tax authorities
It is not surprising that national tax authorities will each seek to obtain their share of the significant amounts involved with intangibles. MNEs often license their valuable intangibles to affiliated companies. When the affiliated companies perform marketing and promotional efforts, the value of the trademarks etc. increases. Given their intangible nature, transactions with intangibles are often hard to monitor. Another problem is the often unique character of an intangible. Whereas a transaction involving hot plated steel is both visible and comparable, the intercompany use of certain management systems is very difficult to detect let alone valuate. Another characteristic of intangibles is the lack of comparables. Intangibles are “still traded in blind markets, i.e. markets that do not provide visible information for intellectual capital”.\(^{59}\) Opportunistic behaviour by tax authorities, which fully exploit the unique character of transactions involving intangibles, should not be ruled out. The recent Glaxo case, which is discussed in par. 3, has sparked fears that tax authorities, instead of offering clear policies on how they treat this delicate subject, will fully exploit the unique character of intangibles by choosing a side that fits them best. Cottani notes regarding marketing intangibles: “it seems that tax authorities are adopting a line of reasoning based on the facts and circumstances of each case.”\(^{60}\)

1.4 DOUBLE TAXATION
This subchapter first describes what double taxation is and in what forms it appears. It subsequently examines double taxation from a transfer pricing perspective. It then discusses the mutual agreement and arbitration procedures, which aim at tackling double taxation in transfer pricing cases. Finally, it describes what an advance pricing agreement is.

1.4.1 Double taxation\(^{61}\)
When MNEs operate in different countries, they encounter that different tax authorities want to levy taxes. In a world where every State applies the same standards and international principles to calculate a company’s profits, all of the taxable components would be taxed in the correct State, for the correct amount. In practice, often more than one state seeks to tax a source of income. How is this possible? One explanation is that to exercise their right to levy, States use one of the different (and concurring) criteria: source, residence and nationality.\(^{62}\) Another explanation is that states interpret these criteria differently. So even when the same criteria are used, this gives rise to potential conflicts. When more than one state levies with respect of one source of income or of one taxpayer, this is called double taxation. Double taxation is traditionally divided into two kinds, juridical double taxation and economic double taxation. Double taxation is not necessarily international double taxation, it may also occur in national situations. However, this subchapter only addresses international double taxation.

\(^{58}\) Lev 2003.
\(^{59}\) Cottani 2007.
\(^{60}\) Id.
\(^{62}\) See Van Raad 2005 for extensive coverage on these three criteria.
1.4.1.1 Juridical double taxation

Juridical double taxation occurs where one person, with respect of one object is taxed by two tax authorities, eligible to impose taxes. Juridical double taxation may arise in three cases:

- where each Contracting State (of the OECD model convention, FB) subjects the same person to tax on his world-wide income or capital
- where a person is a resident of a Contracting State and derives income from, or owns capital in, the other Contracting State and both States impose tax on that income or capital.
- where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State.  

1.4.1.2 Economical double taxation

Economical double taxation occurs (a), when two persons are taxed (by one or two tax authorities) with respect of the same object or (b), when one person is taxed with respect of formally different, but materially identical objects. An example of economical double taxation is where corporate profits are taxed first at the corporate level. When they are distributed they are taxed a second time at the shareholder level.

1.4.2 Double taxation from a transfer pricing perspective

The field of transfer pricing deals with transactions between related parties. Juridical double taxation does not occur in this field, since this requires there to be only one subject. Logically, situations where double taxation occurs are situations of economical double taxation. The most common form in transfer pricing is when a resident’s profit is adjusted by one jurisdiction (State A) without a corresponding adjustment by the second jurisdiction (State B). An example: when a Dutch company imports goods from an affiliated Chinese factory and sells them in the Netherlands. When the transfer prices for the imported goods are deemed to high by the Dutch authorities, they will make an adjustment: cost of goods sold down, Dutch profits up. Without a corresponding adjustment downwards by the Chinese tax authorities the group as a whole will be faced with double taxation.

1.4.3 Corresponding adjustments

Art. 9 (2) of the OECD Model Tax Convention provides for corresponding adjustments. (referred to as an “appropriate adjustment”). The adjustment however, is not automatically to be made in State B simply because the profits in State A have increased. State B will make an adjustment of the profits of the affiliated company only “if it considers that the adjustment in State A is justified both in principle and as regards to the amount”. For the taxable subject, this weakens its position, it is dependent on what State B thinks of State A’s adjustment. In order to offer State B the option to consult with the tax authorities in State A, art. 9 (2) anticipates the possibility of mutual agreement: “in determining such an adjustment (..) the competent authorities of the Contracting States shall if necessary consult each other”.

1.4.4 Mutual agreement procedure

When a taxable subject is of the opinion that his situation is not in accordance with the OECD Model Tax Convention, he is able to litigate his case in the national tax court. When both

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63 According to par. 3, commentary articles 23A and 23B OECD Model Tax Convention.
64 However, many bilateral treaties do not contain a provision similar to art. 9(2), see, inter alia, NL-GER and NL-FRA.
65 Par. 5, commentary art. 25 OECD Model Tax Convention.
States apply the convention incorrectly, the taxpayer would be obliged to litigate in each State. This may ultimately become a very costly and highly uncertain process. Art. 25 of the convention makes available to taxpayers affected a procedure which is called the mutual agreement procedure (MAP). The MAP is aimed at resolving the dispute by reaching an agreement between the competent tax authorities. The MAP should be considered the second stage of eliminating taxation which does not accord with the Convention, the first stage being the objection to the situation in the national tax court. Art. 25 provides for three forms of mutual agreement, for transfer pricing cases, only the one described in the first paragraph is relevant. The first paragraph provides for mutual agreement in case of taxation not in accordance with the convention. There is no special rule as to the form of the objections. This, in combination with the fact that the MAP can be started irrespective of national remedies, makes it interesting for taxpayers.

Critics, however, focus at several weaknesses of the procedure. The first weakness is that “the competent authorities are under a duty merely to use their best endeavours and not to achieve a result.” When deciding to start a MAP the taxpayer will have to consider the possibility that months of waiting will prove idle after all. The Glaxo case is an excellent example: tax authorities, unable to reach a satisfying outcome, eventually led Glaxo to reaching a costly billion-dollar settlement with the IRS. The second issue is that under the MAP, the competent authorities have full control over the entire procedure. Taxpayers are unable to clarify their case in front of a forum or commission. According to transfer pricing expert Vollebregt there is another important reason that deters taxpayers from starting a MAP. The MAP may trigger a full-blown tax audit at the company in the countries involved in the MAP. In some situations this is unwanted.

1.4.5 Arbitration

One of the critics on the MAP is, as mentioned above, the fact that tax authorities are not obliged to reach an agreement. The OECD seeks to increase transparency of the procedure and wants to avoid that these procedures do not reach a satisfying result. It has therefore issued several reports, containing proposals to improve the procedure. Two solutions are mentioned in the Commentary. “The first approach to a solution might consist of seeking an advisory opinion: the two Contracting State would agree to ask the opinion of an impartial third party, although the final decision would still rest with the States.”

The second solution mentioned in the Commentary, is arbitration. Arbitration is a “term used for the determination of a dispute by the judgement of one or more persons, called arbitrators, who are chosen by the parties and who normally do not belong to a normal court of competent jurisdiction.” Mutual agreement would gather momentum when it contained an arbitration procedure. There would be an agreement in every case. Tax authorities, however, are held back by the idea of losing control over the final result. Initially, arbitration was considered an “unacceptable surrender of fiscal sovereignty” by the OECD. Over the years, the OECD

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66 The other forms are the interpretative MA (art. 25 (3), first part) and the legislative MA (art. 25 (3) second part).
67 Par. 26, commentary art. 2 OECD Model Tax Convention.
69 Hugo Vollebregt is partner of the Transfer Pricing Group of PricewaterhouseCoopers, Amsterdam
71 Par. 46, commentary art. 25 OECD Model Tax Convention.
view has shifted towards a more positive attitude to arbitration. On an OECD level there have been initiatives to an arbitration regulation to the OECD Model Convention. Some bilateral treaties already contain arbitration regulations. On a European level, initiatives in the field of arbitration were taken quite some time ago.

1.4.5.1 EC Arbitration Convention
The EC Arbitration convention was ratified July 23, 1990 and became effective January 1, 1995. It was first proposed in the form of a directive in 1976. The first response to the directive was not very enthusiastic one. Having already given up their fiscal sovereignty in the field of indirect taxes, the EC member states were not yearning to give up their sovereignty in the field of direct taxes as well. The form of directive was changed into a convention. Now the national judges were competent to interpret the convention, instead of the European Court of Justice, where judges are not experts in transfer pricing. When in two years time, no agreement is reached under the MAP, an arbitration committee will be founded. The committee has six months time to make a recommendation. The advice is, in principle, binding, unless the competent authorities reach an agreement within two months after the advice. So far only two cases have been submitted for arbitration. This small number may be explained by the costs involved and the duration of the procedure. Another reason is that tax authorities are not particularly anxious to lose control over the outcome of the procedure.

1.4.6 Advance Pricing Agreement
Fortunately, not all situations where double taxation occurs (or is likely to occur) are settled in the courtroom or through tedious mutual agreement procedures. In many countries, both the Netherlands and the US, it is possible for taxpayers to obtain an Advance Pricing Agreement (APA). An APA describes the methods that will be used to determine the arm's length price in transactions between the taxpayer and related parties. Especially bilateral and multilateral APAs are very capable of tackling double taxation issues in advance.

1.5 CONCLUSION
This chapter first provided an introduction to transfer pricing. It stated that transfer pricing is about pricing intercompany transactions. Key in a transfer pricing analysis is the arm’s length principle, which requires reference to independent parties in comparable circumstances. This chapter subsequently discussed the definition of intangibles, and found that no common definition exists. This lack of a common definition creates uncertainty in several fields, for instance with respect to withholding taxes. Finally it discussed that double taxation in the field of transfer pricing will be mostly economical double taxation and it discussed that the procedures that exist to combat double taxation do not guarantee a satisfying outcome.

76 See Burgers 2005 for extensive coverage on the convention.
77 The Decree of April 21, 1970 (70/243) was the first step.
78 One of them was the Electrolux case.
2 Intangibles under Dutch law and OECD Guidelines

2.1 INTRODUCTION
This chapter will discuss how a transfer pricing analysis should be structured under Dutch law and under the OECD Guidelines. This analysis is performed in three steps. The first step is to determine which entity is considered the owner of an intangible and why the determination of ownership is so crucial in a transfer pricing analysis. This step will also discuss how an enterprise, which does not legally own the intangible that performs marketing activities can be compensated by the legal owner. The second step is to identify the arrangements that have been made between parties. The third step is to determine the applicable methodology. The last subchapter will discuss dealings between a Permanent Establishment and a Head Office.

2.2 STEP 1: DETERMINING OWNERSHIP

2.2.1 Introduction
To understand the importance of establishing ownership of an intangible, one should take into account the rationale of transfer pricing. Basically, transfer pricing is about determining what an arm’s length consideration is for dealings between associated parties. A functional analysis is the basis for determining this price. The Guidelines state that, in identifying and comparing the functions it should be taken into account whether intangible assets have been employed. An example of a dealing, which involves intangibles, is the licensing of a brand name to an affiliated distributor. In a comparable situation that involves independent parties, the owner of the brand name would generally be entitled to a royalty fee. In a transfer pricing analysis the determination of ownership is vital “to determine how income generated by the intangible in question is divided among related-party taxpayers who benefit from the intangible in one form or another in the various tax jurisdictions in which they operate.” However, in intercompany dealings, no general standard to determine ownership exists. The lack of a general standard is caused by both often-changing and unclear national laws and by inconsistent behaviour from tax authorities.

2.2.2 Development of intangibles
To understand why there are two standards of ownership, one should first understand how intangibles are developed. In a traditional business environment, legal and economic ownership coincide. The developer of a trademark registers the trademark and consequently exploits the trademark. In this case, legal and economic ownership are in the same hands. For this moment, the economic owner should be considered the party that incurs the market development costs. Within multinational enterprises, this traditional, static model has transformed into a more dynamic model where functions, such as R&D, sales and marketing, are performed by several branches, often in several jurisdictions.

The OECD Guidelines outline three different methods how the development of trade intangibles within a MNE can be structured:

79 OECD Guidelines par. 1.20 and 1.22.
80 Przysuski 2004.
81 See Glaxo 2006.
82 Exemplary are the United States, which firstly stressed the significance of economic ownership in the 1968 treasury Regulations, then emphasised legal ownership and included the possibility of multiple owners in the 1994 Regulations and in the new 2006 Regulations precluded the possibility of multiple owners.
1) the developer may perform the research activity in its own name, that is, with the intention of having legal and economic ownership of any resulting trade intangible, and enter into license agreements with other MNE group members;

2) the developer may perform the research activity on behalf of another group member(s) under a contract research arrangement (contract R&D) with the intention that the beneficiary will have legal and economic ownership of the resulting trade intangible; or

3) the members of the MNE group may jointly develop the trade intangible under a cost contribution agreement in which the members involved in the joint activity have economic ownership of the intangible.\(^{83}\)

Thus, essentially two categories of development exist. The first category, which encompasses the first and the second OECD method, seeks to allocate ownership to one party, irrespective whether it performs the research in its own name (by itself) or whether it outsources the research under a contract arrangement. The second category, the third OECD method, is a cost-sharing/cost contribution agreement, in which parties decide to share the costs, in essence by pooling together resources, to jointly develop an intangible.\(^{84}\) A license agreement is not necessary since the developers have become economic owners of the intangible. A license agreement therefore necessarily involves an already developed intangible, a cost contribution agreement involves the development of an intangible. However, one should not equate development by multiple parties with a cost contribution agreement. Often there is no contractual agreement in place and it will then have to be determined which party has become the owner of intangibles resulting from the global R&D activities and what the proper compensation is for the parties that assisted the owner in the development.\(^{85}\)

Regarding the development of marketing intangibles, the OECD Guidelines provide for a wide range of activities that may lead to this development; they include market research, public relations and sales.\(^{86}\)

2.2.3 Two standards of ownership

The determination of the ownership of an intangible couldn’t have been such a tedious task if only one standard of ownership existed. However, in practice, two standards of ownership can be observed: legal ownership and economic ownership. Below, both standards are discussed.

2.2.3.1 Legal ownership

As the name implies, legal ownership is based on the existence of legal title and legal protection of intangible property. It necessarily requires that the intangible can be legally protected. With the most common intangibles, patents and trademarks, this is the case. However, some intangibles cannot be protected under national laws, e.g. know-how and client lists. The group company that lawfully registers a trademark in the relevant jurisdiction is to be regarded as the legal owner. The legal owner of an intangible will generally be considered the owner of the intangible for transfer pricing purposes. Only in exceptional cases will ownership for transfer pricing purposes be elsewhere, for instance with the licensee.\(^{87}\)

\(^{83}\) OECD Guidelines par. 6.3.
\(^{84}\) Cost contribution arrangements will not be discussed in this thesis.
\(^{85}\) Lemein 2006.
\(^{86}\) OECD Guidelines par. 6.7.
\(^{87}\) Visser 2005.
An example when ownership of an intangible is with the economic owner and not with the legal owner is when a license is issued under the following circumstances:

- the license is issued exclusively,
- for an indefinite period or at least a period that concurs with the expected economic life of the intangible,
- the licensor has no economic interest in the intangible, for instance when the royalties are dependent on turnover, and
- the licensee is allowed to transfer the license without the licensor’s permission.\(^{88}\)

2.2.3.1.1 Importance of legal ownership
Uncertainty about the applicable ownership standard will only occur in the event of a dealing involving a legally protected intangible. The starting point when observing a transaction, which involves legally protected intangibles should be that the profits, which can be attributed to the intangible, are allocated to the legal owner. Both Ossi and Przysuski insist that it is consistent with the economic principles underlying the arm’s length standard to ascribe importance to legal ownership.\(^{89}\)

The main principle behind application of the arm’s length principle is that parties dealing at arm’s length consider the alternatives to a proposed transaction and enter into the transaction only if no alternative is superior to the proposed transaction.\(^{90}\) The number of options open to the legal owner, the licensor, is much greater than the options open to the licensee. The licensor is able to exploit the intangible itself, it is able to license the intangible to an affiliated party and it is able to license the intangible to a third party. The licensee, however, is only able to accept or decline the licensing offer by the licensor. In general, economic bargaining theory then suggests that competition among potential licensees would limit the licensee’s return to a competitive return for the functions performed. The licensor would be able to capture the incremental income attributable to the intangible.

Economic literature has concluded that legal owners of an intangible may sometimes capture less than all of the profits attributable to the intangible; in order to stimulate a licensee to undertake long-term market development responsibilities, the licensor may permit the licensee to retain some portion of the incremental intangible income. Another reason why licensors sometimes capture less-than-all income is caused by market imperfections, such as small numbers bargaining and limited information.\(^{91}\) Support for the idea that the legal owner will be the ultimate beneficiary of an intangible’s income can also be deducted from two actual cases\(^{92}\) which are indicative of the legal owner’s strong position: Absolut vodka\(^{93}\) and Descente-Adidas\(^{94}\).

2.2.3.1.2 Absolute vodka
Carillon Importers Ltd. was the distributor of, amongst others, Absolut vodka in the U.S. Carillon had been responsible for developing the U.S. market and building the U.S. brand

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\(^{88}\) De Hosson 1999.


\(^{90}\) OECD Guidelines par. 1.15 and par. 1.16. This principle is called: ‘analysis of alternatives.’

\(^{91}\) Ossi 1999.

\(^{92}\) The Absolute vodka and the Descente-Adidas examples were taken from Ossi 1999.


recognition and had made the vodka into a best seller in the U.S. However, as a “reward” for its efforts, Carillon’s distribution rights were terminated and subsequently acquired by the Seagram Company.

2.2.3.1.3 Descente-Adidas
Descente, an independent distributor, sold Adidas-brand products in Japan for 28 years. Descente had made large investments in the Adidas brand in Japan and had even developed products specifically designed for the Japanese market to be sold under the Adidas brand. After 28 years, Adidas Germany, the legal owner of the Adidas brand name, terminated the license agreement. As a result, Descente was unable to capture the intangible value of the brand it had developed.

Both examples stress the importance of legal ownership, since the legal owners of the intangible were ultimately able to capture the intangible value created by the licensees. In the Absolut vodka example, the brand owner was able to ask a high licensing fee because of Absolut’s excellent position in the liquor market. In the Descente case, Adidas was able to make a ‘free ride’ on Descente’s promotional efforts in Japan. However, in both examples little emphasis was placed on the compensation due by the licensor. A high compensation fee would naturally diminish the licensor’s yield and would therefore not allow the legal owner to capture the entire value that had been created. A Dutch case, Mattel GmbH v. Borka B.V. 95, indicates that expenses incurred by the licensee should sometimes be reimbursed by the licensor.

2.2.3.1.4 Mattel GmbH v. Borka B.V.
Borka B.V., an unrelated party, sold products of German company Mattel GmbH in the Netherlands. In June 1984, Mattel announced that it would terminate the distribution agreement and perform the distribution function in the Netherlands through a subsidiary as of January 1, 1985. Since 1980, Borka had made significant investments to enhance its distributorship, amongst others by building a new show room and by hiring new personnel. Being unable to reach a “fair and equitable cash settlement by way of compensation”, Borka found its way to the Court.

Both the Court and the Appellate Court held that Mattel should reimburse Borka for the costs it had incurred in vain. Ultimately, Mattel appealed to the Supreme Court. The Supreme Court held that with similar distribution agreements, distributors may make investments assuming that the agreement will last. These investments may not be compensated by the term’s notice. In these cases, in spite of a reasonable term’s notice, reasonableness and equity may impel a compensation fee by the legal owner. 96

There is a good case for considering legal ownership decisive for transfer pricing cases. As both economic theory and actual examples indicate, the legal owner will eventually capture all (or nearly all) of the income attributable to the intangible. However a sheer focus on legal ownership would too easily cause situations of abuse. Imagine a structure where trademarks are owned by a central group company in a low-tax country and are then licensed to the group companies for a royalty fee. This would give rise to a situation in which the group companies, through marketing, promotion, sales etc. would actually develop the brand and still pay a royalty fee to the central company which has no function besides being owner of the trademark. Therefore, under circumstances, more weight should be placed with the economic

96 Id.
owner, since this will prevent legal constructions that are merely tax-driven. Furthermore, it makes sure that the non-legal owner performing marketing activities will be properly compensated. This idea that, under circumstances the legal owner should not be entitled to all the income attributable to the intangible, has been recognised in some instances.  

2.2.3.2 Economic ownership

For transfer pricing purposes, the economic owner of an intangible can be considered the party that bears the greatest costs of the development of the intangible. “The concept of economic ownership reflects the view that the opportunity to realise income from an intangible should reside in the same entity that incurred the economic costs and bore the economic risks to develop the intangible.” When dealing with intangibles that are not legally protected, the standard of legal ownership is not applicable. Economic ownership of these intangibles will have to be determined by analysing the relative contributions to the intangible by the different members of the group.

2.2.3.3 Ownership as a function

Both Van Herksen and Visser state that for transfer pricing purposes, ownership should be established through a functional analysis. Van Herksen: “In most situations it needs to be determined what investments are made by the respective parties and how the allocation of functions performed, risks incurred and assets used is made between the respective parties to determine ownership and resulting arm’s length income allocation.” Visser regards the exclusive use of the terms legal and economic ownership as inappropriate, since this will in his opinion lead to a situation where the intangible’s profits are split in an all-or-nothing way. This does not justify the economic activities performed by the group companies. He considers ownership as a function performed which should be valued, taking into account the risks incurred. According to Visser, being a legal owner is one of the economic activities that concurs with the development and maintenance of an intangible and should be valued at an arm’s length price as such.

2.2.4 Case law

There are several Dutch cases, which have defined the concept of economic ownership. The cases involve taxpayers paying for certain utility rights (lease, rent) who sought to gain access to a fiscal advantage, which was only open to owners of a capital asset. Therefore, the taxpayers wanted their utility rights recognised as capital assets. The Supreme Court ruled, on several occasions, that utility rights, for instance originating from leasing or rent contracts, could not be recognised as a capital asset in case there are recurrent, often annual, payments. The annual payments match the annual use, and should therefore be expensed instead of capitalised. In case the utility rights are acquired through a payment at once, the Supreme

97 For instance, the Belgian ruling service: “taking into account the limited functions performed and risks borne by the special-purpose company (which held the intangible), only a routine profit should be allocated to the latter based on a cost-plus on its own operating expenses and a fair remuneration for its per-financing role in the development of the software intangibles.” Van Stappen 2006.


100 Visser 2005.


102 See Mobach 2005.

103 Investment deduction, investeringsaftrek.

Court ruled that these rights can constitute a capital asset. However, the Supreme Court made one exception to the rule that recurrent payments do not constitute a capital asset. When relations between the payer and the receiver are such, that the entire interest of the licensed product is with the payer, recurrent payments can constitute a capital asset. This occurs when the party with the utility rights contractually bears all the risks of increase and decrease of value and the risks of perish of the licensed product. Thus, under Dutch law, economic ownership is with the party that has the entire interest of the licensed product. For tax purposes, the economic owner is in the same position as the legal owner. The economic owner owns the licensed product itself, not just the capitalised license fee. It has direct interest in the value and the risks of the asset.

2.2.4.1 Economic ownership
It is generally considered that in the Netherlands, the concept of economic ownership applies in transfer pricing. Van Herksen notes that: “it is assumed that the party that manages the activity, makes the (financial) investment in the development of the intangible in issue, incurs ongoing expenses to sustain the intangible (registration fees, infringement defence costs and ongoing R&D cost or cost of improvements) and carries nearly all of the risks related to the value of the intangible will be the economic owner.” The Netherlands does not take the position that the distributor/licensee must be regarded as economic owner of the intangible based on its investment in marketing efforts and related costs.

2.2.4.2 Economic good
An investment in a rented building is called an economic good. The concept was introduced in Dutch law to put companies who own their offices on the same footing as companies who rent office space. The economic good is an intangible asset and should be distinguished from the rented office itself. The capital asset created through payment at once of utility rights can be also be regarded as an economic good. An economic owner has a direct interest in the state and the value of the product in license, and therefore the licensed asset is to him a capital asset. The owner of an economic good doesn’t own the investment he makes; to him, the investment only constitutes an intangible capital asset.

2.2.4.3 Appellate Court of Amsterdam February 18, 2004
A 2004 transfer pricing case shows how a purchase price of GBP 19.2 million was divided between the legal owner and the economic owner.

Taxpayer, X BV, is part of the English XX-group. One of X’s parents is XX Ltd., based in the United Kingdom. As of September 1, 1997, X BV has its actual place of residence in the UK. On June 4, 1992, X BV acquires licensing rights relating to the brand name J from J Ltd. Their total value is GBP 19.2 million. According to the agreement, X BV pays GBP 19 million for the ten-year economic ownership of the licensing rights. J Ltd. sells the legal ownership to W BV for GBP 200,000. X BV owns all shares in W BV. On March 22, 1996, X BV sells the ten-year economic ownership to W BV for NLG 7 million. To support the GBP 19 million price for the economic ownership, a valuation report is drawn up in 1992. The report grounds the price on the “projected royalty streams” which showed increasing royalty streams over the ten-year period 1992-2002.

106 Aardema 1981.
108 Id. and De Hosson 1999.
The tax inspector fully disagrees with this price. In essence, he takes the expected increases in the royalty streams as a starting point. However, in his opinion, with the report assuming increasing royalties over the next ten years, the total value of the brand should have been much higher. He considers it very unlikely that there would be a sudden stop of this flow of income and therefore extrapolates the royalty stream to the period thereafter. The total value of the brand would then be GBP 43 million instead of GBP 19 million. According to the report, GBP 19 million is attributable to the economic ownership and therefore GBP 24 million should be attributed to the legal ownership. However, with the total purchase price being GBP 19.2 million, the inspector states that 19/43 of GBP 19.2 million (GBP 8.49 million) has to be attributed to the economic ownership.

To support its position in the Court, X BV asked two professors to give their opinion on the value of the legal and economic ownership of the brand in 1992. They conclude that the projected income streams did not take into account the Product Life Cycle of the brand. Generally, after a couple of years, first the growth of the sales and eventually the volume of the sales itself decreases. To support the brand and to keep the income streams at a high level, investments in the brand will have to be made, such as advertising and promotional expenses. Since no such expenses were mentioned in the report, the two professors conclude that it is very unlikely that there would have been significant income streams after the ten-year period, therefore attributing GBP 19 million to the economic owner was a right decision.

Analysis by the Appellate Court
The Court attaches great value to the analysis by the two professors. It holds the inspector’s view incorrect, that the brand will continue to produce ever increasing royalty streams. Since there is no evidence that X BV had any plans to make investments to support the brand, and was not held to do so, the Court reckons that it is very unlikely that at the time of the purchase parties expected the brand name would produce royalty streams after the ten year period. To support its findings, the Court emphasises that as of 1994/1995 the royalty stream did indeed perform a declining line. The Court attaches no significance to the 1992 valuation report, which forecasts ever-increasing royalty figures. It reckons that the report was only intended to support the management’s decision to purchase the brand.

The case is important since the Court weighs the relative value of legal ownership and economic ownership. When it is unlikely that a brand name will produce royalty streams after a certain period and when it is unlikely that investments will be made to increase these royalty streams, the economic owner should be allocated the majority of the purchase price. According to Verlinden: “this case illustrates that economic analysis and documentation of it can be vital in defending prices or reported asset values. The existence of a valuation report and a marketing report were key to winning the case.”

2.2.5 OECD Guidelines
To identify the owner of an intangible, no specific rules are provided in the OECD Guidelines. From the language and the approach used in the Guidelines, Ossi seeks to find support for his proposition that legal ownership instead of economic ownership is most significant for determining ownership of an intangible’s value. The language repeatedly refers to the legal owner of a marketing intangible as the owner for purposes of the transfer pricing.

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110 Both being professors in marketing; at the Erasmus University and the University of Groningen respectively.
111 Verlinden 2005.
The approach by the OECD, according to Ossi, nowhere suggests that a licensee may be deemed an owner of a trademark. However, Verlinden states that under the Guidelines “the emphasis is laid on economic ownership of the intangible.”

2.2.6 Marketing activities undertaken by non-legal owners

2.2.6.1 Introduction
The Guidelines acknowledge that difficult transfer pricing issues arise when marketing activities are undertaken by enterprises that do not own the trademarks or trade names that they are promoting (such as a distributor of branded goods). The first question that arises in such a situation is whether the marketer should be compensated as a service provider, *i.e.* for providing promotional services, or whether there are any cases in which the marketer should share in any additional return attributable to the marketing. The second question is how the return attributable to the marketing intangibles can be identified.

2.2.6.2 Analysis
When analyzing a situation in which, say, a distributor performs marketing activities, the analysis should take into account three factors: the height of the marketing expenditures (are they extraordinary?), the reimbursement by the owner of the intangible, and the substance of the rights of the distributor (is it able to obtain the future benefits from its activities?). Based on the outcome the distributor would, in an arm’s length dealing, be entitled to either compensation for its services or to an additional return.

2.2.6.3 Compensation for providing services or sharing in an additional return
An “assessment of the obligations and rights which have been agreed upon by both parties” should be the starting point whether the licensee should be compensated by the owner for providing promotional services or whether it should share in an additional return. The Guidelines state that “it will often be the case that the return on marketing activities will be sufficient and appropriate.”

2.2.6.3.1 Owner reimburses distributor
“One relatively clear case”, as described in the Guidelines, “is where a distributor acts merely as an agent, being reimbursed for its promotional expenditures by the owner of the marketing intangible.” The distributor is not entitled to share in any return attributable to the marketing intangible, and will only receive compensation, most likely a cost-plus, for its agency activities.

2.2.6.3.2 Owner does not reimburse distributor
According to the Guidelines: “When the distributor actually bears the cost of its marketing activities (*i.e.* there is no arrangement for the owner to reimburse the expenditures), the issue is the extent to which the distributor is able to share in the potential benefits from those activities.” The Guidelines state that, in general, in arm’s length dealings, the substance of

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112 For instance, *see* par. 6.36 OECD Guidelines (referring to marketing activities undertaken by firms “that do not own the trademarks or trade names they are promoting”) and par. 6.37 OECD Guidelines (referring to a distributor’s dealings with “the owners of the marketing intangible”). Ossi 1999.

113 Verlinden 2005: “It must always be examined which company has developed the intangible and consequently, has also borne the costs and risks.”

114 OECD Guidelines par. 6.36.

115 *Id.* par. 6.37.

116 *Id.*

117 *Id.* par. 6.38.
the rights of the marketer will determine its ability to obtain the future benefits of the marketing efforts performed. For instance “a long term contract of sole distribution rights” may enable the marketer to obtain benefits from its turnover and market share.\textsuperscript{118} However, when a distributor bears extraordinary marketing expenditures beyond what an arm’s length distributor incurs, this independent distributor might in such a case obtain an additional return from the owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate.\textsuperscript{119}

\textbf{2.2.6.3.3 Compensation from the owner or return on own intangible}

An important question is whether the distributor obtains this return as compensation from the intangible’s owner or whether it does so as a return on its own market intangible. The language used in the Guidelines, which repeatedly refer to the legal owner of a marketing intangible as the owner for purposes of the transfer pricing analysis, makes clear that legal ownership rights of the trademark owner are not to be disregarded.\textsuperscript{120} According to Ossi, “the Guidelines nowhere suggest that a marketing affiliate may be deemed an owner of a trademark or similar marketing intangible solely by virtue of its promotional activity. Instead, the approach of the Guidelines is to determine how the marketing affiliate is to be compensated by the owner of the marketing intangible.”\textsuperscript{121} He then continues, “the determination of the licensee’s or distributor’s share of income in this circumstance is not based on any deemed ownership of the marketing intangible. Rather, the guidepost prescribed by the Guidelines is an evaluation of the return that an independent distributor or licensee at arm’s length would obtain from the trademark owner under similar circumstance.” However, it is not obvious to everyone that the marketer is only entitled to compensation by the legal owner. Jie-a-Joen seeks further explanation from the Guidelines whether the distributor is regarded as the economic owner of the marketing intangible under certain circumstances.\textsuperscript{122}

\textbf{2.2.6.4 Identifying the return attributable to the marketing intangibles}

The Guidelines continue that it is unsure how the return attributable to marketing activities can be identified. They state that it can be very difficult to determine what the advertising and promotional expenditures have contributed to the success of a product. “In many cases higher returns derived from the sale of trademarked products may be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures.”\textsuperscript{123}

\textbf{2.3 STEP 2: IDENTIFYING THE ARRANGEMENTS MADE}

\textbf{2.3.1 Introduction}

The Guidelines state that a trademark may be “sold, licensed, or otherwise transferred by one person to another. Various kinds of license contracts are concluded in practice. (..) The terms and conditions of license agreements may vary to a considerable extent.”\textsuperscript{124} Key in this step is the arm’s length principle, which may lead parties to adjusting the arrangements they made when parties acting at arm’s length would have agreed upon different contractual terms. This step will first discuss the various ways how a company can exploit its intangibles. It will then

\textsuperscript{118} Id.  
\textsuperscript{119} Id.  
\textsuperscript{120} See, inter alia, Id. par. 6.36 (“that do not own”), 6.37 (“the owner”) and 6.38 (“the owner”).  
\textsuperscript{121} Ossi 1999.  
\textsuperscript{122} Jie-a-Joen 2007.  
\textsuperscript{123} OECD Guidelines par. 6.39.  
\textsuperscript{124} Id.
discuss three controversies in the transfer pricing of intangibles: the transfer of intangibles whose value is uncertain, the ‘roundtripping’ problem and the ‘package deal’. Common factor in these three controversies is that the arm’s length principle may require adjustments in the transfer pricing treatment that was envisaged by taxpayers.

2.3.2 License arrangement

The most common way for a company to exploit its intangible is through licensing it to group companies. The group companies that make use of the intangible will generally be required to pay the owner of the trademark an arm’s length consideration. Sometimes the arm’s length consideration is not a separate payment (a royalty fee), but is included in the pricing when the owner of the intangible is able to realise the yield of these intangibles through its pricing levels. Note that especially with high-valuable intangibles, licensing to unrelated parties is not common.\(^{125}\)

2.3.2.1 Low-risk and High-risk license arrangements

According to Barbera, license arrangements can be divided into two categories.\(^{126}\) Low-risk arrangements (LR) enable the licensee to achieve a relatively low but basically guaranteed profit level. The licensee will most often perform a routine function(s) (e.g. advertising, marketing and promotion), but the royalty is set in such a way that the typical risks associated with these functions are essentially transferred to the licensor. This can be established through a flexible royalty rate that provides sufficient ex post gross profit for the licensee to recover its advertising, marketing and promotion expenses plus still earn a competitive and stable profit. In this way, the risks are essentially borne by the licensor.\(^{127}\)

In case of a High-risk arrangement (HR), the licensee conducts all the key functions required to bring the trademarked product to market and it also bears the risks typically associated with these functions. The royalty in this case is not set so that the licensee is guaranteed a certain profit level but will be lower than the royalty in a Low-risk arrangement to reflect the higher risk borne by the licensee. In case of a HR, no third-party licensee would consider receiving only a routine profit. The licensee performs most of the functions related to the intangible and would therefore also want most of its income. In a survey by Barbera, most license arrangements examined could be placed in the HR category. The higher risk incurred was seen by the licensors as an incentive to the licensee to perform in a manner that enhances the value of a trademark.

2.3.2.2 Tax effective license structures

For tax reasons, it is recommendable to locate ownership of the intangible in a low-tax country. This way, intangible income is taxed at a low tax rate, and royalties are offset against highly-taxed income. However, a structure in which this takes place may be difficult to achieve due to several obstacles. It is in practice difficult to locate resources, infrastructure, and personnel in the low-tax country. And tax reasons will have to be overcome, since it will have to be demonstrated to the tax authorities that a significant contribution was made to the intangible in that country. Below is a brief discussion of three common, tax-efficient

\(^{125}\)“Some of the reasons why an MNE may consider licensing such an intangible to a third party include: access to significant R&D resources, access to significant manufacturing and marketing resources, the ability to cross-license the valuable technology of a third party, and the urgent need for an immediate cash infusion.” Markham 2005.

\(^{126}\)Barbera 2003

\(^{127}\)Id. Two other options for the licensor to ensure that it bears the AMP risks are: 1, the licensor explicitly and directly bears all AMP expenses and bears all other risks; and 2, the licensor reimburses the licensee for its AMP expenses.
exploitation models. Each successive model entails an increase in the order of operational changes within the multinational group, specifically the increasing functions and the risk profile of the low-taxed entity.

2.3.2.2.1 License model
In the license model, the low-taxed entity owns the intangibles or enters into a license agreement for intangibles that cannot be transferred. This entity is called the IP Holding Company (IHC). Future intangibles are developed under a contract R&D arrangement, with a cost-plus remuneration. The benefit of the license model is that only minimal operational changes are required, since only relatively limited functions (and workforce) are needed in the low-taxed entity. This is also its weak spot, since it will be difficult to convince the tax authorities of the valid business purposes and the substance of the structure.

2.3.2.2.2 Franchising / service model
This model takes the licensing model as a starting point. Besides being owner of the intangibles, the IHC will now also provide a broad range of services together with the intangibles. For instance, providing know-how and the experience that is connected to intangibles (i.e. more than just licensing the intangible), and the format for being able to run the business. The business model discussed here is mainly used in the retail and services sector. Contrary to the first model, there are now indeed valid business reasons for this structure.

2.3.2.2.3 Entrepreneur structure
In this structure, the IHC is the entrepreneur, which contracts with customers and bears all commercial risks. The entrepreneur also contracts with foreign subsidiaries (and third parties) for production, R&D, sales support etc. via an arrangement that works on the basis of costs and commissions. With the IHC being the entrepreneur, there are valid business reasons to allocate to the IHC all or nearly all of the income attributable to the intangible.

A sliding scale can be observed in these three structures. The license model is easy to implement but will trigger questions from the tax authorities regarding its substance, the entrepreneurial structure requires a complete transformation of operations but will have sufficient economic relevance and will allow most of the income to be allocated to a low-tax country.

2.3.3 When valuation is highly uncertain
When related entities decide to transfer or license nonroutine intangible assets, these assets are often difficult to value because of their unique characteristics. Moreover, their value is often uncertain at the time of transaction. It should be noted that transactions involving the sale of intangibles, especially nonroutine intangibles, are highly exceptional between independent enterprises. Recognising the potential for abuse, related taxpayers could transfer the intangibles for a low transfer price to a low-tax country, there are special rules under the Transfer Pricing Decree and the Guidelines. These rules, which may result in the imputation of a price-adjustment clause, will be discussed here.

128 Diagrams of the structures are provided in Appendix 1.
129 For instance, the Kentucky Fried Chicken chain, www.kfc.nl/21/franchise/.
2.3.3.1 Transfer Pricing Decree
The only paragraph dedicated to intangibles in the Transfer Pricing Decree discusses hard-to-value intangibles. It starts with the general line that “where intangible assets such as patents are transferred, it may be difficult to establish the value at the time of the transfer because not enough information is available about the future benefits and risks.” It refers to the OECD Guidelines which state that if independent enterprises under similar conditions would have demanded a price adjustment clause, a tax administration must be permitted to calculate the prices using this type of clause. It states that when the asset’s value at the time of the transaction is highly uncertain, the Netherlands tax administrations take the position that a price adjustment clause should be incorporated into the contract. It then provides an example of an intangible with a highly uncertain value. Finally, the Decree refers to a 1998 case where the Supreme Court accepted the ‘commensurate with income’ standard as part of Dutch transfer pricing rules.

2.3.3.2 OECD Guidelines
As the Guidelines state: “An independent enterprise may not be willing to sell an intangible for a fixed price if the profit potential of the intangible cannot be adequately estimated and there are other means of exploiting the intangible. It may also not want to risk an outright sale because the price might not reflect the potential for the intangible to become extremely profitable.” However, these transactions may occur between associated parties. Recognising the potential for abuse, both the Guidelines and the Decrees pay much attention to the selling and licensing of intangibles with a highly uncertain value.

According to the Guidelines, starting point to determine the pricing of an intangible, when valuation is highly uncertain at the time of the transaction, is to refer to what independent enterprises would have done in comparable situations. Independent enterprises might use anticipated benefits as a means for establishing the pricing at the outset of the transaction. If pricing based on anticipated benefits would not provide sufficient protection against subsequent developments that might not be predictable, they might adopt shorter-term agreements or include price-adjustment clauses in the terms of the agreement. The Guidelines then continue, that there may be major unforeseen developments (i.e. the unexpected development of an alternative low-cost treatment), which would lead parties dealing at arm’s length to renegotiating the pricing arrangements. Finally, they provide that

131 Transfer Pricing Decree IFZ2001/295M, par 5.
132 OECD Guidelines par. 6.34.
133 For an overview of price adjustment clauses in several countries see S. Blough et al, ’How earn-out clauses can shift risks’, International Tax Review.
135 OECD Guidelines par. 6.13 and par. 1.10.
136 Id. par. 6.13: “For wholly legitimate business reasons due to the relationship between them, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate.”.
137 For instance, see OECD Guidelines par. 1.37, which provides for tax administrations to disregard structures adopted by taxpayers which are not arm’s length: “an example of this circumstance would be a sale under a long-term contract, for a lump sum payment, of unlimited entitlement to the intellectual property rights arising as a result of future research for the term of the contract.”.
139 Id. par. 6.28.
140 Id. par. 6.29.
141 Id. par. 6.30.
the tax administration should be permitted to determine the pricing on the basis of a price adjustment clause when independent enterprises in comparable situations would have insisted on such a clause.\textsuperscript{142} Price adjustment clauses can be observed in transactions of hard-to-value intangibles between third parties and provide for the possibility of future adjustments to ensure that the transfer price reflects the true value of the transferred intangible. The implementation of a price adjustment clause as provided for under the Adjusted Decree is therefore in accordance with the Guidelines.

“A royalty would ordinarily be a recurrent payment based on the user’s output, sales, or in some rare circumstances, profits. When the royalty is based on the licensee’s output or sales, the rate may vary according to the turnover of the licensee. There are also instances where changed facts and circumstances (e.g. new designs or increased advertising of the trademark by the owner) could lead to a revision of the conditions of remuneration.”\textsuperscript{143} In practice, royalty rates dependent on a company’s profits are exceptional.\textsuperscript{144}

2.3.4 The ‘roundtrip’ problem
Taxpayers often seek to maximise differences in tax rates through selling intangibles to a low-tax country and subsequently paying royalties to this country for the use of these intangibles, thereby decreasing the tax-base in the high-tax country. In the transfer pricing world, the sale and subsequent licensing of an asset is called a “roundtrip arrangement”. We will see that the arm’s length principle requires taxpayers to have valid business purposes for such a transaction and requires them to make sure that the royalties are justified, after all, ‘why would an independent company pay royalties to a foreign company for an intangible it previously owned?’

2.3.4.1 Adjusted Decree
The Adjusted Decree was issued on August 11, 2004, after the Secretary of State for Finance had observed that “the policy regarding internal transfer prices contained certain uncertainties and that the OECD Guidelines leave space for further explanation.” The Adjusted Decree intends to “remove these uncertainties and to allow for a more flexible approach within the space that the OECD Guidelines offer”. It is both an addition as well as an adjustment to the Decree of 2001. The Adjusted Decree provides additional rules for transfers of intangibles when the value is uncertain at the time of the transaction. It refers to the situation in which an intangible is being transferred to a foreign group company and where this company furthermore licenses the intangible to a significant extent (i.e. for more than 50%) to the transferor (a Dutch company) and/or related Dutch companies of this company. In this situation a price adjustment clause is deemed to have been entered into, unless taxpayers substantiate that

1) there are business motives for the transactions; and
2) the valuation at the moment of entering into the agreement is determinable in such a way that independent third parties would not have demanded a price adjustment clause.\textsuperscript{145}

\textsuperscript{142} Id. par. 6.34.
\textsuperscript{143} Id. par. 6.16.
\textsuperscript{144} See Oosterhoff 2005 who refers to a survey by Ernst & Young which examined 10.000 license agreements and only found three agreements in which the royalty payments were profit-based.
\textsuperscript{145} Adjusted Decree IFZ2004/124M, par 5.
From a tax administration perspective, the reasons for a price adjustment are obvious; it prevents a sale at a very low price with a consequent high royalty fee to drain the Dutch tax base. Through the price adjustment clause the Dutch tax authorities are guaranteed a fair price for the sale of the intangible.

2.3.4.2 **Lower Tax Court of Breda March 26, 2007**

A tax case, which made it to the Lower Tax Court in 2007, indicates how the Dutch tax authorities aim to combat license structures that possess no economic rationale. The Taxpayer acquires the shares in BV Z (holding). BV Z owns the shares in BV A and BV B (the three BVs form a fiscal unity under the CITA). BV A produces and sells shoes. In 1993, under a self-proclaimed protection clause, BV A sells the trademark of the shoes to BV C, which is also part of the fiscal unity. The protection clause was supposedly intended to protect the trademark in case of default of BV A. Taxpayer had created BV C prior to the sale of the trademark. In 1994, the taxpayer enters into a licensing agreement with BV C: the taxpayer pays NLG 2 to BV C per pair of shoes sold. Next, BV C moves to the Netherlands Antilles, which results in the end of the fiscal unity as of January 1, 1994. The roundtrip arrangement, the sale of an intangible and the subsequent payment of licensing fees, is now complete. The Lower Tax Court rules that that since there is no valid business purpose for the licensing agreement, the licensing fees are not deductible. Taxpayer is unable to demonstrate a valid business purpose for the licensing agreement. Also, the licensing agreement does not produce effective protection of the brand and should therefore be considered as part of a tax planning plan.

2.3.5 **‘Embedded’ intangibles**

At the 2007 IFA congress in Kyoto, Japan, the tax treatment of ‘bundled’ transactions was considered a major controversy. In such a transaction (also know as a ‘package deal’), a company might sell goods, license intangible property and provide technical services, all for an undifferentiated payment. Tax authorities and taxpayers may want to ‘unbundle’ these transactions since tax treatment of the ingredients may differ: the supply of the intangible property might for example be subject to a withholding tax.

As regards ‘package deals’, it may be necessary to disaggregate the goods and the ‘embedded’ intangibles. Not only to evaluate whether the height of the license charge is correct and/or whether requiring a license charge is correct at all, but also to calculate an arm’s length royalty for countries that impose royalty withholding taxes. It may also occur that the compensation for the use of intangible property may be included in the price charged for the sale of goods. An investigation of the circumstances is then recommendable since “any additional payment for royalties would ordinarily have to be disallowed by the country of the buyer.”

2.3.6 **Transfer of know-how in connection with the provision of services**

According to the Guidelines, it is sometimes unclear whether one is dealing with a know-how contract or a service contract: “If the payment is seen as service fees, it is usually not taxed in the country of origin unless the receiving enterprise carries on business in that country through a permanent establishment situated therein and the fee is attributable to the permanent

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146 See the “Artikelsgewijs commentaar” of the “Fiscale Encyclopedie de Vakstudie”.
147 Lower Tax Court of Breda March 26, 2007, VSN June 2, 2007.
149 OECD Guidelines par. 6.17.
establishment.\textsuperscript{150} On the other hand, royalties paid for the use of intangible property are subject to a withholding tax in some countries.\textsuperscript{151} The Guidelines repeatedly state that it may be necessary to segregate the different components of the transaction\textsuperscript{152}, but do not provide further guidance or examples on how to deal with these matters. The further attention from the Working Party No. 1, to which the Guidelines refer, remains forthcoming.

2.3.6.1 OECD Commentary

The Guidelines refer to the OECD Commentary on article 12 OECD Model Tax Convention, which also states that it may be difficult to distinguish payments for the supply of know-how and payments for the provision of services.\textsuperscript{153} It may therefore be useful to see whether the Commentary provides any guidance for the purpose of making that distinction. “In the know-how contract, one of the parties agrees to impart to the other, so that can use them for his own account, his special knowledge and experience which remain unrevealed to the public.”\textsuperscript{154} In the contract for the provision of services, “one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party.”\textsuperscript{155} The Commentary provides both criteria as well as examples to make this distinction.\textsuperscript{156}

Summarizing, the provider of services, contrary to the transferor of know-how generally does not transfer his knowledge to the other party; an example is the engineer providing technical advice. With respect to mixed contracts, where know-how is transferred and services are provided, the commentary suggests breaking down the contract (in a know-how part and a services part) and determining the proper tax treatment. However, if one part of the contract constitutes “by far the principal purpose of the contract”, and the other parts are merely “of ancillary and largely unimportant character”, the Commentary indicates that the treatment applicable to the principal part should be applied to the whole amount of the consideration.\textsuperscript{157}

2.4 STEP 3: CHOOSING THE APPLICABLE METHODOLOGY

2.4.1 OECD Guidelines

The Guidelines recommend that taxpayers select a transfer pricing methodology that is able to provide the best estimation of an arm’s length price, taking into account the facts and circumstances of the case, the mix of evidence available and the relative reliability of the various methods under consideration.\textsuperscript{158} Multinational enterprises are given the freedom to apply methods other than those described in the Guidelines, provided the prices that are thus established satisfy the arm’s length principle.\textsuperscript{159} The OECD Guidelines require a two-sided analysis; from the side of the transferor as well as from the side of the transferee. This would actually disqualify all other methods but the CUP and the profit split method, since the other methods have a scope that is limited to the side of the transferor. In practice, the CUP and the profit split method are most commonly used.\textsuperscript{160}

\textsuperscript{150} Payments made under service contracts generally fall under article 7 OECD Model Tax Convention.
\textsuperscript{151} Id. par. 6.19.
\textsuperscript{152} See, OECD Guidelines par. 1.42, par. 1.43, par. 1.44, par. 6.18 and par. 7.3.
\textsuperscript{153} Par. 11.3 of the commentary on Article 12 OECD Model Tax Convention.
\textsuperscript{154} Id. Par. 11.1.
\textsuperscript{155} Id. Par. 11.2.
\textsuperscript{156} Id. Par. 11.3 and 11.4.
\textsuperscript{157} Id. Par. 11.4.
\textsuperscript{158} OECD Guidelines par. 1.69.
\textsuperscript{159} Id. par. 1.68.
\textsuperscript{160} See Visser 2005, referring to Cauwenbergh 1998.
2.4.2 Traditional transactional methods

The traditional transactional methods rely on data reflecting comparable uncontrolled transactions. According to the Guidelines, “they are preferable to other methods.”\textsuperscript{161} The traditional methods are considered to be the most reliable way of discerning an arm’s length price: “the most direct way of establishing whether arm’s length conditions exist between associated enterprises is to compare prices charged in the controlled transactions with prices charged in comparable transactions undertaken between independent enterprises.”\textsuperscript{162} An analysis of the methodology that should be applied should therefore commence with the three traditional methods.

2.4.2.1 Comparable uncontrolled price method

“In establishing arm’s length pricing in the case of a sale or license of intangible property, it is possible to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises.”\textsuperscript{163} Given the often highly unique character of intangibles and the often-differing conditions under which the intangible is transferred, an identical situation will be hard to find. The goal should therefore be to find a similar transaction.

The Guidelines mention different factors to take into account when comparing controlled transactions to uncontrolled transactions. These factors include: limitations on the geographic area in which rights may be exercised, the possibility of sub-licensing and the exclusive or non-exclusive character of any rights transferred.\textsuperscript{164} These factors, which are basically the conditions of the agreement, provide different outcomes for the licensee to capture the income attributable to the intangible. For instance, an exclusive license in a certain geographic area protects the licensee against the ‘free rider problem’ (a competing licensee who is able to exploit the brand recognition created by the first licensee). An indefinite license, which can only be terminated by the licensee, ensures the licensee that investments he makes in the market will eventually accrue to him.

When the intangible involved is a patent, the analysis of comparability should also take into account, \textit{inter alia}, the nature of the patent, the period during which it is likely to maintain its economic value and the process of production for which the property is used.\textsuperscript{165} When the intangibles involved are marketing intangibles, the analysis of comparability should consider, \textit{inter alia}, the value added by the trademark and consumer acceptability.\textsuperscript{166} Application of the analysis of comparability is exemplified through a transfer of a branded athletic shoe.\textsuperscript{167}

The Guidelines acknowledge that it may be difficult to find comparable uncontrolled transactions in cases involving highly valuable intangible property. They therefore suggest that it may be possible to take as a starting point the amount of consideration charged in comparable transactions between independent enterprises or to take a range of pricing.\textsuperscript{168} Given the typical, subjective, sometimes emotional elements that underlie brand appreciation, the CUP method is seldom if ever applied in practice for transactions involving branded

\begin{itemize}
\item \textsuperscript{161} OECD Guidelines par. 2.49.
\item \textsuperscript{162} Id. par. 2.5.
\item \textsuperscript{163} Id. par. 6.23.
\item \textsuperscript{164} Id. par. 6.20.
\item \textsuperscript{165} Id. par. 6.21 and 6.22. See N. Dolman, ‘Life cycle of intangible property and the implications for arm’s length pricing’, \textit{Tax Planning International Transfer Pricing} 2007, 06/07.
\item \textsuperscript{166} Id. par. 6.24.
\item \textsuperscript{167} Id. par. 6.25.
\item \textsuperscript{168} Id. par. 6.26.
\end{itemize}
items. A question, which arises, is when comparability is established. According to Llinares, comparability of intangibles is generally established only, if the two potentially comparable intangibles meet two conditions: first, the comparable intangibles must show similar profit potential, most reliably measured by calculating the net present value of the benefits to be realised through the use of the intangible. Second, the two intangibles being compared must be used in connection with similar products or processes in the same general industry or market.\footnote{Llinares 2006.}

Comparability under the OECD Guidelines means either that none of the differences (if any) between the dealing and the transaction between independent enterprises materially affects the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effect of such differences.\footnote{OECD Guidelines par. 2.7.}

To illustrate the difficulties in applying the CUP method reliably, reference is made to the Ernst & Young Transfer Pricing 1999 Global Survey: “our experience has been that companies that have historically used transaction-based methods such as CUP are often forced to revaluate when they subject these to closer scrutiny.”\footnote{Markham 2005.} This indicates that the high degree of comparability, as required by the CUP, hardly exists in practice.

2.4.2.2 Resale price method
Applying the RPM in transactions involving intangibles will only be possible in “highly uncommon” situations\footnote{Verlinden 2005: “this method can be called highly uncommon in such cases”.
Markham 2005.}, but is nevertheless recognised as a potentially useful method by the Guidelines. The RPM, like the CUP, is based on a comparative analysis of an uncontrolled transaction. The main difference between the CUP method and the RPM is that the CUP method focuses on product similarity whereas the RPM is concerned with similarity of functions, risks and contractual terms.\footnote{Verlinden 2005.} According to the Guidelines, the RPM may be applied to an intangible transaction “if the associated enterprise sub-licenses the property to third parties.”\footnote{OECD Guidelines par. 6.23.} This would mean that an arm’s length gross margin can be determined that enables the affiliated party to recover its costs and to realise an appropriate profit component. Application of the RPM may also be possible for sales of goods incorporating intangible property.\footnote{Id. par. 6.24.}

2.4.2.3 Cost plus method
Application of the cost plus method to determine an arm’s length consideration assumes that there is a causal connection between cost and income. When intangible assets are involved, the method may therefore be applied when this causal connection exists. Verlinden mentions that the cost plus method is fairly unusual in the case of intangible assets.\footnote{Verlinden 2005.} She refers to both the OECD Guidelines and to empirical evidence to indicate that the connection between cost and income is often weak. The Guidelines state that a causal connection is in general very improbable and that a high return from sales of products with a brand name is often attributable to many different factors.\footnote{See, inter alia, OECD Guidelines par. 6.6, par. 6.27, par. 6.39.} Empirical evidence shows that marketing effectiveness (sales in relation to marketing spend) is often difficult to measure and is often
not consistent. Despite the often weak connection between cost and income, the Guidelines explicitly refer to the cost plus method as applicable in situations of contract research.

2.4.3 Transactional profit methods
The two “other methods” approved by the Guidelines are the profit split method and the TNMM. They are advanced “when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all.”180 These situations may arise where high technology and unique and extremely valuable intangibles are involved. Transactions with these intangibles are generally acknowledged as being extremely rare. Therefore, reliable information on these transactions will be scarce as well and one will have to advance to methods that rely on other data. The essential difference between the “traditional methods” and the “other methods” is that the “traditional methods” rely on actual transactions whereas the “other methods” rely on gross margins of comparable companies.

2.4.3.1 Profit split method
The Guidelines recommend applying the profit split method for transactions involving intangibles. “Since it is often hard to find comparable uncontrolled transactions, application of the traditional transaction methods and the TNMM may be difficult. In these cases the profit split may be relevant although there may be practical problems in its application.”182 Profit split methods rely in whole or in part on internal data rather than on data derived from comparable uncontrolled transactions. Tax authorities therefore, in general, see them as less reliable than the traditional methods. However, the profit split methods encounter increasing acceptance for intangible asset transactions.183 The underlying reasons are that it is not necessary to search for similar uncontrolled comparables and that the profit split method is most appropriate to recognise the value added to the intangible by the licensee. The licensee often adds value to the intangible through adapting and extending the technology in an effort to tailor it to the requirements of the new market. This value cannot be determined through the transaction-based methods or the TNMM since they these methods tend to be geared to situations where the licensee does not make such customisations.184

The profit split method, as envisaged by the OECD, first identifies the profit to be split from the controlled transaction under scrutiny. The profits are then split between the associated parties on an arm’s length basis. The profit to be split may be composed of the total profits arising out of the transactions or, alternatively, of a residual profit, which cannot be clearly assigned to one enterprise, for example the profit arising out of “high-value, sometimes unique, intangibles.”185 Two approaches for estimating the division of profits are discussed in the Guidelines, the contribution analysis approach and the residual analysis approach.186 “Under a contribution analysis, the combined profits, which are the total profits from the controlled transactions under examination, would be divided between the associated

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179 OECD Guidelines par. 2.48, which states that the costs for research have to be compensated and that the additional cost plus may reflect how innovative and complex the research carried out is.
180 Id. par. 3.1.
181 The Tax Executives Institute, a professional organization of in-house tax professionals, has described them as ‘almost non-existent’. Markham 2005.
183 See Markham 2005.
184 Id.
185 OECD Guidelines par. 3.5.
186 Id. par. 3.15.
enterprises based upon the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.\textsuperscript{187}

“A residual analysis divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved through similar types of transactions by independent enterprises. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. “The amount, nature and incidence of the costs incurred in developing or maintaining the intangible property might be examined as an aid to determining comparability or possibly relative value of the contributions of each party, where a profit split method is used.”\textsuperscript{188}

“In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises.”\textsuperscript{189}

An interesting issue is that while transfer pricing seeks to focus at what independent parties would have done, independent parties, in general, do not use the profit split method for their transfer pricing.\textsuperscript{190}

2.4.3.2 Transactional net margin method
To understand the TNMM, the concept of ‘tested party’ comes into play.\textsuperscript{191} The TNMM seeks to validate the arm’s length character of a transaction from the perspective of one party in a controlled transaction. This party is called the ‘tested party’. The ‘tested party’ is usually the party whose prices or profits are easiest to determine through reliable information with the least adjustments and where information on comparable uncontrolled transactions is available.\textsuperscript{192} This is most often the case when the ‘tested party’ performs ‘routine functions’, such as distribution or sales. Applied to transactions involving intangibles, the ‘tested party’ will ordinarily be the party that does not own valuable intangible property or unique assets that distinguish the transaction from the comparable uncontrolled transactions. This will be the licensee in a license arrangement, assuming that its functions are limited. The net margin of the licensee will be tested against the net margin of, say, a routine distributor. The licensing fee is then set at a price, which allows the licensee to achieve only an arm’s length profit; the excess profit will go to the licensor. Although the method is easy to apply and it avoids the need for directly valuing the intangible, it contains two flaws.

The first flaw is that the TNMM assumes that the ‘tested party’, say, the licensee, is willing to enter into a license arrangement that only leaves him a routine reward. This may not be in line with the economic reality, especially given the evidence below that licensees generally capture a significant share of the intangible’s income.\textsuperscript{193} However, one may also argue that

\begin{itemize}
\item \textsuperscript{187} Id. par. 3.16.  
\item \textsuperscript{188} Id. par. 6.27.  
\item \textsuperscript{189} Id. par. 3.19.  
\item \textsuperscript{190} Markham 2005. An exception here might be joint venture undertakings.  
\item \textsuperscript{191} Verlinden 2005.  
\item \textsuperscript{192} OECD Guidelines par. 3.43. Par. 3.6 – par. 3.10 provide an overview of the strengths and weaknesses of the profit split method.  
\item \textsuperscript{193} See par 3.2.1.  
\end{itemize}
this outcome is just as described earlier; the legal owner is able to capture the incremental income and merely a routine profit is left for the licensee. On the other hand, there were both reasons for the legal owner to capture a little less than the entire incremental income, thereby incentivising the licensee, as well as market imperfections, which allowed the licensee to capture (a little bit) more than merely a routine return.

The second flaw is that it is very rare to find a situation in which the licensee is really bringing so little to the table that there are no intangible assets relevant to its side of the table. Using the traditional transactional methods always leads back to the same problem: a lack of comparability. When high-value, nonroutine intangibles are involved the profit-based methods will be preferred to the traditional methods. “A major advantage of profit based methods is that their focus lies on allocating actual profits earned by MNEs in cross-border transactions, rather than concentrating on a determination of what the correct or arm’s length price should be.” Markham concludes that as a result of the proliferation of intragroup intangibles in the global economy and the consequent shortage of information on uncontrolled transactions, the use of profit-based methods will continue to increase. Evidence from the OECD also shows that it appears to be moving towards a greater acceptance of profit methods. 195

2.4.4 2007 IFA Congress 196
Practitioners at the IFA Congress in Kyoto, Japan found that in practice the traditional transaction-based methods are only used incidentally because they fail to measure arm’s length considerations reliably. The TNMM or CPM can theoretically be applied to value intangibles but they are rarely used because of the lack of comparables. Instead, the practitioners found that profit splits and other unspecified methods are increasingly used.

2.5 PERMANENT ESTABLISHMENTS

2.5.1 OECD Commentary
So far, only transactions with intangibles between associated enterprises have been discussed. Intangible assets may also be used in dealings that involve Permanent Establishments. There is little existing guidance on intangible property in the 2000 version of the Commentary to article 7; par. 17.4 discusses the treatment of intangible property within a single enterprise operating through a PE. It recommends not to apply the concept of notional payments for the use of intangible property by one part of the enterprise. 197 It suggests that “it may be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly.” 198 These costs should then be allocated between the various parts of the enterprise without any mark-up for profit or royalty.

194 Markham 2005.
195 As the OECD indicates in the “Invitation to comment on transactional profit methods”, February 2006, www.oecd.org: “It is expected that the ultimate outcome of the review of transactional profit methods should be a revision of Chapter III of the 1995 Guidelines.”.
196 See Aritake 2007 for a report of the Congress.
197 “Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise.”.
198 Attribution of profits par. 107.
only proposes minor changes to the existing Commentary with respect to intangibles.\textsuperscript{200} The revised version of the Commentary was released to take into account the conclusions included in Parts I, II, and III of the OECD Report on the Attribution of Profits to Permanent Establishments that do not conflict with the interpretation of article 7 in the existing Commentary. In the author’s opinion, since the Report’s findings were not included in the revised Commentary, it is unsure what will happen to these findings. The reason for this omission may be that the Discussion Draft’s recommendations were not considered to be in accordance with the existing interpretation of article 7 and were therefore omitted. According to the Discussion Draft, the discussion in par. 17.4 is deficient since it is silent on other important issues relating to intangibles and since it does not provide guidance how to perform such an allocation. The Discussion Draft therefore aims to provide guidance on applying the authorised OECD approach to intangible property.

2.5.2 The Discussion Draft
The Discussion Draft, as opposed to the Commentary, first states that there is “a clear implication that arm’s length notional payments between different parts of the enterprise could be allowed if the costs of creation could actually be identified as having been, in practice, incurred by one part of the enterprise.”\textsuperscript{201} It then continues that the concept of functional and factual analysis of Chapter VI (of the Guidelines) could be applied by analogy in PE situations to identify which part of the enterprise created the intangible.\textsuperscript{202}

2.5.2.1 Functionally separate entity approach
In 2006, the OECD released the latest version of its Discussion Draft “The attribution of profits to Permanent Establishments”, which focuses on the preferred interpretation and application of art. 7 OECD Model Tax Convention.\textsuperscript{203} The Draft states that “it is vitally important that, in determining the profits attributable to a PE under the authorised OECD approach, due consideration is given to the treatment of intangible property.”\textsuperscript{204} The authorised OECD approach brings about that “the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle under article 7(2).” This approach is called the “functionally separate entity approach.”\textsuperscript{205}

2.5.2.2 Ownership: “significant people functions”
The discussion then explores whether it is possible to use the concept of “significant people functions” to attribute economic ownership of the intangible property to one part of the enterprise.\textsuperscript{206} Identification of the economic owner is necessary since it determines the beneficiary of the notional royalty payments.

2.5.2.2.1 Internally developed trade intangibles
The first step of the authorised OECD approach is to perform a functional and factual analysis to determine what intangible property the PE uses and under what conditions. “The

\begin{itemize}
\item \textsuperscript{200} Adding to the existing Commentary: “or acquisition” and “as well as the costs subsequently incurred with respect to these intangible rights”.
\item \textsuperscript{201} Attribution of profits par. 109.
\item \textsuperscript{202} Id. par. 110.
\item \textsuperscript{203} For purposes of this thesis, the discussion of the OECD Draft will be limited to the treatment of intangibles therein. For a complete discussion of the Draft, see Bennet 2007.
\item \textsuperscript{204} Attribution of profits par. 105.
\item \textsuperscript{205} Id. par 79.
\item \textsuperscript{206} Id. par. 111.
\end{itemize}

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performance of the development function(s) does not of itself determine the legal ownership. Rather, the key issue is which enterprise acts as the entrepreneur in deciding both to initially assume and subsequently bear the risk associated with the development of the intangible property. With respect to the determination of the economic ownership of internally created intangibles, the Draft introduces the concept of “significant people functions”. They are functions that require “active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property.” Relevant functions as regards trade intangibles include “designing the testing specifications and processes within which the research is conducted, reviewing and evaluating the data produced by the tests.”

2.5.2.2.1 Acquired trade intangibles

The authorised OECD approach to attribute the economic ownership of such assets within the single enterprise is to identify the significant people functions relevant to determining economic ownership. This approach is thus similar to the approach to internally developed intangibles. With regard to acquired intangibles, significant people functions might include: “the evaluation of the acquired intangible, the performance of any required follow-on development activity, and the evaluation of and management of risks associated with deploying the intangible asset.”

2.5.2.2.2 Marketing intangibles

The concept of “significant people functions” is also used to determine economic ownership of marketing intangibles. The significant people functions “will likely be those associated with the initial assumption and subsequent management of risks of the marketing intangibles” and may include: functions “related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles.”

2.5.2.3 Attributing profits to the PE

When it can be determined that the PE performed the function of creating an intangible, at least in part, or bears extraordinary marketing expenditure in relation to the intangible, the PE would in an uncontrolled situation be entitled to an arm’s length return. “The conditions under which the PE performs that function also need to be taken into account and, in particular, whether the PE is the ‘sole or the joint owner’.” The Draft then mentions several ways to ensure that the intangible owner (the PE) receives an arm’s length return. Only one of these ways “attributes the return in a manner similar to a royalty transaction between independent enterprises in similar circumstances. (..) Between independent enterprises other ways of rewarding the owner of the intangible include incorporating the reward in the price of goods sold by the intangible owner, or by sharing part of the overall profit with the intangible owner, for example through a residual profit split method.”

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207 Id. par. 115.
208 Id. par. 116.
209 Id. par. 119.
210 Id. par. 123.
211 Id. par. 125.
212 Id. par. 128.
213 Id. par. 235.
214 Id. par. 236.
215 Id. par. 238.
2.5.2.4 Internal dealings
Whereas the previous parts discuss situations where the PE is the owner of an intangible, the Draft continues with an example where the Head Office is the ‘sole owner’ of the intangible and provides the intangibles to the PE for use in the latter’s business. The analysis of this transaction may result in different outcomes. For instance, under the authorised OECD approach, a functional and factual analysis of the situation might show that the PE should be treated as engaging in a dealing with the head office in respect of that intangible property. The profit that is attributable to the Head Office and the PE would in such a situation be determined through a functional and factual analysis. However, since it is common for intangible property to be used simultaneously by more than one part of the enterprise, it is also possible that the PE should be treated as having obtained not the intangible asset itself, but rather a beneficial interest in that asset or a non-exclusive right to use the intangible.

Another outcome of the analysis could result in the PE being treated as having acquired an interest in the intangible or a notional right to use the intangible property analogous to a licensing agreement. In such a case, depending on the factual circumstances and the comparability analysis, the PE might be entitled to deduct an amount equivalent to the arm’s length charge (notional royalty) for a license arrangement that would have been agreed upon between independent enterprises dealing at arm’s length.

2.5.3 Applying the Discussion Draft to associated enterprises
The Discussion Draft often refers to the Guidelines to be applied by analogy. Is the reverse situation also possible? Especially the Draft’s views on determining economic ownership through the concept of “significant people functions” are useful in dealings between legally separate entities. The OECD’s view on ownership in the Guidelines, which according to Ossi, suggests that legal ownership of an intangible is determinative, might well be supplemented or replaced by the concept of “significant people functions”. If the legal owner does not perform functions such as defending against infringements or setting up brand strategies, it is debatable why it should be entitled to the intangible’s income. The concept of significant people functions would in this respect help to combat IHCs based in low-tax countries that hardly perform intangible-related functions and that are created for purposes of tax avoidance. Evidence from the Dutch tax law practice indicates that taxpayers as well as Dutch tax administration already apply the concept of “significant people functions” to structures that include IHCs.

2.5.4 Existing guidance in the Netherlands
Starting point in the Netherlands is that, although OECD Commentaries and the Discussion Draft have shown a tendency towards increasing independence for PEs, internal interest and royalty fees should not be taken into account. An exception to this rule was established in a 1989 case where the Supreme Court decided that a deduction of interest was allowed when this would have been agreed upon between third parties. It is not sure whether this outcome would also apply to royalties.

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216 Id. par. 241.
217 Id. par. 242.
218 Id. par. 244.
219 For instance, par. 110, par. 235 and par. 241 refer to Chapter VI of the Guidelines.
220 Ossi 1999.
221 According to Harmen van Dam, shareholder of the Dutch law firm Loyens & Loeff.
222 Betten 2005.
2.6 CONCLUSION
The OECD Guidelines do not use a clear ownership standard. Based on the language used in the Guidelines, legal ownership seems determinative. It is controversial whether the non-legal owner of an intangible that performs marketing activities should only receive compensation from the legal owner or whether it is also entitled to a return on the marketing intangible it created. Many tax effective license structures exist; there is a correlation between the operational changes required and the level of acceptance by the tax authorities. When valuation of intangibles is uncertain, the Guidelines offer various instruments (e.g. short-term contracts and price adjustment clauses) for parties to ultimately reach an arm’s length consideration. With respect to ‘package deals’, the Guidelines state that segregation may be required. Profit-based methods become preferable to transaction-based methods since the profit-based methods do not rely on data from hard-to-find comparable uncontrolled transactions. The Guidelines are also applicable in dealings involving Permanent Establishments. The reverse, applying the Discussion draft to transactions between associated enterprises also occurs; especially the concept of “significant people functions” may be of use.
3 Intangibles under U.S. Law

3.1 INTRODUCTION
This Chapter will apply the three-step method from the second chapter to the U.S. transfer pricing legislation. The United States are considered to have significant influence on the worldwide transfer pricing debate and many transfer pricing concepts originate from U.S. legislation. To provide insight in these concepts, this chapter will not only discuss the rules that currently apply but will also discuss previously applicable rules. Due to the important role of case law in the United States, a “common-law” country, the transfer pricing cases will be discussed extensively.

3.2 HISTORY OF U.S. TRANSFER PRICING
The United States have a long history of political concern with the effectiveness of the taxation of foreign-based MNEs located in the United States, as well as with obtaining sufficient fiscal revenue from U.S. intangibles. The 1968 Regulations’ initial focus for transfer pricing cases involving intangibles was on comparability. The emphasis on comparables contained several weaknesses: good comparables were (and are) very hard to find and are often easier to discredit than to defend. Where the same or similar intangibles could not be found, the Regulations listed twelve factors to take into account when determining an arm’s length royalty rate.

The landmark case *E.I. DuPont de Nemours & Co.* marked the beginning of a modern era of use of economic data in transfer pricing. In this case, the government applied a thorough economic analysis to show that profits attributed to a Swiss subsidiary of a U.S. parent company were too high. The company had used inexact comparables to determine its transfer pricing.

In the 1980s, Congress and the U.S. Revenue started to perceive that they made losses through intellectual property transfers that did not adequately reflect their income earning potential. The focus on comparables and comparability was abandoned in favour of more thorough economic reasoning. The introduction of the ‘commensurate with income’ standard in the 1988 “White Paper” was the first step to develop a clear methodology in the absence of comparables.

3.3 STEP 1: DETERMINING OWNERSHIP

3.3.1 Introduction
According to Andrus: “Under general U.S. transfer pricing principles, ownership affects transfer pricing determinations in the following ways:

- the owner of intangible property is entitled to the income attributable to the intangible property in dealings between related entities;
- where the owner of intangible property makes an interest in that intangible property

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224 Markham 2005. For a detailed chronology of U.S. transfer pricing development see: www.intltaxlaw.com/SHAREDF/TRANSFER/tpchron.htm
225 Id.
227 See Moses 2007 for a discussion of the *Du Pont* case and the importance of Charles Berry’s contribution to the case.
available to a related entity, the related entity is obligated to make an arm’s length payment for the intangible property rights made available;

- where one entity undertakes activities or services that enhance the value of intangible property owned by a related entity, the intangible property owner is obligated to make an arm’s length payment for the activities or services provided.²²⁹

Below is a discussion of the history of the ownership concepts under U.S. transfer pricing Regulations and case law. The extensive coverage of the ownership concepts in the United States is justified for several reasons. Firstly, there have been significant changes in the ownership concepts in the U.S. The discussion gives the reader useful insight in the advantages and weaknesses of the different concepts. Secondly, it is useful in the understanding how ownership determines who is entitled to intangible income and how the parties that develop an intangible should receive compensation for these efforts. Finally, it gives an indication on how political concern finds its way in tax legislation.

The long-held idea that the U.S. is a provider of high-value services, thus requiring it to have some of the intangible’s income, is clearly determinable in the Regulations and case law. It is therefore no surprise that in the majority of the cases discussed, the IRS seeks to allocate intangible income to a U.S. distributor.

3.3.2 Revenue procedure 63-10²³⁰

The first published administrative guidance for determining arm’s length prices was revenue procedure 63-10.²³¹ It provided transfer pricing guidance for transactions between U.S. companies and their Puerto Rican affiliates. If intangibles “belonged to” the Puerto Rican affiliate, the income properly allocable to the affiliate would be increased.²³² Whether the intangibles “belonged to” the Puerto Rican affiliate would be determined under the facts and circumstances of each particular case. As an example, the revenue procedure stated that “if the mainland affiliate acts as the marketing and servicing organization for products produced by the island affiliate, any market position, consumer acceptance, or similar factors of goodwill attributable to the distribution and product servicing activities in the United States do not, as a matter of substance, belong to the island affiliate.”²³³ Other than this example, the revenue procedure did not provide specific guidance on how ownership of intangibles was to be established. In Eli Lilly & Co., however, reference was made to the Internal Revenue Manual, which instructed commissioners to examine documents and other evidence to determine whether “intangibles, such as patents, trademarks, trade names, etc., originally developed or owned by the mainland affiliate (..) have been transferred to the island affiliate.”²³⁴

Under revenue procedure 63-10 the distinction between legally protected and non-legally protected intangibles emerged. For items of the first category, such as patents and trademarks, ownership for transfer pricing purposes was to be determined based on legal ownership. For intangibles that were non-legally protected, the example in the revenue procedure indicated that ownership resided with the developer of the intangible.

²²⁹ Andrus 2007.
²³⁰ See Ossi 1999.
²³¹ 1963-1 C.B. 490.
²³² Revenue procedure 63-10 section 4.01, 1963-1 C.B. at 495.
²³³ Id. at 496.
²³⁴ See Eli Lilly & Co. v. Commissioner, 856 F.2d 855, 864 (7th Cir. 1988).
The 1968 Regulations did not provide an explicit, generally applicable rule to identify which member of a related-party group was considered the owner of an intangible for transfer pricing purposes. They did, however, establish the ‘developer-assister’ rule, which determined, for R&D activities outside cost sharing arrangements, which party would be considered owner (the ‘developer’), and which parties merely assisted in the development of the intangible (the ‘assisters’). The ‘developer-assister’ rule provided that when one party of a group, (the ‘developer’) would undertake the development of an intangible, no allocation with respect to the development activity would be made under the intangible property provisions or the Regulations until the ‘developer’ transferred the property it developed, or an interest in such property, to a related party.

Under the ‘developer-assister’ rule, only one member of a group could be identified as the ‘developer’ of an intangible, the other members that contributed were ‘assisters’, which were entitled only to appropriate compensation for the value of their assistance. Factors relevant to the determination of which member of a related-party group was the ‘developer’ and which members were assisters included the location of the development activities, the capabilities of the various members of the group to perform the development activities, and the degree of control over the project exercised by the various members. In theory, the ‘developer-assister’ rule could have appointed as ‘developer’, and therefore owner of the U.S. trademark, a U.S. distributor of a foreign-made product if it bore the risk of developing the U.S. market. Nevertheless, it would not be before 2002 that a tax court invoked the ‘developer-assister’ rule to hold that ownership of an intangible had actually shifted away from the legal owner.

Development, according to Ossi, in the context of the ‘developer-assister’ rule meant the creation of a new item of intangible property, as might be attempted through a R&D project. He reckons it unlikely that the 1968 Regulations would have considered trademark promotion activities of a licensee to be the ‘development’ of intangible property. He also argues that it is likely that the intended scope of the rule was limited to activities specifically aimed at developing a new item, taking into account that none of the examples illustrating the rule dealt with marketing intangibles and that the Tax Court in *Ciba-Geigy Corp.* clearly distinguished the ‘development’ of an intangible from the activity of exploiting the intangible after it has been developed.

Under the 1968 Regulations, three major cases (*Ciba-Geigy Corp.*, *Eli Lilly & Co.* and *G.D. Searle & Co.* ) were decided by the Tax Court. The three cases contained a similar factual pattern: the IRS would seek to allocate profits to the U.S. group companies that could be attributed to the intangibles. In order to do so, the IRS would disregard legal titles to the intangibles of the foreign companies. The outcomes of the cases were similar as well: three consecutive defeats for the IRS.

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238 Id. 1.482-2(d)(1)(ii)(c) (1968).
239 In the DHL case, see par. 3.1.3.4.
240 See Ossi 1999.
3.3.3.1 Ciba-Geigy Corp.

Ciba-Geigy, Ltd., a Swiss corporation, granted its U.S. subsidiary, Ciba-Geigy Corporation, an exclusive license to manufacture and sell various patented herbicides and defoliants in the United States for a ten percent royalty fee. The IRS argued that both parties should be treated as having entered into a joint research arrangement that, in an arm’s length setting, would have permitted the U.S. subsidiary to share in the benefits of the intangible. The Tax Court rejected this argument: “In the absence of more persuasive evidence that petitioner and Ciba-Geigy, Ltd. impliedly intended to share the costs and benefits of developing new herbicides and defoliants, we refuse to write a joint venture agreement for them.” Thus, the court recognised the legal rights and obligations of parties with respect to the intangible property at issue and found that the subsidiary was a licensee entitled to deduct an arm’s length royalty, but not entitled to share in the benefits. Interestingly, there is discussion, although the case was decided under the 1968 Regulations, whether or not the court invoked the ‘developer-assister’ rule to reject the proposed joint venture agreement. According to Lemein, Ciba-Geigy demonstrates the heavy burden of proving the facts regarding global joint research programs and identifying the owners of resulting intangible property. The detailed facts regarding the development program consume 44 (!) pages. Carefully documenting joint research programs is therefore recommended.

3.3.3.2 G.D. Searle & Co. 244

G.D. Searle & Co. involved a pharmaceutical company that transferred pharmaceutical patents and the trademarks for the related products to its subsidiary in Puerto Rico. The IRS argued that the subsidiary’s ownership of the intangibles should be disregarded. The Court’s analysis focused solely on the presence or absence of a business purpose for the transfer. As long as the transfer from the parent had a legitimate business purpose, the court assumed that the subsidiary should be regarded as the owner of the intangibles. Finding such a business purpose, the Court concluded that the subsidiary had to be treated as the owner. As a consequence, Searle was thus able to fully exploit the tax-planning opportunities that occur when emphasizing legal ownership: deducting the development costs of the research on Searle’s U.S. returns and after transferring the intangibles offshore, exploiting them almost free of charge.

3.3.3.3 Eli Lilly & Co. 245

Eli Lilly & Co. involves a transfer of intangible property from a U.S. parent company to its subsidiary. The parent company, a pharmaceutical company, transferred valuable pharmaceutical patents and manufacturing know-how to its subsidiary in Puerto Rico. The IRS argued that it could completely disregard the transfer to the Puerto Rican subsidiary and claimed that it could allocate all of the income from the transferred intangibles to the U.S. parent. This argument was rejected by the Tax Court. The Tax Court’s reasoning was that it did not accept the IRS’s notion that ownership for tax purposes should forever reside with the party that developed the intangible: “Respondent’s argument, that petitioner, having originally developed the patents and know-how, is forever required to report the income from those intangibles, is without merit. Respondent ignores the fact that petitioner, as developer and owner of the intangible property, was free to and did transfer the property to the Puerto Rican

243 Compare Ossi 1999: “Interestingly, the court did not rely on the developer-assister rule of the 1968 Regulations in deciding that the U.S. subsidiary should not be treated as a joint owner of the intangibles” and Lemein 2006: “In rejecting this argument (that parties should be treated as having entered into a joint research arrangement), the Tax Court applied the developer-assister rules.”.

244 See Schmid 2005.

affiliate in 1966.” The Tax Court did not accept the IRS’s argument that because Lily could have retained the ownership of the patents and know-how, it should have realized all the income attributable thereto. Since Lily did not do this, “it was under no obligation to so arrange its affairs and those of its subsidiary to result in a maximum tax burden”, the Tax Court held that it could not ignore the transfer of intangibles. The Tax Court nevertheless held that the transfer caused a distortion of income by depriving the parent company of income needed to fund its ongoing R&D activities. The Tax Court adjusted the prices of the sales to the parent company to give it sufficient income to fund a proportionate share of its general R&D expenses.

The Seventh Circuit reversed the Tax Court’s adjustment on the grounds that the parent company had received an arm’s length consideration for the transfer of intangibles in the form of stock in the subsidiary and that it had sufficient income after the transfer to continue its R&D activities. Thus, the Seventh Circuit disallowed the allocation of the intangibles’ income to the United States.

Eli Lilly is significant for the application of section 482 in transfers involving intangible property. The IRS contended the transfer under the ‘substance-over-form’ principle. Their main argument was that the parent company could have opted not to transfer the intangible and earn the income itself. The Tax Court rejected this argument by saying: “We find that both the form and the substance of petitioner’s transfer of assets to the Puerto Rican affiliate comported with economic reality. Petitioner transferred patents and know-how to its newly formed subsidiary. (...) Such a transfer of intangibles to a wholly owned subsidiary is a common transaction.”

Thus, although the three cases discussed above were decided under the 1968 regulation, the Tax Court repeatedly focused on contractual rights rather than development activities, to determine ownership. In the DHL case, the Tax Court also followed this approach, however, the Ninth Circuit reversed the Tax Court’s decision.

3.3.3.4 DHL Corp.\(^\text{246}\)

In 1969, DHL began as a domestic courier company in the United States and in 1972 formed DHL International (DHLI) to handle its international operations. DHL took care of the domestic services, DHLI handled international operations and the two cooperated for mixed U.S./international deliveries. In 1974, DHL granted DHLI a royalty free license to the DHL trademark for an initial term of five years, although terminable on 90 days notice. The agreement was continually extended until 1990. DHL registered the DHL trademark in the U.S. in 1977 and DHLI began registering the trademark internationally in 1983. Although DHLI registered the foreign trademarks in its own name, DHL and DHLI continued to treat DHL as the owner of the non-U.S. trademark rights in internal documents. DHL bore the development costs of the trademark (advertising, marketing, promotion and registration costs) in the U.S. and DHLI bore these costs outside of the U.S.

In 1990, when DHL struggled in the U.S. market but when DHLI was profitable abroad, a Japanese/German consortium reached agreement to purchase DHLI and the DHL trademark. The consortium recognised that DHL’s U.S. activities were essential to the viability of the international network and to solve the continuing cash flow problems in DHL, a proposal was made for DHLI to purchase the DHL trademark to provide DHL with a capital injection. After

a variety of advisers came up with estimates ranging from USD 20 million to USD 200 million, eventually a USD 20 million price tag was placed on the trademark; a price which was confirmed by DHL’s regular adviser Bain & Company.

The IRS contended both the value of the trademark and the royalty payments prior to the sale of the trademark. After an audit that was “protracted” and pre-trial and trial dialogues that were “contentious”, the IRS noted at the trial, in an aggressive note of deficiency, that the trademark was worth a staggering USD 300 million. The large difference in value of the DHL brand resulted from the discussion who the owner was of the international rights to the DHL trademark. DHL claimed it did not own the non-U.S. rights since DHLI registered the trademarks abroad in its own name and was solely responsible for the advertising of the brand and the registration of the trademark outside of the U.S. Put in perspective of the ‘developer-assister’ rule, DHL thus argued that DHLI was the ‘developer’ of the non-U.S. trademark. The IRS, however, argued at the trial that DHL owned 100 percent of the worldwide rights to the trademark.

The Tax Court, relying on the contractual terms governing the legal relationship between the parties, held that DHL owned the worldwide rights to the name. In the Court’s view, DHL failed to show that DHLI had expended more on the development of the trademark than an arm’s length licensee would have done and neither did it convince the Court how DHLI’s expenditures had increased the value of the trademark. In other words, the Tax Court stated that it was unable to ascertain whether the costs incurred by DHLI had actually developed the brand or whether they were of a routine nature, i.e. costs that every licensee would logically incur. The Court did, however, lessen the value of DHL’s ownership rights to USD 150 million for imperfections in its title, since contractual documentation was ambiguous and since DHLI had registered the name abroad.

Noteworthy is that the Court declared that the ‘developer-assister’ rule was “clearly not intended for purposes of deciding the ownership of an intangible” and therefore it rejected application of this rule. According to Ossi, however, the Court did apply the ‘developer-assister’ rule, but considered trademark promotion activities outside the scope of development activities. The Tax Court also imputed royalty income to DHL for DHLI’s use of the trademark during the years before 1990. The IRS sought to impute royalty income (based on royalty rate ranged from .75 to 15 percent) to DHL for DHLI’s use of the trademark during the years before 1990. DHL argued that an allocation of royalty income was improper because DHLI had ‘developed’ the trademark and contended that an unrelated licensor would not have required royalty payments. The Tax Court, however, dismissed DHL’s arguments and held that unrelated parties dealing at arm’s length would have charged a .75 percent royalty. It then imputed royalty income to DHL based on this .75 percent rate.

The Ninth Circuit reversed the Tax Court on the trademark purchase price and the royalty issues. Central in its analysis was that it did focus on the ‘developer-assister’ rule. The Ninth Circuit found that DHLI had developed the non-U.S. trademarks since it had spent over USD 340 million on promoting the brand outside the United States, while DHL had only promoted the mark in the U.S. (spending USD 150 million). It therefore rejected the Tax Court’s argument that the costs incurred by DHLI were not identifiable as development costs. For the first time, development activities were decisive in the determination of ownership. Being the economic owner of the non-U.S. rights to the trademark, the Ninth Circuit found that DHLI owed no royalty for its use.
3.3.3.5  

At issue in *H Group* were royalties allocated to Hyatt and Hyatt International from foreign subsidiaries. The case was decided in 1999, shortly after the Tax Court’s decision in the *DHL* case (interestingly, by the same judge: Joel Gerber). The IRS had determined a 1.5 percent rate of hotel gross revenues for the use of the Hyatt trade names and trademarks by the foreign subsidiaries. The Tax Court rendered this rate “unreasonable and an abuse of discretion”, but did not accept taxpayer’s argument that no royalties were due either. According to Faiferlick, “because the taxpayer failed to quantify the foreign companies’ efforts to develop the trade name.” He compared that aspect to the *DHL* case, “it’s normal for a licensee to maintain and promote an intangible. If they could show they made extraordinary efforts, that would be a different story,” he said. The Tax Court instead found that 0.4 percent of hotel gross revenues was an arm’s length charge. This lower rate recognised to some extent that the Hyatt names and trademarks were less important outside of the United States.

The outcome of the case is significant since a royalty was due, even though there was some development of the intangibles offshore. “This raises the question of what the IRS would argue if the situation was reversed”, that is, where U.S. subsidiary companies are paying royalties back to some foreign entity for the use of foreign-owned intangibles.

3.3.4  

The 1992 Proposed Regulations and 1993 Temporary Regulations sought to diminish the role of legal ownership and instead emphasized the role of market development costs. Although intended to “clarify” the 1968 ‘developer-assister’ rule, the examples in the 1992 Regulations revealed a dramatic expanded reach of the rule. The examples, which became famous (or rather: notorious) as the “Cheese examples”, involved a U.S. distributor of cheese (Fromage Frère) produced by its foreign parent. The consecutive examples showed an increase in marketing costs to be borne by the distributor. One example (no. 4.) in which the distributor had a long-term, exclusive license, stated that promoting a trademarked product represented “undertaking the development of intangible property” and stated that the “enhanced” value of the trademark could be owned separately from the trademark itself. Thus, although the foreign parent was the legal owner of the trademark, the U.S. distributor could be considered the developer of the “enhanced U.S. rights to the trade name.”

Ossi criticised this departure from the legal ownership standard in the example by saying that it was not consistent with the ‘developer-assister’ rule it purported to illustrate and that it conflicted with another example in the Regulations that ascribed significance to legal ownership. De Hosson also contended the conclusion that ownership should reside with the distributor that developed the market for the Fromage Frère brand. Another point of

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250 Ossi 1999.
253 See De Hosson 1999 for a discussion of the “Cheese examples”.
254 Proposed treasury Regulations section 1.482-2(d)(8)(iv).
255 Id., example 4.
256 Ossi 1999.
257 “Whatever the case, the most important conclusion must be that not even the acquisition of a substantial part of the relevant rights makes the licensee the owner of the trademark. Transfer of the ownership of the trademark to the licensee should only be involved, at least for tax purposes, if the licensee acquired nearly all of the
criticism was that attributing all intangible income to the licensee would be at odds with the arm’s length principle, since in arm’s length situations the licensor can replace its distributor when profits to the distributor becomes too generous.258

3.3.5 1994 Regulations259

As a result of the comments on the ‘developer-assister’ rule, which would disregard legal ownership, the 1994 Regulations take a different approach and suggest that legal ownership is determinative for tax ownership. 260 One should distinguish between legally protected and non-legally protected intangibles. The legal owner of a legally protected intangible is recognised as owner for transfer pricing purposes.261 Although the 1994 Regulations thus emphasize the importance of legal ownership, the definition of legal ownership is confusing. For instance, the Regulations state in the revised third “Cheese example” that a licensee with exclusive rights to exploit an intangible for a long-term period is considered an owner of the intangible with respect to its exploitation rights. 262 Accordingly, if the legal owner licenses part of its rights to another person, both the licensor and the licensee are considered owners for purposes of the Regulations.263

This expansion of the term ‘legal ownership’ was generally criticized. Ossi contends characterising the licensee as owner of the intangible, because a licensee’s exploitation rights are subject to whatever temporal and other restrictions that are imposed by the license. 264 Mentz criticizes the example since “it confuses the concept of ownership itself by equating ownership with the right to use property.” 265 Under the 1994 Regulations it is possible that there are multiple owners; this to prevent an ‘all or nothing’ treatment. In an ‘all or nothing’ treatment, taxpayers allocate all of an intangible’s income to the legal owner, irrespective of whether the other party (often the licensee) may have helped to develop or enhance the intangible.

Another example, where the intended emphasis on legal ownership is not so clearly reflected in the Regulations, is where the Regulations provide authority to the IRS to allocate to the U.S. a portion of the intangible income attributable to a trademark that is legally owned by the distributor’s foreign parent. This is based on the fact that the distributor in prior years incurred unreimbursed expenses promoting the trademark that were substantially above the level of such expenses incurred by comparable distributors. 266 The example does not take into account the legal rights of the foreign affiliate. In the case of non-legally protected intangibles, the ‘developer-assister’ rule continues to apply. Here, the ‘developer’ will be considered owner of the intangible. Other parties that participate in the development of the intangible are considered to be providing “assistance” to the owner, for which appropriate allocations may be made. Being assisters, they are not considered to share ownership of the intangible.

258 See the Absolut Vodka and Adidas/Descente examples discussed above.
260 Preamble to treasury Regulations section 1.482-4(f)(3).
262 Id. 1.482-4(f)(3)(iv), example 3. See Appendix 2 for the text of the 1994 “Cheese examples”.
263 Id. 1.482-4(f)(3)(ii), (iii)(A) (1994): the licensee is considered the owner of the licensed rights and the licensor is considered the owner of the retained rights.
264 Ossi 1999.
265 Mentz 1999.
266 Id. 1.482-1(d)(3)(ii)(c), example 3.
3.3.5.1 Medieval Attractions, N.V.267

In Medieval Attractions, the Tax Court applied the 1994 Regulations to identify the owner of marketing intangibles. The IRS had contended royalty payments paid to an affiliate in the Netherlands Antilles in exchange for the use of the trademark of a medieval-theme dinner theatre in the U.S., claiming the payments lacked substance and were undertaken solely for tax-avoidance purposes. Before registration of the trademarks in the name of the Netherlands Antilles N.V. and before concluding a licensing agreement, taxpayer had operated the dinner theatre. The Court invoked the ‘developer-assister’ rule, since prior to the registration of the trademarks none of the licensed intangibles were legally protected, and identified the taxpayers as the ‘developer’. Employees of the taxpayer had developed the “formula” for operating the facility and had used the name that was later registered as a trademark. However, the Court went further and also examined the “substance of the relationship” between the parties. It observed that the medieval-theme concept was a non-proprietary idea and that taxpayer was free to use this concept without payment to any other party. The Court also determined that prior to registration of the trademark the foreign affiliate would have had no recourse against taxpayer (or any other party) to use or register the trademark. The Court therefore concluded that a party dealing at arm’s length would not have paid royalties and that the N.V. did not own the intangible property rights.

3.3.5.2 GlaxoSmithKline268

The Glaxo case is arguably the most discussed transfer pricing case in transfer pricing history. After a dispute that lasted years, the IRS and GlaxoSmithKline (Glaxo) finally reached a settlement worth USD 3.4 billion. All commentators considered the settlement a victory for the IRS.269 Glaxo involved two major issues. The first issue at stake was whether Glaxo was rightfully denied an APA for the Zantac drug, whereas the IRS did award one to SmithKline Beecham Corp. for competing drug Tagamet. The second issue was how the U.S. company Glaxo was to be remunerated for marketing and distributing the products developed by affiliated company Glaxo U.K. Only the second issue will be discussed here.

In 1976, Glaxo U.K. developed ranitidine hydrochloride, a pharmaceutical ingredient for the treatment of peptic acid disease. All pharmaceutical research was managed in British laboratories by local employees. In 1986, under the commercial name Zantac, it became the highest selling drug in the worldwide healthcare market. It was a blockbuster drug in the U.S. with an integrated profit of USD 12.7 for the period 1989-1996. At stake was how this integrated profit from U.S. sales had to be split between Glaxo and Glaxo U.K. The IRS argued that Glaxo was not entitled to deduct the royalties it paid for the trademarks and other marketing intangibles, because it was the owner, for tax purposes, of these intangibles. Key in this determination was the notion that Glaxo U.K. was not the holder of a valuable intangible at the time of introduction of Zantac in the United States, in light of the high degree of uncertainty related to the product distribution. It claimed that Zantac was not a pioneering drug with unique qualities, since it would compete with the pre-existing Tagamet drug.270 According to the IRS, the success of Zantac was not attributable to its unique qualities, but rather to the marketing efforts performed by Glaxo. Glaxo, argued reversely, claiming the

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269 Inter alia, M. Levey: “The settlement gives testosterone to the IRS” and B. Andreoli: “IRS agents are probably going to look upon the settlement as a positive endorsement.” Wright 2006.
270 See, however, Musselli 2007: “The IRS claim, in fact, is not even well grounded, as Zantac had fewer side effects than competing drugs and was more effective under a lower dosage of the active ingredient, as evidenced by independent physicians.”.
main reason why Glaxo had such high sales in the U.S. was the R&D function performed in the U.K. To determine the arm’s length consideration for Glaxo, the IRS used a profit split method and compared the relative contributions of Glaxo and Glaxo U.K.\textsuperscript{271}

In 2006, both parties settled for USD 3.4 billion, the largest amount ever in a transfer pricing dispute. To make things worse, due to the failure of the mutual agreement procedure between the U.S. and the U.K., there was no corresponding adjustment to reduce taxable profits in the U.K. by the same amount. Roughly speaking, this meant that only a third of the total profits were left to the group that made the profits.\textsuperscript{272}

The IRS’s view was received with scepticism by most commentators. The settlement prevents the possibility of much-needed jurisprudence on marketing intangibles. Some commentators say that the IRS’s position, creating a secondary intangible in a trademark that Glaxo did not own, would have caused intellectual property issues, had the case made it to the court.\textsuperscript{273}

And according to Musselli, the IRS’s view that the majority of the profits were attributable to Glaxo is potentially conflicting with the ‘commensurate with income’ standard.\textsuperscript{274} How can the licensor of an intangible have an income that is commensurate with the intangible’s profit potential when the licensee is able to capture most of its profit? It is not unlikely that the IRS tried to avoid this question by claiming that Glaxo was the owner of the trademarks and marketing intangibles because it developed these intangibles. Some commentators argue, that if Glaxo implies that the IRS consistently supports the opinion that intangibles are developed in the country where marketing expenses are implemented and not where research expenses are implemented, the U.S. consolidated tax base will be lower since U.S. multinationals are net performers of research.\textsuperscript{275} Glaxo may also imply the position that only U.S. distributors are allowed to develop intangibles. This one-sided view, according to Wrapp\textsuperscript{e}, is justified due to factors unique of the U.S. pharmaceutical industry.\textsuperscript{276} Others predict that this view will trigger a reaction from foreign tax authorities that will seek to assess valuable intangibles in the hands of local distributors of U.S. products.\textsuperscript{277} The outcome: a non-cooperative environment, a lower level of global trade, and double taxation, is rejected by all commentators.

3.3.5.3 A different kind of Glaxo
As indicated before, the IRS’s scrutiny has often focused on transactions involving outbound royalty payments where marketing efforts were performed by the U.S. licensee. Taxpayers ordinarily seek to understate these marketing efforts to justify the royalty payments and to prevent the allocation of profits to the U.S. Interestingly, there are also situations where a company emphasises its U.S. marketing efforts in order to keep the outbound royalty rate low. Exemplary is the Tempur-Pedic Corporation, which licenses the intangibles from its Danish affiliate. The Danish tax authorities argue that the royalty rate is too low. In spite of the lower tax rate in Denmark, the company claims that it has developed the formerly unknown brand into a household name in the U.S. and argues that it should therefore pay a low royalty rate. The reasons behind this unusual position are that company needs the cash in the United States

\textsuperscript{271} From an initial 30-70 split, the proposed adjustment from the IRS lead to an overall split of around 80-20 in favour of the U.S. See Fris 2006.

\textsuperscript{272} As observed by Green 2006.

\textsuperscript{273} See M. Levey and B. Andreoli in Wright 2006.

\textsuperscript{274} Musselli 2007.

\textsuperscript{275} Id.

\textsuperscript{276} The size of the market, the affluence of the population, and the relative freedom of government restrictions. S. Wrapp in Moses 2006.

\textsuperscript{277} See Moses 2006 and Musselli 2007.
and that due to Subpart F (CFC legislation) and withholding taxes, it pays less taxes when the intangible’s income is taxed in the United States.  

3.2.6 2006 Temporary Regulations

On July 31, 2006, the U.S. Treasury Department issued Temporary Regulations regarding the provision of intercompany services and intangibles. These Temporary Regulations completely modify the part of section 1.482-4 that deals with ownership of intangibles, specifically the 1994 Regulations (and the “Cheese examples”). Again, the distinction between legally protected and non-legally protected intangibles applies. With respect to the first category, the owner for transfer pricing purposes is the legal owner of the intangible. But as the preamble states: “Taxpayers have substantial freedom to adopt contractual terms and (...) such terms are given effect under section 482.” However, the IRS will not adhere to contractual terms agreed upon by parties when “such ownership is inconsistent with the economic substance of the underlying transactions.” The Regulations indicate that greatest weight will be given to whether parties’ actual behavior is consistent with their contractual arrangements. Apparently, no reference is made to what uncontrolled parties would have done. It is unsure how this relates to the arm’s length principle.

The example in this section indicates that in a typical license situation, the licensor will be the legal owner of the intangible and the licensee will be the owner of the license pursuant to the terms of the license. Note that the licensee only becomes the owner of a contractual license right and not of the underlying intangible itself. With regard to intangible property that is not legally protected, the Temporary Regulations provide that “the taxpayer who has control of the intangible will be considered the sole owner of the intangible.”

Allen discusses how the concept of single ownership in the Temporary Regulations is capable of preventing the aforementioned ‘all or nothing’ treatment. Firstly, the Temporary Regulations acknowledge that ownership of a license to use an intangible is an intangible in itself, which deserves a portion of the intangible’s income. Secondly, the Temporary Regulations require arm’s length compensation for a related entity that contributes to the development and enhancement of the value of an intangible. This prevents the IRS’s fear, that the U.S. distributor is not compensated. With respect to marketing activities performed by

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278 See the “income tax statement” of the 10-Q filing of Q3 2007 on www.tempur.com: “On October 24, 2007, the Company received an income tax assessment from the Danish tax authority with respect to 2001, 2002 and 2003 tax years. The tax assessment relates to the royalty paid by our U.S. companies to our Danish subsidiary, and the position taken by the Danish tax authority could apply to subsequent years.”.


280 Treasury Regulations section 1.482-4T(f)(3)(i)(A). “Three key indicators whether the form adopted between related entities can be disregarded by the IRS are: whether the contractual form of a particular agreement entered into by controlled parties corresponds to the actual conduct of the parties; whether a controlled entity purporting to bear a risk in connection with a related party transaction has the financial wherewithal to bear losses that may arise because of its assumption of that risk; and whether a controlled entity purporting to assume a risk in connection with a related party transaction has actual managerial control over the activities giving rise to the risk.”.

281 Treasury Regulations section 1.482-1(d)(3)(B)(1): “In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties (...) If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.”.

282 As the preamble to the proposed treasury Regulations states: “whether a particular arrangement entered into by controlled parties has economic substance is not determined by reference whether it corresponds to arrangements adopted by uncontrolled parties.”.


284 Id. 1.482-4T(f)(4)(i).
the non-legal owner, six examples are provided (wristwatches have replaced French cheeses), all of which assume that the licensee is expected to conduct marketing activities to enhance the value of the intangible.\textsuperscript{285} In each case, the example concludes that the licensee should be compensated for enhancing the value of the intangible.

With respect to typical supplier-distributor relations, where generally no license agreement is in place, the Regulations provide examples that give the IRS increased possibilities to allocate income from the intangible to the U.S. distributor.\textsuperscript{286} In the examples, the distributor performs marketing activities that are “incremental”, \textit{i.e.} beyond what is observed in arm’s length transactions. Since no arm’s length distributor would be willing to perform these activities without contemporaneous or future compensation, the example allows the IRS to impute either a services agreement or a contingent payment scheme to compensate the U.S. distributor.\textsuperscript{287} Allen states that it is difficult to determine whether expenses are “incremental”, since the expenses may be part of the start-up expenses (in which case, one would expect the licensee incurring temporary losses in an arm’s length setting) or when one takes into account that virtually all related-party resellers incur higher marketing costs than would independent distributors.\textsuperscript{287}

3.4 STEP 2: IDENTIFYING THE ARRANGEMENTS MADE

3.4.1 When valuation is highly uncertain

A discussion of the treatment of intangibles with a value that is highly uncertain at the time of the transaction automatically results in a discussion of the ‘commensurate with income’ standard. It is this standard, which was introduced in 1986, which drew attention to a major transfer pricing issue: the value of an intangible is often unsure at the time of transfer. The political dissatisfaction with the perceived under-taxation of MNEs compared to U.S. companies resulted in the introduction of the ‘commensurate with income’ standard in the Tax Reform Act in 1986. The concern was mostly with high-profit intangibles licensed to foreign subsidiaries. The provision, which has become known as the ‘super-royalty’ provision, reads:

\begin{quote}
In the case of any transfer (or license) of intangible property (within the meaning of s.936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.
\end{quote}

Its goal was twofold. Firstly, it intended to prevent taxpayers from basing intercompany royalty rates for nonroutine intangibles on average industry rates for routine intangibles. In the 1980s, the trend was for MNEs not to license nonroutine intangibles, but rather to exploit them on their own.\textsuperscript{289} In their search for comparables, taxpayers would use royalty rates of less valuable intangibles, either intended or because comparable transactions could not be found. Secondly, it intended to prevent the transfer of nonroutine intangibles to foreign subsidiaries at a relatively low royalty rate, as the success of the intangible might prove impossible to measure.\textsuperscript{290}

\textsuperscript{285} Id. 1.482-1T(b)(2), examples 1-6.
\textsuperscript{286} Id., example 3.
\textsuperscript{287} See Allen 2006: “It is factual, however, that virtually every subsidiary of a multinational corporation incurs marketing expenses in excess of those borne by independent distributors.”
\textsuperscript{288} Internal revenue code section 482.
\textsuperscript{289} Markham 2005 referring to R.E. Ackerman et al., ‘The Real World of Transfer Pricing Today’, \textit{Taxes: The tax magazine} 1999, 3.
\textsuperscript{290} Id.
The ‘commensurate with income’ standard triggered worldwide reactions expressing fears that the IRS would now aggressively target companies licensing such intangibles.\footnote{Markham 2005.} Furthermore, several aspects of the rule may have unreasonable implications.

Firstly, the ‘commensurate with income’ standard implies that renegotiation of the price or royalty rate is possible. It remains to be seen whether, in an actual arm’s length setting, parties would actually be willing to renegotiate a previously agreed upon price. A solution to the need for renegotiation is the use a ‘tiered’ royalty rate\footnote{The ‘tiered’ royalty is a contingent-based royalty: “if sales are between A-B, then the royalty will be X, if sales are between C-D, then the royalty will be Y.” Wright 1996.}, which can be observed in actual cases. This eliminates the need for renegotiation and fulfils the ‘commensurate with income’ requirement. Secondly, the standard may have unreasonable implications when, for instance, a trademark is licensed. When a licensee successfully markets the trademark in its territory, the ‘commensurate with income’ standard would require an upward adjustment of the royalty rate.

The ‘commensurate with income’ approach differentiates from the OECD Guidelines, which state that royalties are only in rare circumstances based on profits. Although most U.S. companies tie royalty rates to sales or output, they must be concerned with the relationship between the royalty rate and the profits generated by the intangible. The OECD seems to disagree with this practice, at least under normal circumstances.\footnote{A study of Intercompany Pricing under Section 482 of the Code, Notice 88-123, 1988-2 CB 458, example 7.} The ‘commensurate with income’ standard requires a periodical adjustment for every transfer or license of intangibles where the initial forecast of future income generated by the intangible was insufficient. The White Paper argued that parties negotiating at arm’s length renegotiate when the value of an intangible is uncertain and that the ‘commensurate with income’ standard thus complies with the arm’s length principle. There are two circumstances where no periodic adjustments are made: where the actual profits are within a range of plus or minus twenty percent of the forecasted profits\footnote{Treasury regulation section 1.482-4(f)(2)(ii).} and where the taxpayer supports the royalty rate by a comparable third-party license for the same intangible.\footnote{See Markham 2005.}

Does ‘commensurate with income’ mean ‘being entitled to all income’? This would imply that when a legal owner decides to license its intangibles, the licensee would have only a routine return, and that the residual income goes to the licensor. Examples in the White Paper\footnote{Proposed treasury Regulations section 1.482-2(f)(11) (1992).} and the 1992 Proposed Regulations\footnote{A study of Intercompany Pricing under Section 482 of the Code, Notice 88-123, 1988-2 CB 458, example 7.} suggested that the ‘commensurate with income’ standard indeed intended to allocate the residual income to the owner. These examples were, however, heavily criticised as being inconsistent with the arm’s length principle, also because Court rulings seemed to indicate otherwise. From the cases discussed in this chapter \textit{a.o. Bausch & Lomb},\footnote{Bausch & Lomb v. Commissioner, 92 TC 525 (1989), aff’d, 933 F.2d 1084 (2nd Cir. 1991).} \textit{Sundstrand Corp.},\footnote{Sundstrand Corp. v. Commissioner, 96 TC 226 (1991).} and \textit{Perkin-Elmer Corp.}\footnote{Perkin-Elmer Corporation v. Commissioner, 66 TCM 634 (1993).} and from actual arm’s length evidence, one may conclude that the licensee, in general, is likely to retain a substantial share (generally fifty percent or more) of the income attributable to the intangible. The relating ‘rule of thumb’, that licensees should retain at least fifty percent of the income attributable to the intangible, has been applied in several court cases.\footnote{See Andrus 2007, inter alia Ciba-Geigy Corp.} In the cases

\begin{thebibliography}{99}
\bibitem{Markham 2005.} Markham 2005.
\bibitem{Wright 1996.} The ‘tiered’ royalty is a contingent-based royalty: “if sales are between A-B, then the royalty will be X, if sales are between C-D, then the royalty will be Y.” Wright 1996.
\bibitem{Markham 2005.} Treasury regulation section 1.482-4(f)(2)(ii).
\bibitem{Markham 2005.} See Markham 2005.
\bibitem{A study of Intercompany Pricing under Section 482 of the Code, Notice 88-123, 1988-2 CB 458, example 7.} A study of Intercompany Pricing under Section 482 of the Code, Notice 88-123, 1988-2 CB 458, example 7.
\bibitem{Andrus 2007, inter alia Ciba-Geigy Corp.} Andrus 2007, inter alia Ciba-Geigy Corp.
\end{thebibliography}
where the IRS sought to invoke its contract manufacturer theory, the arm’s length royalty rates allowed licensees to earn profits substantially in excess of the routine manufacturing profits of a contract manufacturer.\(^{302}\)

Since the 1994 Regulations, the IRS expressly recognises that the ‘commensurate with income’ standard is subordinate to the arm’s length principle.\(^{303}\) And as the preamble to the 2006 Temporary Regulations state: “The Treasury Department and the IRS believe that the commensurate with income principle of the statute is consistent with the arm’s length principle and fundamentally relates to the underlying economic substance and true risk allocations inherent in the relevant controlled transactions.” The standard should thus be conceived as a mechanism to correct misapplications of the arm’s length principle instead of a deviation from it. Therefore, in the author’s opinion, the licensor or transferor should be entitled to a significant share of the intangible’s income, but based on arm’s length evidence not to all of the intangible’s income.

3.4.2 The ‘roundtrip’ problem

As Andrus acknowledges, roundtrip arrangements have led to some of the most difficult transfer pricing controversies.\(^{304}\) The typical scenario is a U.S. owner of intangible property that licenses or otherwise transfers the intangibles to a non-U.S. related party based in a low-tax jurisdiction (Ireland, Puerto Rico). The licensee then utilizes the intangibles to manufacture products, which are sold back to the U.S. company or to its customers. Below, three major cases are discussed which correspond to this scenario.

3.4.2.1 Bausch & Lomb\(^{305}\)

In this case, Bausch & Lomb (B&L), a producer of soft contact lenses, licensed intangibles related to the manufacture of the lenses to its Irish subsidiary (B&L Ireland). The license allowed B&L Ireland to use the intangible property to manufacture and sell the lenses in exchange for a five percent royalty. The intangibles enabled B&L Ireland to manufacture the lenses at a cost considerably less than the manufacturing costs of its competitors. B&L Ireland sold the lenses to overseas affiliates and sold them to B&L for resale in the United States. The IRS took the position that the license and sales transactions should be collapsed and that B&L Ireland should effectively be treated as a contract manufacturer, entitled only to a modest markup on its manufacturing costs. The IRS’s main argument was that B&L “would have been unwilling to pay an independent third party much more that its cost would have been had it chosen to produce the contact lenses itself.”

B&L, on the other hand, contended that the license and sales transactions should be evaluated separately and argued that each of those transactions was at arm’s length. The Tax Court agreed with B&L. “Respondent’s argument would have some merit had we found that B&L was required to purchase B&L Ireland’s production of soft contact lenses.” However, not finding such a purchase requirement or a guarantee that the transfer price for the lenses would not erode, the Court rejected the IRS attempt to collapse the transactions. The Court did, however, increase the royalty rate significantly. Focusing on the licensee’s prospective profits and capital investment, and taking into account that unrelated parties would divide projected pre-royalty profits 50/50, the Court increased the royalty rate to twenty percent.

\(^{302}\) Lemein 2006.
\(^{304}\) Andrus 2007.
\(^{305}\) See Lemein 2006 and Andrus 2007.
3.4.2.2 **Sundstrand Corp.**

Sundstrand, a U.S. parent, licensed manufacturing intangibles to produce parts for custom speed drives used in aircraft to its Singapore subsidiary (SunPac). SunPac manufactured the parts in Singapore and sold them to Sundstrand for worldwide distribution. As in Bausch & Lomb, the IRS sought to identify SunPac as a contract manufacturer, entitled only to a modest cost-plus markup. Again, the Court held that the transactions should be analyzed separately, and after determining that SunPac bore both volume and price risks, it rejected the contract manufacturer theory.

3.4.2.3 **Perkin-Elmer Corp.**

In this case, the U.S. parent licensed intangibles to manufacture certain instruments, accessories and lamps to its subsidiary in Puerto Rico. The subsidiary manufactured the products in Puerto Rico and shipped them to the United States for resale. At the audit, the IRS sought to invoke its contract manufacturer theory. However, at the trial, having learned from Bausch & Lomb and Sundstrand, the IRS gave up its contract manufacturer theory and directed its arguments at the consideration for the individual transactions. The Tax Court determined the royalty rate based on comparable transactions with unrelated parties. The three cases show that the IRS’s contract manufacturer theory was not successful. In each case the Court evaluated the transactions on a separate basis. It is noteworthy that the royalty rates set by the Court (twenty percent in Bausch & Lomb, 10 percent in Sundstrand) allowed the licensee to earn profits substantially in excess of the routine manufacturing profits of a contract manufacturer.

Although decided by the New York Tax Appeals Division instead of the U.S. Tax Court, the cases Sherwin-Williams Co. and Lowe’s Home Center Inc. (both decided in 2004) are illustrative to see how a U.S. court sought to combat the roundtrip arrangement through the lack of economic substance/lack of business purpose argument.

3.4.2.4 **Lowe’s Home Center Inc.**

Lowe was under competitive pressure from its main rival, Home Depot and decided to implement a reorganization plan that would centralize management. Lowe created a Delaware-based holding company (LF) to control Lowe’s trade names and trademarks. Lowe claimed it had a business purpose for transferring the intangibles to the holding company and licensing them back: it would help prevent diminution of trademarks or trade name rights by showing the company had not abandoned its rights and the holding company could monitor use of trade names and trademarks by third parties. The Administrative Law Judge (ALJ) pointed out that Lowe was rendering services (including trademark maintenance services and quality controls of the marks) that enhanced the value of LF’s intangibles for which it was not compensated. Furthermore, the ALJ held that the licensing agreement “had no business purpose apart from tax avoidance (and) lacked economic substance other than the creation of tax benefits.” According to the judge, a key test to determine whether LF served a business purpose was to determine whether taxpayer’s functions had changed after the round-trip arrangement. Finding that the Delaware subsidiary’s role was very limited and that the key functions were still performed by Lowe, the ALJ held that LF did not serve a business purpose.

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306 See Lemein 2006.
307 Id.
310 Lowe’s Home Center 2004.
3.4.2.5  **Sherwin-Williams Co.**

In *Sherwin-Williams*, taxpayers formed two subsidiaries to hold and manage its intangibles (trademarks, trade names and service marks). The subsidiaries were based in Delaware, where their profits would not be taxed. Sherwin-Williams claimed it had a valid business purpose for the structure and claimed that it should therefore be allowed to deduct royalties. The Appeals Division however, claimed that there was no business purpose and decided that the arrangement lacked economic substance.

3.4.2.6  **1994 Regulations**

The Temporary Regulations contain an example similar to the example in the Dutch Adjusted Decree. In the example in the Regulations, Company X has been in operation in the pharmaceutical sector for many years. After four years of R&D activities, X develops a pharmaceutical compound. X transfers the technical data relating to the compound to a related party, company Y, without compensation. Y uses the data to register the patent rights with respect to the compound and thus becomes the legal owner of the patents. Subsequently, Y enters into licensing agreements with group members, allowing it to earn all of the returns attributable to the intangible. The example concludes that it “is unlikely that an uncontrolled taxpayer operating at arm’s length would make available the results of its R&D or perform services that resulted in a transfer of valuable know how to another party unless it received contemporaneous compensation or otherwise has a reasonable anticipation of receiving a future benefit from those activities.” Accordingly, the example allows the IRS to impute one or more agreements between X and Y that are consistent with the economic substance of their course of conduct. The IRS may for instance impute a separate services arrangement that affords X contingent-payment compensation for its services, or it may impute a transfer of patentable intangible rights from X to Y. This solution to the ‘roundtrip’ problem, the imputation of contingent-payment compensation is thus similar to the Adjusted Decree, which provides for implementation of a price-adjustment clause.

Another potential weapon for the IRS to prevent taxable income from flowing to low-tax jurisdictions is the aforementioned clause that contractual terms agreed upon by parties have to be consistent with the “economic substance” of the underlying transactions. Especially with situations where the U.S. entity still performs most of the functions related to the intangible will the roundtrip arrangement be vulnerable to arguments based on “economic substance”. In determining an arm’s length price, taxpayers must consider the “alternatives realistically available” to the parties. As Andrus notes, this principle may be utilized by the IRS to argue that a taxpayer, in an arm’s length setting, might have opted to use the intangible itself to produce a product, instead of licensing it to a foreign entity, thereby surrendering part of the intangible’s income to the licensee. Summarizing, there are several options for the IRS to combat ‘roundtrip’ arrangements: through imputing contingent-payment compensation or assuming a transfer of intangible rights; through the “economic substance” argument; and through the “realistic alternatives” argument.

3.4.3  **‘Embedded’ intangibles**

Whereas the approach to the provision of services seems rather aggressive in the search for intangibles, the Regulations are less inclined to see ‘embedded intangibles’ in transfers of

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312 Treasury Regulations section 1.482-1T(b)(2), example 6.
313 See Andrus 2007.
314 Treasury Regulations section 1.482-3(b)(2)(ii)(B)(8).
315 Andrus 2007.
tangible property. A transfer of ‘embedded intangibles’ will not be considered a transfer of intangible property where the purchaser of the tangible property does not acquire any rights to exploit the intangible, other than the right to resell the intangible property under normal commercial circumstances. The transfer of the package will then be treated as a transfer of tangible property and will result in a comparability issue.

However, where the purchaser acquires the right to exploit the intangible property separately, e.g. if the transfer of a machine conveys the right to exploit a manufacturing process incorporated in the machine, there will be a need for a separate determination of the arm’s length consideration for the transfer of that right.

3.4.4 Transfer of know-how in connection with the provision of services

A controversial aspect of the 2006 Temporary Regulations is a provision that sets out a special rule for services transactions that constitute a transfer of intangible property, or may result in a transfer, in whole or in part, of intangible property. The IRS has long held the view that taxpayers often seek to disguise a transfer of valuable intangibles as a provision of services. An example would be, the before mentioned, unique and highly valuable services provided by an engineer to a plant in another country, which, according to the IRS, may constitute a transfer of intangibles. As Andrus and Bonano note, the definition of intangible property states that an intangible must have value “independent of the services of any individual.” Therefore, special skills of individual employees do not constitute intangible property. However, according to Bonano, “if the employee reduces the knowledge to writing in the form of designs, formulas or processes or other written forms (..) the IRS might argue that a transfer of intangibles has occurred.” He also stipulates that U.S. tax treaties do not regard the provision of services as a transfer of services.

The new provision states that the arm’s length consideration for the intangible element of the services provided must be determined under the transfer pricing rules for intangible property. The rule is controversial for practitioners fear that the provision could authorize the IRS to apply the rules for intangible property, including the ‘commensurate with income’ standard, to situations that are appropriately evaluated as services transactions. However, the IRS states in the preamble to the Regulations that it will apply the provision only once it is determined that a services transaction actually contains a material intangible component. It may in such a case be necessary to segregate the service and intangible property transfers. To demonstrate the unclarity of the rule, Chung comes up with an example where a group’s headquarters develop a marketing campaign, which contains copyrighted marketing materials and which it then provides to affiliates on a cost plus basis. The copyrighted materials are clearly intangible property; however, under most circumstances this type of activity would in an arm’s length transaction be contracted from an agency under a

316 Treasury Regulations section 1.482-3(f).
317 Id. See Markham 2005.
319 See, inter alia, Markham 2005, who speaks of: “government concern that taxpayers were transferring valuable intangibles out of the U.S. by disguising them as service transactions.”.
321 Referring to Article 12, par. 4 of the Treasury Department Technical Explanation of the United States-Australia Income Tax Treaty which treats the engineer or architect preparing a design for a customer as performing personal services and to Article 12, par. 2 of the Treasury Department Technical Explanation of the United States Model Tax Convention which states that income from the design of a refinery by an engineer of the production or a legal brief by a lawyer is not income from the transfer of know-how. Bonano 1999.
322 See Chung 2006 and Markham 2005.
323 Id.
fee-for-services basis. It appears that distinguishing between the provision of services and the transfer of intangibles will present a considerable challenge with the possibility of leading to either tax risks or tax opportunities from the side of the taxpayer.  

3.5 STEP 3: CHOOSING THE APPLICABLE METHODOLOGY

3.5.1 ‘Best method’ rule
Contrary to the OECD guidelines, with its hierarchical system that prefers the transaction-based methods to the profit-based methods, the Regulations have adopted the ‘best method’ rule. The rule requires taxpayers to select the pricing method that, taking into account the facts and circumstances of the case, provides the most reliable measure of an arm’s length result, relative to the reliability of other applicable methods. There is no strict priority of methods and no method is considered more reliable per se than the others. It is not necessary to establish that another method is inapplicable when a method has been adopted. Where another method has shown to be more reliable, such other method must be used. Acceptable methods under the 1994 Regulations include the comparable uncontrolled transaction method (CUT), the comparable profits method (CPM) and the profit split. Unspecified methods are also allowed as long as they provide the most reliable measure of an arm’s length result under the principles of the ‘best method’ rule.

3.5.1.1 Comparable uncontrolled transaction method
The CUT method is the only transaction-based method that taxpayers are allowed to apply to transactions involving intangibles. The method is similar to the OECD’s CUP method. Where a transaction involving the same intangible under the same or substantially the same circumstances cannot be found, the Regulations allow the use of data from comparable intangibles under comparable circumstances. Comparability depends on the intangibles involved in the controlled and uncontrolled transactions being used in connection with similar products or processes within the same general industry or market, and having similar ‘profit potential’.

The IRS seems to insist that high-value intangibles are not ordinarily licensed or transferred between unrelated parties and this makes finding a comparable transaction hard, if not impossible. Nevertheless, the H Group case shows that the Tax Court is willing to accept inexact comparables for the determination of an arm’s length royalty. In another interesting case, Compaq Computer Corp., the taxpayer also successfully invoked a CUP. In this case, Compaq U.S. used a Singapore subsidiary, Compaq Asia, to manufacture printed circuit assemblies. The Tax Court heavily criticized the IRS for using a cost plus method to

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324 See Markham 2005.
325 Treasury Regulations section 1.482-1(c).
326 See Markham 2005 for an excellent discussion of the three methods.
327 Id. 1.482-4(a) and (d)(1).
328 Id. 1.482-4(c)(2)(ii).
329 Id. 1.482-4(c)(2)(ii)(B)(1). ‘Profit potential’ is determined by calculating the net present value of the expected future benefit stream related to the intangible transfer, considering the required capital investment and start-up expenses, as well as risks assumed and other relevant considerations. See Markham 2005.
determine an arm’s length price for the assemblies and for focusing on profit margins instead of prices Compaq paid to unrelated subcontractors.\textsuperscript{332} Pointing to \textit{Bausch & Lomb}, \textbf{McClure}, a practitioner, said \textit{Compaq} was not the first time a court rejected an IRS cost plus in favor of the taxpayer’s CUP.\textsuperscript{333} As he notes, the cost plus method or the CUP method should have yielded the same result “unless the manufacturing company was allowed to use a valuable intangible asset without charge.” In this case, there were hints that this had happened. Compaq used companies in the U.S. as comparable companies to Compaq Asia and this suggested that the Singapore company got its technology from Compaq U.S. In \textit{Compaq}, contrary to \textit{Bausch & Lomb}, the Court did not find that Compaq U.S. was due a royalty for the provision of valuable manufacturing technology to its overseas affiliate. \textit{H Group} and \textit{Compaq} show that taxpayers may use the CUT method if they are able to find sufficiently reliable comparable transactions.

\textbf{3.5.1.2 Comparable profits method}

The CPM is similar to the OECD’s TNMM.\textsuperscript{334} It evaluates the arm’s length nature of a controlled transaction by using objective measures of profitability, referred to as Profit Level Indicators (‘PLIs’), derived from uncontrolled taxpayers engaging in similar business activities under similar circumstances.\textsuperscript{335} PLIs are ratios that measure relationships between profits and costs incurred or resources employed\textsuperscript{336}, for instance the rate of return on capital employed.\textsuperscript{337} The CPM thus compares the operating profit of one of the parties to a controlled transaction with the profit of one of the parties to a similar uncontrolled transaction.\textsuperscript{338} The tested party will in most cases be the licensee: “in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables.”\textsuperscript{339} The reason is that, as the preamble to the 1994 Regulations explains, in most cases where the controlled taxpayer owns certain highly valuable intangibles, it will not be possible to locate an uncontrolled comparable taxpayer that owns similarly valuable intangible property.

A weakness of the method is that operating profit can be influenced by factors totally unrelated to prices or margins involved in intercompany transactions.\textsuperscript{340} The CPM can be considered a method of last resort where the tested party uses valuable, non-routine intangibles. Therefore, the tax courts do not regularly use the CPM.\textsuperscript{341} It should be noted, that even when the tested party does not own (nonroutine) intangibles, application of the method might still be troublesome. The licensee of an intangible generally captures a significant share of the intangible’s residual income (some 50%). These profits can be considered as a reward for the entrepreneurial risks assumed by the licensee in agreeing to license and putting the

\begin{itemize}
  \item \textsuperscript{332} Quoting from the Tax Court’s opinion in \textit{Bausch & Lomb}, Judge Cohen wrote, “The fact that B&L Ireland could, through its possession of superior production technology, undercut the market and sell at a lower price is irrelevant. Petitioners have shown that the $7.50 they paid for lenses was a ‘market price’ and have thus ‘earned the right to be free from section 482 allocations.’” The same is true in Compaq’s case, Cohen said. “The CUP method establishes arm’s length prices for PCAs that were sold by Compaq Asia, and a large profit margin does not prevent use of the CUP method”, she wrote.
  \item \textsuperscript{333} H. McClure of Arthur Andersen LLP in Atlanta, Georgia in Compaq Computer Corp. 1999.
  \item \textsuperscript{334} OECD Guidelines par. 3.1. However, under the Guidelines, the CPM is only acceptable to the extent it is consistent with the Guidelines.
  \item \textsuperscript{335} Treasury Regulations section 1.482-5(a).
  \item \textsuperscript{336} \textit{Id}. 1.482-5(b)(4).
  \item \textsuperscript{337} \textit{Id}. 1.482-5(b)(4)(ii).
  \item \textsuperscript{338} Markham 2005.
  \item \textsuperscript{339} Treasury Regulations section 1.482-5(b)(2)(i).
  \item \textsuperscript{340} \textit{See} Markham 2005.
  \item \textsuperscript{341} According to Bonano 1999.
\end{itemize}
intangible to use in a going business.\textsuperscript{342} The profit levels of the licensee can therefore not be compared to a regular distributor that performs only routine services.

3.5.1.3 Profit split methods
The 1994 Regulations contain two potentially applicable profit split methods: the comparable profit split method (CPSM) and the residual profit split method (RSPM).\textsuperscript{343}

3.5.1.3.1 Comparable profit split method\textsuperscript{344}
As the name suggests, the CPSM, similarly to the CPM, focuses on the operating profit derived by each relevant party. However, as opposed to the CPM, the CPSM does not use financial ratios. The Regulations explain that a comparable profit split is derived by combining the operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity.\textsuperscript{345} The profit split in an uncontrolled transaction is used as benchmark for the profit split between the controlled parties. The CPSM may be based on either external (transactions \textit{between} third parties) or internal (transactions \textit{with} third parties) comparable transactions. To establish comparability of transactions under the CPSM, the factors that could affect profits should be evaluated, they include: functions performed, contractual terms, risks assumed, economic conditions, and property and services transferred.\textsuperscript{346} The Regulations provide that if the combined operating profit of the uncontrolled parties varies significantly from that of the controlled parties (as a percentage of the combined assets), this method may not be used.\textsuperscript{347}

\textbf{Llinares} explains how the CPSM can be applied in a three-step analysis to determine an arm’s length royalty.\textsuperscript{348} “The first step requires computing the net present value (NPV)\textsuperscript{349} of the licensee’s operating profit resulting from the use of the trademark and the licensor’s operating profit associated with licensing the trademark based on third-party trademark agreements. (..) In the second step, a similar NPV calculation is repeated for the controlled transaction involving the transfer of a trademark to a controlled party to compute the total amount of profits from the exploitation of the trademark to be shared between the licensee and the licensor. (..) The last step entails determining the arm’s length royalty rate (or a range of arm’s length royalty rates) based on the total amount of profit to be shared and the arm’s length profit allocations between licensees and licensors based on evidence drawn from comparable third party trademark licensing arrangements.”\textsuperscript{350}

Opinions appear to be divided as to whether the CPSM is suitable for transactions involving intangibles. Some argue that in practice the difficulties involved in obtaining the extensive data on the comparable uncontrolled transactions prevent taxpayers from using this method.\textsuperscript{351} Others argue that for trademarks and patents, when trademark intangibles are the only intangibles driving residual profit and when third-party trademark licensing agreements with

\textsuperscript{342} Andrus 2007.
\textsuperscript{343} Treasury Regulations section 1.482-6-(c)(4).
\textsuperscript{344} For an extensive discussion of the CPSM, reference is made to Llinares 2006.
\textsuperscript{345} \textit{Id.} 1.482-6(c)(2)(i).
\textsuperscript{346} Llinares 2006.
\textsuperscript{347} Treasury Regulations section 1.482-6-(c)(2)(ii)(B)(1).
\textsuperscript{348} Llinares 2006.
\textsuperscript{349} The NPV is computed as the present value of an investment’s net future cash flows discounted using the opportunity cost of capital minus the initial cost of the investment. Llinares 2006.
\textsuperscript{350} A diagram of the three steps is provided in Appendix 3.
enough financial data are available, the CPSM is the “most appropriate” method.\textsuperscript{352} The CPSM is implicitly referred to in the description of the profit split method in the Guidelines. According to Andrus, the CPSM has been little used because of the difficulty of obtaining financial information regarding both sides of an unrelated party transaction.\textsuperscript{353}

3.5.1.3.2 Residual profit split method
The RPSM, which is similar to the RPSM under the OECD Guidelines, uses a two-step approach to determine an arm’s length royalty. The first step is to estimate the market returns for the routine functions performed, which are then allocated to the parties that performed them. The second step is to divide the residual income between the licensor and the licensee, based on the relative value of the intangible property contributed by each taxpayer. The Regulations provide three methods of apportionment.\textsuperscript{354} Firstly, the relative value of the intangible property contributed by each taxpayer may be measured by external market benchmarks that reflect the fair market value of such intangible property. Secondly, this may be estimated by the capitalized cost of developing the intangibles and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, the relative value of intangible contributions may be measured through the amount of actual research and development expenditures in recent years to estimate the relative value of intangible contributions.\textsuperscript{355}

Three factors may have influence on the reliability of the results: the costs of developing the intangibles may not be related to its market value, the allocation of indirect costs, and the assumptions regarding the useful life of the intangible.\textsuperscript{356} As Llinares acknowledges: “A practical difficulty to determine an arm’s length royalty for trademarks is when there is more than one factor driving residual profits, for example, technology, know-how, other marketing intangibles, and other entrepreneurial activities that require determining the contribution of each intangible to split the residual profits.\textsuperscript{357} According to Andrus, the RPSM is applied in three cases: where both parties contribute nonroutine intangibles to a transaction, where highly integrated global businesses are involved, and where contributions are made serially by two or more related parties.\textsuperscript{358} In general, due to its entire reliance on internal data rather than on external data, the RPSM, is considered less reliable than the other methods in reaching an arm’s length result. However, its major advantage is that, unlike the other methods, it evaluates all parties to the controlled transaction under the profit split and this may be especially helpful when both parties own valuable intangibles.

3.5.2 2006 Temporary Regulations
The Temporary Regulations introduce three new methods, similar to the methods used for tangible property, which are specifically tailored to the provision of services.\textsuperscript{359} However, no new methods were introduced for transactions involving intangibles. The Temporary

\textsuperscript{352} Llinares 2006.
\textsuperscript{353} Andrus 2007.
\textsuperscript{354} Treasury Regulations section 1.482-6(c)(3)(i)(B).
\textsuperscript{355} Id. In this case the expenditures have to be relatively constant and the useful life of the intangible asset of all parties has to be approximately the same.
\textsuperscript{356} Markham 2005, referring to Treasury Regulations section 1.482-6(c)(3)(ii)(D).
\textsuperscript{357} Llinares 2006.
\textsuperscript{358} Andrus 2007.
\textsuperscript{359} The comparable uncontrolled services price method (CUSP), gross services margin method and the cost of services plus method (Temporary Regulations section 1.482-9T(c)-(d)-(e)), which are similar to the CUP, RPM and the cost plus method.
Regulations do provide a new example of the ‘best method’ rule, which suggests that the RPSM may be the best method for distributors.\textsuperscript{360}

The example involves a U.S. manufacturer that produces apparel under the AA trademark (which is owned by a foreign parent), and that enters into a distribution arrangement with its foreign subsidiary to distribute the apparel in the subsidiary’s country (X). The U.S. manufacturer has long-term endorsement contracts with professional athletes and the distributor has a long-term arrangement with a nationwide sporting goods chain. Since both parties make “valuable, nonroutine contributions” to the marketing and promotional activities in Country X, the example states that “the most reliable measure of an arm’s length result is the residual profit split method.” Interestingly, the example does not discuss the position of the foreign parent as the legal owner of the trademark.\textsuperscript{361} In the author’s opinion, neglecting to discuss the position of the foreign intangible owner reflects the U.S. bias towards finding intangibles in U.S. distributors.

3.5.3 2007 APA Report

Every year, the IRS issues its Announcement and Report Concerning Advance Pricing Agreements (APA Report). The APA Report provides information on the APA program and the nature of the APAs that have been submitted or executed during the year. The most recent report\textsuperscript{362} contains interesting information on how intangibles are treated in APAs. One noteworthy figure is that the number of APAs that involved the evaluation of a U.S. distributor has declined over the last three years whereas the number of APAs that evaluated multiple tested parties rose sharply (2004: 44/19 vs. 2006: 31/37). This suggests that the IRS is moving away from a mostly U.S.-centric view towards a global view, which examines the returns earned by all parties to a transaction. This conclusion is supported by Fris, who concludes from the Glaxo case that it shows “the IRS leaving the field of CPM (the unilateral “testing mode”) and undertaking a multilateral approach, where insight into the commercial and financial relations between the parties involved is required.”\textsuperscript{363} According to Allen, it is safe to conclude that concerns about the value of marketing intangibles owned by U.S. sales and distribution companies drive part of this trend. Another interesting figure is the increased use of the RPSM in APAs (2004: 3 vs. 2006: 20). The use of an operating margin under the CPM remains the most popular method for APAs. Allen predicts that operating margins (such as the CPM) will continue to be a popular choice for APAs but he also expects that profit split methods will be observed in more and more APAs as a result of IRS focus on U.S.-developed marketing intangibles.\textsuperscript{364}

3.6 PERMANENT ESTABLISHMENTS

3.6.1 Existing guidance in the United States\textsuperscript{365}

Under the Code, the transfer or licensing of intangible property from a Head Office to a Permanent Establishment or vice versa is generally disregarded. Accordingly, no royalty is

\textsuperscript{360} Temporary Regulations section 1.482-8, example 12: “Residual profit split preferred to other methods”.

\textsuperscript{361} This is also observed by Allen 2006.

\textsuperscript{362} Covering the year 2006, it was issued February 27, 2007. See Allen 2007.

\textsuperscript{363} Fris 2006.

\textsuperscript{364} Allen 2007.

\textsuperscript{365} Caridi 2005.
taken into account for income tax purposes. Both the U.S. Model Tax Convention\textsuperscript{366} and the most recent tax treaties\textsuperscript{367} indicate that the treatment by the Code is unlikely to change.

3.7 CONCLUSION

The ownership concept in the United States has been very dynamic. The 1968 Regulations introduced the ‘developer-assister’ rule which placed ownership in the hands of the ‘developer’ of an intangible. However, the Courts respected legal ownership until the 2002 DHL reversal by the Ninth Circuit. The “Cheese examples” earned worldwide scorn for introducing the idea that a marketing intangible could be created by a distributor that does not own the intangibles used. The ‘commensurate with income’ standard is rather rigid codification of the arm’s length principle but the results reached under the standard appear to be in accordance with actual arm’s length evidence. Courts have rejected the ‘contract manufacturer theory’ as an instrument to combat ‘roundtrip’ arrangements and they evaluate the transactions separately. The Regulations provide extensive rules that ensure that the intangible component of a transaction that also involves services or tangible goods is valued appropriately. The ‘best-method’ rule requires taxpayer and tax authorities to carefully select the method used. Similar to the OECD Guidelines, there is increased acceptance towards profit-based methods.

\textsuperscript{366} The Treasury Department Technical Explanation to the U.S. Model Tax Convention states that under art. 7(3) a PE may not deduct a royalty deemed paid to the HO.

\textsuperscript{367} E.g. The United Kingdom or Japan.
Conclusion

This thesis discussed the complex matter of determining an arm’s length consideration for intercompany transactions involving intangibles. It is not unlikely that this discussion provided more questions than answers. In a transfer pricing analysis, one should not refrain from posing questions: What has really happened? Why did parties act as they did? Would third parties in similar circumstances have done the same? Perhaps searching for clear-cut answers should not be the goal when the Guidelines acknowledge that “transfer pricing is not an exact science.”

This conclusion will first address the general observations when determining an arm’s length consideration. It will then specifically discuss the comparison between the United States and the Netherlands. Finally, it will provide two general conclusions based on a comparison how the Courts reached their decisions.

General observations

The first chapter commenced with defining intangibles. It is remarkable that in spite of the growing importance of intangibles, the staggering amounts that are at stake and the increased focus by tax authorities, there is no common definition of intangibles. For instance, how should we consider a software program? Is it a product, an intangible, or both? The lack of a common definition may result in tax authorities seeing a transfer of intangibles where taxpayers are unaware of such a transfer. For instance, the engineer that provides an offshore oil rig with highly valuable technical advice in the form of a booklet that he prepared may be considered to transfer an intangible. The first chapter subsequently provided an introduction to transfer pricing and international taxation. It offered the reader insight to terms such as the arm’s length principle and double taxation. In essence, it stated that transfer pricing is about comparing a controlled transaction to ‘what third parties would have done’.

The second chapter introduced a three-step method for the determination of an arm’s length consideration. The first step involved determining the owner of an intangible. Whereas the determination of ownership of a tangible asset is often a straightforward process, it is a major source of controversy for intangibles. Ownership in the context of transfer pricing answers a very important question: who is entitled to the income of an intangible? It is not surprising that many high-stake transfer pricing disputes evolve around the determination of ownership: taxpayers seek to assign ownership of valuable intangibles to group companies in tax-havens, something tax authorities zealously contend. The two standards of ownership were discussed: legal and economic ownership. Legal ownership is easy to determine and may therefore seem a good candidate to be decisive for transfer pricing purposes. However, it is generally perceived that allocating all of the intangible’s income to the legal owner would too easily open up the way to tax avoidance: merely holding legal ownership in a tax-haven would be sufficient in that respect. Economic ownership, which essentially identifies as owner the company that developed the intangibles, is more difficult to determine than legal ownership. However, economic ownership, rather than legal ownership, is best capable of compensating the parties that develop the intangible.

The second step identified the arrangements made between the parties. Key in the second chapter was that, although contractual terms agreed upon by parties should be taken into account, one should always adhere to the arm’s length principle; observing every aspect of the transaction from the notion: what would uncontrolled parties in comparable circumstances have done? From this perspective, the second step discussed several controversial issues. The

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OECD Guidelines par. 1.12.
arm’s length principle might, for instance, require adjusting the contractual arrangement when parties transfer an intangible asset with an uncertain value, for instance through imputing a price-adjustment clause or short-term agreements. It subsequently discussed the ‘roundtrip’ arrangements. Tax authorities contend these arrangements through the ‘economic substance’ (‘Have things really changed?’) or the ‘valid business purposes’ (‘Would an independent company do this?’) arguments. The arm’s length principle is clearly reflected in the ‘valid business purposes’ argument, as it refers to what other parties would have done. The ‘economic substance’ argument is used to determine whether the arrangement does not merely exist ‘on paper’. The second chapter finally discussed ‘package deals’, where services, tangible goods, and intangibles are intertwined. Sometimes segregation of the package is required: either because the methods for determining a transfer price vary or because treatment under tax treaties (withholding taxes) varies for each of the ‘ingredients’ of the ‘package deal’.

As the third and final step, this thesis discussed which transfer pricing methods are suitable for determining an arm’s length consideration. In general, finding comparable uncontrolled transactions is difficult due to the often unique characteristics of intangibles and the lack of data available. The methods that are not transaction-based, but instead rely on more widely-available gross margins, are therefore becoming increasingly popular, especially the profit split methods.

The U.S. and the Netherlands – a comparison
Since the Transfer Pricing Decree declared the OECD Guidelines applicable in the Netherlands and transfer pricing guidance on intangibles is rather limited, for purposes of this comparison, the focus from the Dutch perspective will be on the Guidelines. Table 2, below, provides a brief overview of the eight major topics that this thesis used as basis for the comparison. When comparing the Guidelines to the U.S. Regulations, two conclusions arise: There are indeed differences between the Guidelines and the U.S. Regulations. However, these differences are insignificant and can be attributed to the Regulations being more detailed and more explicit. For instance, where the Guidelines only provide examples of intangibles, the Regulations provide an extensive general characterization of intangibles. Or where the Guidelines, in respect of intangibles that have an uncertain value, speak of “referring to what others would have done” and come with three options, the Regulations explicitly require periodical adjustments when the market value of the intangible exceeds twenty percent of expected value. The level of detail in the U.S. Regulations stems from the U.S. legal culture, which is ‘rule-based’ rather than ‘principle-based’ and which seeks to record as many situations as possible in its legislation.

In the author’s opinion, this lack of significant differences between the Guidelines and the Regulations should be explained in light of the arm’s length principle. Both the OECD countries and the U.S. adhere to this principle. It may therefore be expected that results reached under the Guidelines and Regulations do not deviate from arm’s length evidence.

It is therefore illustrative, in the light of actual arm’s length evidence, to consider two U.S.-related topics that caused a fuss in the OECD countries: the ‘commensurate with income’ standard and the Glaxo case.

Since the ‘commensurate with income’ standard was made subordinate to the arm’s length principle, it should not be considered to conflict with the arm’s length principle. For arm’s length evidence shows that tying a royalty rate to a company’s profits is exceptionally rare,
fears that the ‘commensurate with income’ standard will do so, thereby allocating all of the intangible’s income to the licensor/transferor, are not realistic. Besides, arm’s length evidence indicates that parties do indeed renegotiate when the intangible’s market value deviates from the expected value.

In the author’s opinion, the reactions against Glaxo were aimed at two features of the case: the incredible amount of double taxation and the IRS’s view that Glaxo U.S. had created a valuable marketing intangible. The double taxation is, in the author’s view, not necessarily a transfer pricing issue. It is very likely that it is the result of the noncommittal mutual agreement procedure. Regarding the marketing activities; evidence from actual arm’s length cases indicates that a licensee generally captures a large share of the intangible’s income. The IRS’s position should not be considered to conflict with the arm’s length principle. The OECD countries can always hold this view against the U.S., by stating that highly valuable marketing intangibles were created in the hands of OECD distributors.

Now that it has been determined that U.S. views are in accordance with actual arm’s length evidence, it is useful to reconsider the other example mentioned in the introduction to this thesis, the Rolling Stones and their holding companies. Every Dutch lawyer knows why Dutch holding companies are very useful in a tax-planning strategy: royalties that flow in or out of the holding companies are exempt of taxes and the Netherlands has a wide network of tax treaties. According to the author, these characteristics, rather than a lenient transfer pricing regime, are the main reason for the perception of the Netherlands as a tax haven for royalties.

Summarizing, the author concludes that differences between the Netherlands and the United States as regards the transfer pricing of intangibles are insignificant. The reason is that both countries adhere to the arm’s length principle. If both countries continue to do so, and make a strong commitment to use economic analyses to determine arm’s length consideration, the author expects no significant disputes between these countries. After all, observing what unrelated parties under similar circumstances would have done, will always provide the right answers. It is now up to the international tax lawyers to create a mutual agreement procedure that does have effect.

Analysis of the Courts’ decisions
Below is an overview of the transfer pricing cases discussed in this thesis. Especially in the United States, a ‘common-law’ country, case law creates precedents and often provides useful insights. In the Netherlands, unfortunately, transfer pricing cases involving intangibles have been exceptional. Since this thesis provides insight in how a transfer pricing analysis should be structured, it is illustrative to see how the Courts performed this analysis. The cases were therefore compared on five issues:

1. What was the issue at stake?
2. Which transfer pricing standards were applied (e.g. 1994 Regulations or OECD Guidelines)?
3. Did the Court perform a functional analysis?
4. Did the Court perform a comparability analysis?
5. Who won?
Dutch case law

Appellate Court of Amsterdam February 18, 2004.
1. Allocation of income to legal / economic ownership.
2. Unclear.
3. Yes.
5. Taxpayer.

Lower Tax Court of Breda March 26, 2007.
1. A ‘roundtrip’ arrangement.
2. Unclear.
3. Yes, the Court observed the risks allegedly mitigated by the licensing agreement.
5. Tax authorities.

U.S. case law

Ciba-Geigy Corp.
1. The IRS wanted to allocate intangible income to the U.S.
2. 1968 Regulations.
3. Yes, it observed rights and obligations of parties.
4. No.
5. Taxpayer.

G.D. Searle & Co.
1. The IRS disregarded foreign subsidiary’s ownership.
2. 1968 Regulations.
3. Unclear.
4. Yes, indirectly, through focus on “legitimate business purpose”.
5. Taxpayer.

Eli Lilly & Co.
1. The IRS disregarded foreign subsidiary’s ownership.
2. 1968 Regulations.
3. Yes, recognising legal rights of parties.
4. Yes, holding that the transfer of intangibles to subsidiary is a “common transaction”.
5. Taxpayer.

DHL Corp.
1. Ownership of non-U.S. trademarks.
2. 1968 Regulations.
3. Yes, it used a functional analysis to conclude that DHLI had developed the brand abroad.
4. It did not rely on arm’s length evidence to determine whether the AMP costs were indeed development costs.
5. Taxpayer.

H Group Holding
1. Allocation of royalties to U.S. companies.
2. 1968 Regulations.
3. Yes, it took into account factors such as brand recognition.
4. No, the Court determined the royalty rate based on its own calculations, since parties provided no suitable arm’s length evidence.
5. “Compromise verdict.”

Medieval Attractions, N.V.
1. Ownership of marketing intangibles.
2. 1994 Regulations.
3. Yes, it examined the functions performed, which led to development of the theme-concept.
4. Unclear, it did hold that a party dealing at arm’s length would not have paid royalties.
5. Tax authorities.

Bausch & Lomb
1. A ‘roundtrip’ arrangement.
2. 1968 Regulations.
3. Yes, significant focus on risks borne by Irish manufacturer.
4. Yes, the Court relied on arm’s length evidence to set royalty rate. It did not rely on license agreements between unrelated parties that were offered by B&L but instead it focused on the rate of return and division of projected pre-royalty profits that unrelated parties would negotiate under the circumstances.
5. Taxpayer.

Sundstrand Corp.
1. A ‘roundtrip’ arrangement.
2. 1968 Regulations.
3. Yes, significant focus on risks borne by Singapore manufacturer.
4. It rejected the uncontrolled license transactions proffered by Sundstrand and used the highest royalty rate that Sundstrand ever obtained from an unrelated licensee.
5. Taxpayer.

Perkin-Elmer Corp.
1. A ‘roundtrip’ arrangement.
2. 1968 Regulations.
3. Unclear.
4. Yes, it determined the royalty rate based on comparable transactions with unrelated parties.
5. Taxpayer.

Lowe’s Home Center Inc.
1. A ‘roundtrip’ arrangement.
2. State tax law.
3. Yes, focus on the functions performed before and after the ‘roundtrip’.
4. Indirectly, through focus on “business purpose” of the arrangement.
5. Tax authorities.

Sherwin-Williams
1. A ‘roundtrip’ arrangement.
2. State tax law.
3. Unclear.
4. Indirectly, through focus on “business purpose” of the arrangement.
5. Tax authorities.
Based on this comparison two conclusions may be drawn:

1) The Courts apply a functional analysis in the vast majority of the cases. In ten of the thirteen transfer pricing cases discussed in this thesis, the Court applied a functional analysis to reach its decision. Under the 1968 Regulations, the functional analysis often focused on the rights and obligations agreed upon by parties. The IRS’s notion that legal agreements between parties should be disregarded, was repeatedly rejected by the Courts. DHL is the only major case where the Court provided insight whether AMP functions performed would lead to the development of a marketing intangible. Unfortunately, the Glaxo case, which would have provided useful insights in these matters, was settled. As regards ‘roundtrip’ arrangements, Courts often focus on whether functions performed before and after the arrangement have really changed and whether the foreign company that owns the intangibles actually incurs risks with respect to these intangibles.

2) The Courts are hesitant in relying on comparable uncontrolled transactions: nowhere did the Court rely on data of transactions between unrelated parties. Only in Sundstrand and Perkin-Elmer, did the Court rely on transactions with unrelated parties. However, in the author’s opinion, the Courts often do rely on comparability data indirectly; focusing on whether the transactions served “valid business purposes” implies reference to “what other parties would have done”.

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369 The Glaxo case was not discussed here since it is a settlement and therefore provides no insight in how the Court reached its decision.
| **Table 2: A comparison on eight issues between the Guidelines and the Regulations** |
|-------------------------------------------------|--------------------------------------------------------------------------------------------------|
| **Definition**                                  | OECD Guidelines: Examples. “Commercial rights”. Distinction between marketing intangibles and trade intangibles | U.S. treasury Regulations: “Commercially transferable”, has value ‘independent of the services of any individual’, which it derives ‘not from its physical attributes but from its intellectual content or other intangible properties’. |
| **Marketing activities by non-legal owner**     | OECD Guidelines: Focus on obligations and rights agreed upon by both parties. Compensation for providing services or sharing in an additional return? | U.S. treasury Regulations: Licensee receives compensation, and possibly shares in intangible income. No license arrangement: imputation of services agreement or contingent-payment compensation. |
| **When valuation is highly uncertain**          | OECD Guidelines: Reference to what other parties would have done: anticipated benefits, short-term agreements or price-adjustment clauses. | U.S. treasury Regulations: ‘Commensurate with income’ standard: periodical adjustments. |
| **The ‘roundtrip’ problem**                     | OECD Guidelines: Price adjustment clause, unless business motives or no such clause in arm’s length transactions. ‘Valid business purposes’? | U.S. treasury Regulations: Imputation of contingent-payment compensation or a transfer of rights. ‘Economic substance’. ‘Alternatives realistically available’. |
| **Know-how and the provision of services**      | OECD Guidelines: May be necessary to segregate the components. If one part of mixed contract constitutes principal purpose: apply treatment applicable to principal part. | U.S. treasury Regulations: Services contain material intangible component: apply rules for intangible property. No material component: treatment as services. |
| **Methodology**                                | OECD Guidelines: CUP, RPM, cost plus (although unusual) TNMM and profit split methods. | U.S. treasury Regulations: ‘Best method’ rule. CUT, CPM, CPSM and RPSM. |
Appendices

Appendix 1: Tax effective license structures

License model

R&D activity → IP holding company (in a low tax jurisdiction) → producer / sales company

Franchising/service model

R&D activity → IP holding company (in a low tax jurisdiction) → provision of services → producer / sales company

Entrepreneur structure

R&D activity → IP holding company (in a low tax jurisdiction)

contract R&D

contract manufacturing

producer

sales to third parties

sales to third parties

sales agents
Appendix 2: The "Cheese examples" under the 1994 Regulations

The first “Cheese example”
Example 2. FP, a foreign producer of cheese, markets the cheese in countries other than the United States under the tradename Fromage Frere. FP owns all the worldwide rights to this name. The name is widely known and is valuable outside the United States but is not known within the United States. In 1995, FP decides to enter the United States market and incorporates U.S. subsidiary, USSub, to be its U.S. distributor and to supervise the advertising and other marketing efforts that will be required to develop the name Fromage Frere in the United States. USSub incurs expenses that are not reimbursed by FP for developing the U.S. market for Fromage Frere. These expenses are comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer. Since USSub would have been expected to incur these expenses if it were unrelated to FP, no allocation to USSub is made with respect to the market development activities performed by USSub.

The second “Cheese example”
Example 3. The facts are the same as in EXAMPLE 2, except that the expenses incurred by USSub are significantly larger than the expenses incurred by independent distributors under similar circumstances. FP does not reimburse USSub for its expenses. The district director concludes based on this evidence that an unrelated party dealing at arm's length under similar circumstances would not have engaged in the same level of activity relating to the development of FP's marketing intangibles. The expenditures in excess of the level incurred by the independent distributors therefore are considered to be a service provided to FP that adds to the value of FP's trademark for Fromage Frere. Accordingly, the district director makes an allocation under section 482 for the fair market value of the services that USSub is considered to have performed for FP.

The third “Cheese example”
Example 4. The facts are the same as in EXAMPLE 3, except that FP and USSub conclude a long term agreement under which USSub receives the exclusive right to distribute cheese in the United States under FP's trademark. USSub purchases cheese from FP at an arm's length price. Since USSub is the owner of the trademark under paragraph (f)(3)(ii)(A) of this section, and its conduct is consistent with that status, its activities related to the development of the trademark are not considered to be a service performed for the benefit of FP, and no allocation is made with respect to such activities.

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Appendix 3: Using the CPSM to determine arm’s length royalties for trademarks

<table>
<thead>
<tr>
<th>Steps</th>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Compute NPVs of the operating profits of the</td>
<td>Compute NPV of the combined operating profits</td>
<td>Determine an arm’s length royalty rate</td>
</tr>
<tr>
<td></td>
<td>licensee and the licensor based on third-party agreements</td>
<td>of the licensor and the licensee for the controlled transaction</td>
<td></td>
</tr>
<tr>
<td>Means</td>
<td>Data sources: comparable trademark agreements</td>
<td>Analysis of the projected financial outcome based on the controlled transaction</td>
<td>The royalty rate is determined such that the split of profits between the licensor and the licensee corresponds to the split of profits observed at arm’s length based on the third-party agreements</td>
</tr>
<tr>
<td></td>
<td>Licensee data: Determine operating profits from the use of the trademark</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Licensor data: Royalty income from the trademark licensing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outcome</td>
<td>Two NPVs for each comparable third-party agreement (amount in currencies)</td>
<td>Total profit to be shared (in currencies)</td>
<td>An arm’s length royalty rate or a range of arm’s length royalty rates</td>
</tr>
<tr>
<td></td>
<td>A range of arm’s length profit allocations (in %)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This diagram was taken from E. Llinares and N. Mert-Beydilli, ‘How to determine trade marks royalties’, *International Tax Review* 2006, 12.
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**Recommended**


Books

Used


Recommended


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