T.C.
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KAMU HUKUKU ANABİLİM DALI

MADDİ OLMAYAN İKTİSADİ KIYMETLERİN TRANSFER FİYATLANDIRMASI

Yüksek Lisans Tezi

HASAN İKBAL ATASOY

İstanbul, 2020

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ABSTRACT

The world we live in today witnesses two radical changes. The first is associated with the notion of supply chains. With cross-border business activities, the supply chain concept is globalized. Research and development, manufacturing, distribution, and service-providing functions of business have moved beyond merely domestic boundaries. The other is as to a transformation from the industrial revolution to the knowledge economy. As a result, intangibles, for example, a patent caused by one's knowledge and intellectual efforts, have become more valuable than non-intangibles, such as assets created by muscle power. In other words, it is no longer case that the product of muscle is of more value than the product of the mind. Trademarks, patents, copyrights, industrial designs, know-how, licenses, and other intangibles, as valuable income generators, have become prominence subjects of trade and law. In this regard, this study focuses on transfer pricing aspects of intangibles, covering inter alia the OECD's BEPS project, the arm's length principle, comparability analysis, cost contribution arrangement, intangible ownership, transfer of intangibles, the application of transfer pricing methods pursuant to the analytical framework provided in the OECD Transfer Pricing Guidelines as well as functional analysis centered around development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles.

Keywords: Multinational Enterprises, OECD, UN, Base Erosion and Profit Shifting (BEPS), Arm's Length Principle, Comparability, Intangible Ownership, Cost Contribution Arrangements, Functional Analysis, DEMPE Concept, Control over Risk, Transfer Pricing Methods, Transactional Profit Split Method, Residual Analysis, Discounted Cash Flow Method.

ÖZET

İçinde yaşadığımız dünya iki önemli paradigma değişikliğine tanıklık etmektedir. Birincisi tedarik zinciri konseptinin globalleşmesiyle ilgili olup işletmelerin araştırma ve geliştirme, üretim, dağıtım ve servis sağlama gibi fonksiyonları uluslararası nitelik kazanmıştır. Diğer önemli değişiklik ise endüstriyel ekonomiden bilgi ekonomisine geçişle ilgilidir. Bunun bir yansıması olarak bilgiye ve entelektüel uğraşıya dayalı ürünler ve kıymetlerin kas gücüyle ortaya çıkan varlıklardan ve ürünlerden daha değerli hale geldiği söylenebilir. Bu bağlamda markalar, patentler, telif hakları, endüstriyel tasarımlar, teknik bilgi, ilgili kamu otoriteleri tarafından verilmiş lisanslar ve diğer maddi olmayan iktisadi kıymetler ifade ettikleri değerler bakımından hem ticaretin hem de hukukun önemli konuları arasında yerlerini almışlardır. Bu açıklamalar ışığında ilgili kıymetlerin çok uluslu işletmeler bünyesinde kontrollü işlemlere konu olması, bu kıymetlerin transferlerinin ve kullanımlarının fiyatlandırılması ile bunlarla bağlantılı uluslararası vergi alanında ortaya çıkan sonuçlar bu çalışmanın ana konusunu oluşturmaktadır. BEPS Eylem Planı, emsallere uygunluk ilkesi, karşılaştırılabilirlik analizi, maliyet katılım anlaşmaları, maddi olmayan iktisadi kıymetin sahipliği, ilgili kıymetlerin geliştirilmesi, değerlerinin artırılması, devamlılığının sağlanması, korunması ve kullanılması merkezli işlev analizi ile transfer fiyatlandırması metotları incelenen konular arasındadır.

Anahtar Kelimeler: Çok Uluslu İşletmeler, Globalleşme, OECD, Matrah Aşındırma ve Kar Kaydırma, Maddi Olmayan İktisadi Kıymetlerin Sahipliği ve Transferi, Maliyet Katılım Anlaşmaları, Fonksiyonel Analiz, DEMPE Konsepti, Risk Üzerinde Kontrol, Transfer Fiyatlandırması Metotları, Kar Bölüşüm Metodu, Kalan Kar Analizi, İskontolanmış Nakit Akımları Yöntemi.

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Hasan İkbal Atasoy

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Abbreviations and Acronyms

BEPS	Base Erosion and Profit Shifting
CC	Cloud Computing
CCA	Cost Contribution Arrangement
CPLM	Cost-Plus Method
CSA	Cost Sharing Agreement
CSR	Corporate Social Responsibility
CUP	Comparable Uncotrolled Price
CUPM	Comparable Uncontrolled Price Method
DAEMPE	Development, Acquisition, Enhancement, Maintenance, Protection and Exploitation
DCF	Discounted Cash Flow
DCFM	Discounted Cash Flow Method
DEMPE	Development, Enhancement, Maintenance, Protection and Exploitation
Eds.	Editors
EU	European Union
G20	Group of Twenty
IP	Intellectual Property
IT	Information Technology
IVSC	International Valuation Standards Council
MNEs	Multinational Enterprises
NGOs	Non-governmental Organizations
OECD	Organization for Economic Co-operation and Development
OEEC	Organization for European Economic Co-operation
p.	page
para.	paragraph
PCT	Patent Cooperation Treaty
pp.	pages
PPA	Purchase Price Allocation
R&D	Research and Development
RACI	Responsible, Accountable, Consulted, and Informed
RPM	Resale Price Method
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TPSM	Transactional Profit Split Method
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UN	United Nations
US	United States
VCA	Value Chain Analysis
WIPO	World Intellectual Property Organization

INTRODUCTION

The world we live in today witnesses two important paradigm shifts. The first is related to the concept of supply chains. With the growing cross-border activities of businesses, today, it has been more globalized. Research and development, manufacturing, distributing, selling things, and providing services have been divided among countries as though there were no boundaries. Secondly, the knowledge economy[1] has brought about radical changes in many industries. Accordingly, intangibles have become prominent value-contributors for businesses. In a globalized world, with the growing prominence of intangibles, intangible-related transfer pricing became a significant matter.

In this regard, intangible-related transactions that occur between affiliate entities need to be examined from a transfer pricing perspective with their implications in international taxation. When we move one step further, the question may arise with respect to how to delineate intangible-related intra-group transactions. Accordingly, fundamental issues are centered around the identification and ownership of intangibles under review, as well as pricing them in line with the arm's length principle.

Against this background, Chapter 1 will give information about prominent stakeholders and the OECD's Base Erosion and Profit Shifting (BEPS) initiative. Also, having a closer look at transfer pricing with the leading comparability factors will provide a better understanding of its aspects of intangibles discussed in later chapters.

Chapter 2 dwells on the world of intangibles, with the illustrations of definition and classification of intangibles as well as items that may be thought of as intangibles or important as comparability factors for transfer pricing purposes.

[1] See Appendix I.

In Chapter 3, unique issues to intangibles will be highlighted. In this respect, matters of creation and ownership, cost contribution arrangements, and the transfer of intangibles are among the topics guided through this chapter.

Chapter 4 will discuss how to delineate transactions involving intangibles. In this regard, the chapter covers the OECD-recognized six-step approach, DEMPE-centered functional analysis, transfer pricing methods and briefly economic valuation that can be useful in arriving at the arm's length price for controlled intangible-related transactions and/or arm's length profit allocation among related entities. This chapter will draw a reader's attention to the transactional profit split method since its wide practical utilization in intangible-relevant cases.

1. SETTING THE SCENE

1.1 Background

1.1.1 Multinational Enterprise

Multinational Enterprise(MNE) is described as a group of companies typically operating at the international level through different entities such as subsidiaries, joint ventures, and partnerships.[2] There are several important features with regard to MNEs and their operations. Firstly, MNEs enter into cross-border transactions. That is, their *"commercial activity moves beyond a purely domestic setting,"*[3]carrying on business in more than one country.[4] As pointed out by the UN, fast progress "*in technology, transportation and communication"* has induced plenty of MNEs that *"have the flexibility to place their enterprises and activities"* in any part of the world. [5] Secondly, in today's world*, "intra-group trade"* has reached a different stage, which has snowballed.[6] In this regard, from the international taxation point of view, particular attention needs to be drawn into MNEs' transfer pricing activities. Finally, intangibles are significant value drivers for MNEs[7], which can be matters of intra-group transactions. Accordingly, transfer pricing aspects of intangibles is an essential subject to study.

[2] United Nations, Practical Manual on Transfer Pricing for Developing Countries, 2017, https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf (Accessed 2 May 2020), p.1. [hereinafter "*the UN Manual"*]

[3] Michael P. Devereux and John Vella, "Are We Heading Towards a Corporate Tax System Fit for the 21st Century?", 2014, Fiscal Studies, Forthcoming; Oxford Legal Studies Research Paper No. 88/2014, https://ssrn.com/abstract=2532933 (Accessed 2 July 2020), p.2.

[4]European Commission, Eurostat Statistics explained: Glossary Multinational Enterprise (MNE) https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Multinational_enterprise_(MNE) (Accessed 1 July 2020)

[5] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, 2011, https://www.un.org/esa/ffd/wp-content/uploads/2011/06/20110607_TP_Chapter1_Introduction.pdf, (Accessed 16 May 2020), para. 1.2.

[6]OECD, OECD/G20 Base Erosion and Profit Shifting Project Final Reports: Executive Summaries, 2015, http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf (Accessed 9 August 2020), p.27.

[7] For examples concerning patent applications under PCT, see Appendix III and IV.

1.1.2 Organization for Economic Co-operation and Development

As an intergovernmental organization, the Organization for Economic Co-operation and Development(OECD) works in collaboration with governments, policymakers, and other relevant stakeholders in a wide scope of *" social, economic and environmental"* issues such as *"(i)improving economic performance, (ii)creating jobs, and (iii) fighting international tax evasion."*[8]

With respect to the historical development of OECD's role in international taxation, Douma has suggested the following:

> *"As the end of the 19th century and the beginning of the 20th century saw an uprise in cross-border economic activity, the issue of international juridical double taxation, which is the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods became more pressing. Consequently, individual states entered into bilateral agreements for the avoidance of double taxation. At first, bilateral treaties were concluded on a relatively small scale between neighbouring countries. But after the First World War, an extensive treaty network developed in central Europe. […] This patchwork of differing bilateral treaties stimulated the League of Nations, the predecessor of the current United Nations and founded in 1920 after World War I, to develop a kind of uniform, model tax treaty. […] In 1946, the model treaty of London was completed, and after the Second World War, the League of Nations ceased to exist. It was succeeded by the United Nations. The work on the model tax treaties was, however, continued by the Organization of European Economic Co-operation, or OEEC and its successor organization, the OECD."*[9]

[8] OECD, "Who we are", http://www.oecd.org/about/ (Accessed 12 June 2020)
[9] Sjoerd Douma, Rethinking International Tax Law: Video 1.2b of Module 1, The OECD&The EU, Leiden University|Coursera,2015, https://www.coursera.org/learn/international-taxation/lecture/wjmCR/the-oecd-the-eu (Last visited 9 August 2020)

As depicted in the above quote, preventing double taxation was the primary issue that needed to be dealt with for a long time. Recent developments in international taxation have shown that the OECD focuses more on preventing double non-taxation[10] or stateless income.

1.1.3 BEPS Action Plan

1.1.3.1 Origin

Underlying principles of international taxation had not been modernized for a very long-time.[11] They, including transfer pricing rules, were established on *"physical transactions and trade."*[12] However, today, various new business models, value drivers, and types of transactions exist. Accordingly, this new era of doing business and the origin of the BEPS Project have been discussed.

Henshall argues the need to develop traditional rules in the field of international taxation as follows:

> *"*[Firstly]*, back in 1926, international trade meant dragging things around on a horse and cart, sailing ships, steam trains and telegrams. That is not how iTunes works. Business practice has evolved, but our tax rules did not. Governments now believe that we need to modernize our rules to apply to modern business transactions. Secondly, every country holds their its sovereign right to set its own tax rules, but that means the rules that countries create do not always interact with each other very well. As the importance of global trade increases, the irritation that these frictions caused to governments also increases. And now we have reached the level where governments want to do something about it. Thirdly, most countries look at tax incentives offered by others to encourage […] investment as*

[10] Mustafa Cemil Kara and Ersan Öz, "Bir Küresel Vergi Uyumu Projesi: BEPS", *Vergi Dünyasi*, 2016, Sayi 414, http://ersanoz.com/makaleler/05-02-2016-bir-kuresel-vergi-uyum-projesi.pdf (Accessed 4 September 2020), p.174.

[11] John Henshall, Transfer Pricing of Intangibles: Legal and Practical Issues, Deloitte Dbriefs Legal, 2015, https://youtu.be/neojS00Fm5c (Accessed 4 August 2020)

[12] George Yijun Tian, "Cloud Computing and Cross-Border transfer Pricing: Implications of Recent OECD and Australian Transfer Pricing Laws on Cloud Related Multinational Enterprises and Possible Solutions." *Rutgers Computer & Technology Law Journal,* 2018, Vol. 44, No.1, https://www.thefreelibrary.com/_/print/PrintArticle.aspx?id=563460051 (Accessed 4 July 2020), p.37. See also. John Henshall, Transfer Pricing of Intangibles: Legal and Practical Issues, Deloitte Dbriefs Legal, 2015, https://youtu.be/neojS00Fm5c (Accessed 4 August 2020)

> *being unfair* […] *So, something needs to be done to set a standard and prevent what is now being called unfair tax competition. And finally, all of that is looked at by governments through the suspicion. The business has lots of information that they are simply not sharing. So, governments want transparency."*[13]

Against this background, for the concerns mentioned above, the OECD had first addressed Base Erosion and Profit Shifting (BEPS)[14] problem and then accordingly released Action Plan[15] in 2013, with the primary focus on tax planning strategies causing to *non-taxation*. [16] The Action Plan is premised upon three fundamental pillars[17], which is composed of 15 points[18] covering such matters as challenges regarding the digital economy[19], special considerations for intangibles[20], and effort to make existing dispute avoidance and resolution mechanisms more effective.[21] In this regard, transfer pricing was addressed among issues related to the BEPS. Taking the profit-shifting activities of MNEs into account, the OECD had addressed transfer pricing in the report[22] , and accordingly, it was covered in the BEPS Action Plan.[23]

In short, BEPS initiative is an endeavor, in the field of international taxation, to put an end to exploitative tax avoidance strategies.[24] Pascal Saint-Amans addressed the aim of the

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[13] John Henshall, Transfer Pricing of Intangibles: Legal and Practical Issues, Deloitte Dbriefs Legal, 2015, https://youtu.be/neojS00Fm5c (Accessed 4 August 2020)
[14] OECD, Addressing Base Erosion and Profit Shifting, 2013, https://read.oecd-ilibrary.org/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page14 (Last visited 8 August 2020)
[15] OECD, Action Plan on Base Erosion and Profit Shifting, 2013, https://www.oecd-ilibrary.org/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en, (Accessed 2 May 2020)
[16] Lisa Katharina EVERS, Intellectual Property Box Regimes: Tax Planning, Effective Tax burdens, and Tax Policy Options, 2014, http://madoc.bib.uni-mannheim.de/37562/4/Dissertation_Lisa_Evers_IP_Box_Regimes.pdf (Accessed 8 June 2020), p.1. See also Kara and Öz, p.174.
[17] John Henshall, Transfer Pricing of Intangibles: Legal and Practical Issues, Deloitte Dbriefs Legal, 2015, https://youtu.be/neojS00Fm5c (Accessed 4 August 2020)
[18] Kara and Öz, p.174.
[19] OECD, Action Plan on Base Erosion and Profit Shifting, p.14.
[20] OECD, Action Plan on Base Erosion and Profit Shifting, p.20.
[21] OECD, Action Plan on Base Erosion and Profit Shifting, p.23.
[22] OECD, Addressing Base Erosion and Profit Shifting, p.84.
[23] OECD, Action Plan on Base Erosion and Profit Shifting, p.20. and p.23.
[24] OECD, Inclusive Framework on Base Erosion and Profit Shifting, http://www.oecd.org/tax/beps/ (Accessed 12 June 2020)

project as *"realigning the location of profits with the location of the activities. […] Through pure contractual arrangements, the profit has been shifted to low or non-tax jurisdiction, where there is no reason. This does not pass the smell test."*[25], he said.

1.1.3.2 Concerns

In cases where MNEs' implementation of aggressive tax planning strategies to minimize their groupwide tax burden goes against the law, the issue is referred to as *"tax evasion."*[26] And, this is, in itself, illegal. There is, however, another way of reducing tax burden by staying within the boundaries of the law[27], namely "*tax avoidance."*[28] The consequences of *tax evasion* and *tax avoidance* can be quite similar, and the question is how to draw the line between them.

Accordingly, major BEPS-related issues arising from the tax planning of MNEs resulting in tax avoidance can be grouped into three following categories[29]:

[25] Pascal Saint-Amans, interviewed by Sjoerd Douma, Rethinking International Tax Law: Module 6-Tax planning & ethical dimensions, Leiden University | Coursera,2015, https://www.coursera.org/learn/international-taxation/lecture/zjGc0/interview-pascal-saint-amans (Accessed 5 June 2020)

[26] Tanja Bender and Dirk M. Broekhuijsen, Corporate Social Responsibility for Future International Business Lawyers-Great Debates: The Relationship between CSR and Tax Avoidance, Working Paper, 2015, https://d396qusza40orc.cloudfront.net/internationaltaxation/CSR%20tax%20working%20paper%20April%202015.pdf (Accessed 28 July 2020), p.2.

[27] Bender and Broekhuijsen, p.1.

[28] Bender and Broekhuijsen, p.2.

[29] Frank Engelen, Rethinking International Tax Law: Module 1: Video 1.5 Advanced Track, Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/hpDtc/introduction-to-beps (Accessed 3 May 2020)
To Bender and Broekhuijsen, tax avoidance also results in *"… undermining a voluntary compliance by other taxpayers, who see multinational corporations legally avoid income tax; the creation of countermeasures making tax systems more complicated; and to an increase in compliance costs for companies and administration costs for governments."* This quote is sourced from Bender and Broekhuijsen, p.1.

(i) concern relating to fairness[30]: tax avoidance means revenue losses for governments, giving rise to transfers of tax liability to individuals and businesses run on a national level.[31] It has been noted that BEPS-related activities result in a loss of corporate income tax to the world between 100 to 240 billion USD per annum.[32]

(ii) its adverse effects on competition: cross-border operating businesses, as a result of avoiding taxes, will have been placed in a superior position compared to other domestically-operating businesses.[33]

(iii) its distortive effects on enterprises' investment decisions: businesses make relevant decisions, intending to tax avoidance, based on tax-return rates, and that may eventually lead to inefficiency on resource allocations.[34]

1.1.4 Intangibles in BEPS Action Plan

The OECD is dedicated to developing rules with a view to preventing intangible-related BEPS. In this regard, pursuant to Action 8, four main areas relating to intangibles are as follows[35]:

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[30] The term corporate social responsibility (CSR) denotes a notion which "*suggests business decision-makers consider ethical issues - including the interests of customers, employees, creditors, the public, and other stakeholders - in addition to legal and financial concerns."* This information is sourced from James Everil Smyth, Dan Soberman, Alex Easson, Shelley McGill, **The Law and Business Administration in Canada**, 14th edition, Pearson Canada, 2016, p.9. [hereinafter "*Smyth et al.*"] Margaret Hodge said: *"We are not accusing you of being illegal, we are accusing you of being immoral."* See the following testimony in which a committee is questioning famous MNEs' tax planning strategies from the Corporate Social Responsibility standpoint: Public Accounts Committee Hearing (12/11/2012) on Taxation of Multinational Corporations, witnesses: Matt Brittin (CEO, Google UK), Troy Alstead (Global CFO, Starbucks), Andrew Cecil (Director Public Policy, Amazon), https://www.parliamentlive.tv/Event/Index/ab52a9cd-9d51-49a3-ba3d-e127a3af018c (Accessed 30 April 2020)

[31] Bender and Broekhuijsen, p.1.

[32] John Henshall, Transfer Pricing of Intangibles: Legal and Practical Issues, Deloitte Dbriefs Legal, 2015, https://youtu.be/neojS00Fm5c (Accessed 4 August 2020)

[33] Bender and Broekhuijsen, p.1.

[34] Bender and Broekhuijsen, p.1.

[35] OECD, Action Plan on Base Erosion and Profit Shifting, p.20. See also OECD, Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project, 2018, www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf (Accessed 10 July 2020), p.11; Kara and Öz, p.176.

- *"[…] definition of intangibles;*
- *ensuring that profits associated with the transfer and use of intangibles are appropriately allocated* in line with *[…]value creation;*
- *developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and*
- *[…] cost contribution arrangements."*

In doctrine, some argued that the aims set under Action 8 by the OECD had required more clarification. To Devereux and Vella, the OECD does not clarify whether the notion of value creation is differentiated from the idea of economic activity. "*If it is not meant to be different, the use of different terms can only create unnecessary confusion. If it is meant to be different, it is not at all clear what the difference is."*[36]

Also, Verlinden and Bakker has argued "*…the identification of where the development, enhancement, maintenance, protection and exploitation functions take place is a hard nut to crack.*[…]*,and many have voiced how they struggle with the practical implementation."*[37]

In 2014, the OECD released its *"Guidance on Transfer Pricing Aspects of Intangibles,"*[38]wherein the information can be found on the definition of intangibles, ownership issue, and the arm's length principle's application to transactions involving intangibles, among others.

1.1.5 Previous Work

More recently and specifically about transfer pricing, in 2017, the OECD released its publication entitled *"Transfer Pricing Guidelines for Multinational Enterprises and Tax*

[36] Devereux and Vella, pp. 15-16.
[37] Isabel Verlinden and Anuschka Bakker (Eds.), **Mastering the IP Life Cycle from a Legal, Tax and Accounting Perspective: Grasping the Intangible,** Amsterdam, The Netherlands: IBFD, 2018, p.XX. [hereinafter *"Verlinden and Bakker (Eds.)*"]
[38] OECD, Guidance on Transfer Pricing Aspects of Intangibles, 2014, http://dx.doi.org/10.1787/9789264219212-en (Accessed 21 May 2020)

Administrations."[39] *[hereinafter "the OECD TP Guidelines" or "the Guidelines]* Chapter VI of the Guidelines examines transfer pricing aspects of intangibles. Besides, Cost Contribution Arrangements are discussed in detail in Chapter VIII of the Guidelines. In 2017, the United Nations (UN) also released *"Practical Manual on Transfer Pricing for Developing Countries."*[40] [*hereinafter "the UN Manual"]* In 2018, *"Revised Guidance in the Application of the Transactional Profit Split Method"*[41] *and "Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles"*[42] were introduced as part of the BEPS Project.

[39] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017, https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm (Accessed 3 June 2020)[hereinafter *"the OECD TP Guidelines"*]

[40] United Nations, Practical Manual on Transfer Pricing for Developing Countries, 2017, https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf (Accessed 2 May 2020)

[41] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, 2018, http://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf (Accessed 26 July 2020)

[42] OECD, Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles - BEPS Actions 8-10, OECD/G20 Base Erosion and Profit Shifting Project, 2018, www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf (Accessed 10 July 2020)

1.2 Transfer Pricing

1.2.1 General

Transfer pricing is about setting a price for transactions that transpired between related enterprises of an MNE group.[43] It deals with how to price intra-group transactions[44], in line with a set of rules. From a different perspective, it can be seen as a tool used by *"a group of companies"* to split relevant profits among *"the individual group members."*[45] In this regard, Simontacchi addressed the importance of transfer pricing as follows: *"with ongoing economic globalization, cross-border intra-group transactions are becoming increasingly important,*" and today transfer pricing is the fundamental issue for profit-allocation between related entities of an MNE.[46]

Service-providing and/or transferring property between affiliate enterprises within the same MNE may lead to the transfer of profits.[47] This practice typically includes under-charging or over-charging the transferee for the intra-group transaction with the aim of minimizing worldwide tax liabilities of the MNE.[48] It may be put forward that the aforementioned issues are dealt with through transfer pricing regulations. The core element of the transfer pricing is the arm's length principle. The possible application of manipulative pricing strategies is eliminated through the proper application of the arm's length principle.

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[43] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.6. See also para 1.10. of the same source for the following definition of transfer pricing: *"the amount that is charged by a part or segment of an organization for a product or service that it supplies to another part or segment of the same organization."*

[44] The term *intra-group transaction* refers to a transaction that is carried out within an MNE group. In this regard, the subject matter of a given transaction may be in the form of goods, services, and intangible assets, among others. Source for this information: United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.3.

[45] Sjoerd Douma, Rethinking International Tax Law: Video 4.1. of Module 1: Intro-Transfer Pricing , Leiden University|Coursera,2015,https://www.coursera.org/learn/international-taxation/lecture/N1E4Q/intro-transfer-pricing (Accessed 21 May 2020)

[46] Stefano Simontacchi, Rethinking International Tax Law: Video 4.1 of Module 4: Introduction to Transfer Pricing and Why It is Important , Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/wRSfc/introduction-to-transfer-pricingand-why-it-is-important (Last visited 17 July 2020)

[47] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 2.5.

[48] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 2.5.

1.2.2 Controlled Transaction

A distinction should be made between "controlled" and "uncontrolled" transactions. While the former refers to transactions made between associated enterprises, the latter indicates transactions carried out between enterprises that are not related to each other.[49]

Driven forces of a controlled transaction and an uncontrolled transaction may not be the same. For instance, in the case of controlled transactions, an MNE group may have a significant impact on the pricing of own goods, services, and assets. Where uncontrolled transactions, on the other hand, since the buyer and seller, under these circumstances, are not associated with each other, market-driven forces are assumed to price the transaction. As indicated, *"the structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities."*[50] Also, it is suggested that an increasing number of cross-border transactions are ceased to be administered completely *"by market forces."*[51] Instead, these aforementioned transactions are now governed *"by forces which are driven by the common interests of the entities of a group."*[52] Likewise, the UN has pointed out that *"when associated enterprises deal with each other, their commercial or financial relations may not be directly affected by market forces but may be influenced more by other considerations."*[53] In such cases where a price set by group-driven forces, the pricing strategy of the MNE group may be used in an abusive manner, and such application of transfer pricing may be regarded as *"jeopardizing the arm's length principle."*[54]

[49] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.6.
[50] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para 1.5.
[51] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.5.
[52] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.5.
[53] The UN Manual, para. B.1.4.8.
[54] Stefano Simontacchi, Rethinking International Tax Law: Video 4.1 of Module 4: Introduction to Transfer Pricing and Why It is Important, , Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/wRSfc/introduction-to-transfer-pricingand-why-it-is-important (Last visited 17 July 2020)

1.2.3 Arm's Length Principle

1.2.3.1 General

The arm's length principle[55] ("*the principle*") is established in order to deal with transactions made between associated enterprises.[56] Its origin traces contract law with the aim of making *"an equitable agreement that will stand up to legal scrutiny, even though the parties involved may have shared interests."*[57] The principle also aims at *"preventing distortions in the tax obligations of the companies."*[58] Accordingly, it can be suggested that one objective of applying to the principle is to prevent tax avoidance by not allowing abnormal pricing activities for controlled transactions, which is likely to be conducted between associated enterprises located in different tax jurisdictions. The application of the principle covers *"all forms of intra-group transactions,"*[59]including but not limited to the sale of goods, providing services, business restructuring[60] as well as intangible-related intra-group transactions.[61]

The principle is grounded on the assumption that a price for a transaction made between associated enterprises is set as though the transaction was entered into between independent enterprises. As indicated in the UN Manual, *"the marketplace comprising independent*

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[55] Article 9(1) of the OECD Model Convention on Income and Capital has suggested that *"…conditions are made or imposed between 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."* See the following source: OECD, "Article 9 Associated enterprises", in *Model Tax Convention on Income and on Capital 2017 (Full Version)*, 2019, https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_64c1a893-en#page1 (Last visited 30 July 2020)

[56] Stefano Simontacchi, Rethinking International Tax Law: Video 4.1 of Module 4: Introduction to Transfer Pricing and Why It is Important, Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/wRSfc/introduction-to-transfer-pricingand-why-it-is-important (Last visited 17 July 2020)

[57] The UN Manual, para. B.1.4.3.

[58] Alexander Fedan, Transfer Pricing and Intellectual Property: Identifying Issues and Reviewing the Existing and Alternative Solutions, *Social Science Research Network*, 2014, https://ssrn.com/abstract=2915434 (Accessed 3 July 2020), p.4.

[59] Stefano Simontacchi, Rethinking International Tax Law: Video 4.2 of Module 4: "The arm's length principle: Legal Framework", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/U7FuX/the-arms-length-principle-legal-framework (Last visited 17 July 2020)

[60] Stefano Simontacchi, Rethinking International Tax Law: Video 4.2 of Module 4: "The arm's length principle: Legal Framework", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/U7FuX/the-arms-length-principle-legal-framework ((Last visited 17 July 2020)

[61]Lisa De Simone and Richard C. Sansing, Income Shifting Using a Cost Sharing Arrangement, 2018, *Journal of American Taxation Association, Social Science Research Network*, https://ssrn.com/abstract=2516471(Accessed 11 July 2020), p. 6. (emphasis added)

entities is the measure […] for verifying the transfer prices for […] intra-group transactions and their acceptability for taxation purposes."[62]

To the OECD, *"the application of the […] principle is generally based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions between independent enterprises"*.[63] In this regard, some have argued that given that the comparability analysis is the cornerstone of the principle, in circumstances where comparable transactions and entities cannot be found, the application of the arm's length principle is to be challenging.[64]

As a key pillar of the arm's length principle, special consideration ought to be given to comparability analysis, particularly to functional analysis with respect to transfer pricing matters associated with intangibles.

1.2.3.2 Comparability Analysis

1.2.3.2.1 General

The arm's length price of the subject transaction is typically to be determined through comparability analysis and the selection of appropriate transfer pricing method.[65] The question of how things become a subject matter of the comparability analysis can be based on many factors. As the old saying goes, *"comparing apples to apples,"* emphasizing the notion of comparing similar things.[66]

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[62] The UN Manual, para. B.1.4.4.

[63] The OECD TP Guidelines, para. 2.6. Quite similarly, Simontacchi has suggested that *"the principle is based on the comparison between the terms and conditions set in intra-group transactions with the conditions that independent parties would have entered into under comparable circumstances."* See the following source for this quote*:* Stefano Simontacchi, Rethinking International Tax Law: Video 4.2 of Module 4: "The arm's length principle: Legal Framework", Leiden University | Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/U7FuX/the-arms-length-principle-legal-framework (Last visited 17 July 2020)

[64] Devereux and Vella, p.6.

[65] The UN Manual, para. B.2.1.2.

[66] *Merriam-Webster.com Dictionary*, "compare apples and/to/with apples," https://www.merriam-webster.com/dictionary/compare%20apples%20and/to/with%20apples (Accessed 16 June 2020)

The UN indicates the meaning of comparable as follows[67]:

> *"To be comparable does not mean that the two transactions are necessarily identical, but instead means that either none of the differences between them could materially affect the arm's length price or profit or, where such material differences exist, that reasonably accurate adjustments can be made to eliminate their effect."*

Against this background, it can be suggested that the analysis can be carried out with a view to comparing situations/transactions/entities which of similarities. Where non-adjustable differences exist, such dissimilarities prevent one from carrying out a reliable comparison between given transactions and thus reaching an accurate, reliable outcome. Under some circumstances, however, when adjustable differences exist between economic conditions of transactions in question, it is possible to make a comparability analysis.[68] The term *comparability adjustment* refers to this ability through which differences between transactions can be removed to determine the arm's length price.[69]

As pointed out by the UN, difficulties may come into existence when *"associated enterprises may engage in transactions that independent enterprises would not undertake."*[70] In such cases, conducting comparability analysis is not an easy task due to the fact that *"there is little or no direct evidence of what conditions would have been established by independent enterprises."*[71] The aforementioned difficulties often appear in cases involving intangibles. In this regard, challenging situations may arise from:

- the lack of comparables,

[67] The UN Manual, para. B.2.1.5.
[68] Stefano Simontacchi, Rethinking International Tax Law: Video 4.2 of Module 4: "The arm's length principle: Legal Framework", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/U7FuX/the-arms-length-principle-legal-framework (Last visited 17 July 2020)
[69] OECD, Comparability, 2010, http://www.oecd.org/tax/transfer-pricing/45765363.pdf, (Accessed 21 May 2020) para. 6.
[70] The UN Manual, para. B.2.1.3.
[71] The UN Manual, para. B.2.1.3.

- insufficient information *in financial statements* concerning the subject transaction,
- a complicated contractual relationship entered into by associated enterprises, and,
- an intricate business structuring. [72]

1.2.3.2.2 Internal and External Comparables

Under comparability analysis, particular attention must be given to terms of internal comparable and external comparable. Accordingly, the OECD puts forward the following:

> *"A comparable uncontrolled transaction [...] can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent enterprises, neither of which is a party to the controlled transaction ("external comparable").*[73]

In reference to the use of external comparables, Ditz said *"database analysis is one way to find such comparables. Many publications also contain royalty rates for specific branches of industry."*[74]

1.2.3.2.3 Leading Comparability Factors

While determining whether two transactions (situations) are comparable, there have been five main factors indicated by the OECD[75] and the UN.[76]

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[72] Tian, pp. 56-59.
[73] OECD, Comparability, para. 8.
[74] Xaver DITZ, "Transfer Prices for Intangible Property", Funda Başaran Yavaşlar (Ed.), in **Transfer Pricing in International Discussion** (pp. 133-138), Istanbul: Marmara University Press, 2013, p.135.
[75] The OECD TP Guidelines, para. 1.36. See also Stefano Simontacchi, Rethinking International Tax Law: Video 4.2 of Module 4: "The arm's length principle: Legal Framework," Leiden University|Coursera,2015, https://www.coursera.org/learn/international-taxation/lecture/U7FuX/the-arms-length-principle-legal-framework(Last visited 17 July 2020)
[76] The UN Manual, para. B.2.1.6.

Those are:

(1) Characteristics of property or services;
(2) Functional Analysis;
(3) Contractual Terms;
(4) Economic Circumstances; and
(5) Business Strategies.

Each of those comparability factors will be described below. In addition, it is important to acknowledge that additional factors, owing to their unique nature, may be necessary to take into account with regard to intangible-related transfer pricing matters.

1.2.3.2.3.1 Characteristics of Property or Services

In determining whether transactions are comparable, distinctive features of property or services transferred may be a useful parameter to be taken into consideration. As noted by the OECD, *"differences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market."*[77]

1.2.3.2.3.2 Functional Analysis

Under the functional analysis, the contribution of parties to a transaction is discovered. In doing so, "*functions performed, assets used, and risks assumed"* by the parties are to be examined.[78] Accordingly, functional analysis has been described in the UN Manual as *"a process of finding and organizing facts about the transaction"* in connection with *"the functions, risks and assets"* so as to determine how these are split among relevant parties.[79]

The UN has exemplified some functions in the Manual, and those can be listed inter alia as follows:

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[77] OECD, Comparability, para. 23.
[78] The OECD TP Guidelines, para 1.37.
[79] The UN Manual, para. B.2.3.2.10. See also the OECD TP Guidelines, para. 1.51., suggesting that *"functional analysis seeks to identify the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transaction."*

- "*research and development,*
- *product design and engineering,*
- *manufacturing, production,*
- *process engineering,*
- *design work*,
- *marketing, advertising,*
- *publicity and distribution*, and
- *market intelligence on technological developments*."[80]

Under functional analysis, in addition to the assessment of functions performed and assets utilized by the parties to the controlled transaction, the evaluation of risks assumed by each relevant party is of utmost significance. It has been said, *"controlled and uncontrolled transactions and entities are not comparable if there are significant differences in the risks assumed for which appropriate adjustments cannot be made."*[81]

Besides these general statements on functional analysis, the development, enhancement, maintenance, protection, and exploitation functions also need to be examined owing to their distinct significance in transfer pricing matters involving intangibles.

1.2.3.2.3.3 Contractual Terms

In transactions carried out between independent enterprises, the contractual terms and conditions address the right and obligations of the parties. In this regard, the illustration of *"how the responsibilities, risks and benefits are to be divided between the parties"*[82] can be a useful source in making comparability analysis for the determination of an arm's length price of a controlled transaction.

[80] The UN Manual, para. B.2.3.2.14.
[81] OECD, Comparability, para. 29.
[82] OECD, Comparability, para. 32.

Sometimes, it might be the case in which the relationship between parties to an agreement is not well-defined in the contract. In such circumstances, *"the contractual terms"* must be figured out through the *"economic relationship"* between parties and conducts they perform.[83] Similarly, under some circumstances, one needs to go beyond the contractual terms and conditions and analyze parties' actual behaviors to identify whether the parties genuinely entered into a contract.[84] Therefore, examining contractual relationships as a whole can be regarded as a must to take a look at, depending upon facts and circumstances of the case.

1.2.3.2.3.4 Economic Circumstances

One other significant parameter for comparability analysis is economic circumstances with regard to respective transactions. Although the subject matter of controlled and uncontrolled transactions is "*the same property or services*," the arm's length price may not be the same for the transactions owing to the differences in their economic circumstances.[85] With respect to economic circumstances, one needs to consider "*the geographic location"*, "*the size of the markets"*, *"the extent of competition in the markets", "the levels of supply and demand in the market"*, *"cost of production"* among others.[86] Also, depending upon facts and circumstances of the case, taking the differences in economic circumstances into account, one will examine if those differences can be adjustable in order to make a comparability analysis possible. [87]

1.2.3.2.3.5 Business Strategies

Such strategies implemented by businesses are to maintain and further develop their functions of commercial activities. "*Innovation and new product development* […], *risk*

[83] The UN Manual, para. B.2.3.2.3.
[84] The UN Manual, para. B.2.3.2.4.
[85] OECD, Comparability, para.36.
[86] OECD, Comparability, para.37.
[87] OECD, Comparability, para.38.

aversion[88]*, assessment of political changes*" are among business strategies.[89] It is commonly known that businesses have a tendency to maximize their profitability and minimize their costs.[90] Accordingly, they can develop strategies that may impermanently influence pricing the subject matter of transaction.[91] Overall, they ought to be taken into consideration in comparability analysis.[92]

[88] James Chen, Risk Averse, 2020, https://www.investopedia.com/terms/r/riskaverse.asp (Accessed 19 June 2020)
[89] OECD, Comparability, para.39.
[90] Gowling WLG, Transfer Pricing Guide, 2017, https://gowlingwlg.com/getmedia/6aee815c-5a72-45b0-b5c8-6a434e28d0b3/Guide-to-Transfer-Pricing.pdf.xml (Accessed 28 August 2020), p.13. (Here, the authors specifically talk about the primary goal of MNEs.)
[91] OECD, Comparability, para.40.
[92] OECD, Comparability, para.39.

2. INTANGIBLES

2.1 Introduction

2.1.1 Definition of Intangible

When talked about property, the first thing coming to mind is an object that can be *"picked up, passed around, and trampled upon."*[93] Such objects are called tangibles, and usually having a physical form.[94] Tangibles, by themselves, however, do not reflect all assets that can be a matter of business transactions.[95] There are also non-physical property, entitled intangibles. [96] Intangibles *"may not be visible to the naked eye the same way tangible assets are."*[97] Hence, measuring and quantifying intangibles are *"much harder than their tangible counterparts."*[98] Overall, their unique nature gives rise to difficulties in recognizing, delineating, and evaluating intangibles.[99]

> In reference to the significance of intangibles for MNEs, Prasanna has noted that, *"for many MNEs, intangibles play a crucial role in the value creation process. Eighty percent or more of the value in Fortune 500 companies is set to be derived from intangibles that are developed or acquired. Therefore, understanding the role of intangibles in the Value Chain Analysis (VCA) and*

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[93] Mitchell McInnes Ian R. Kerr, and J. Anthony VanDuzer, **Managing the Law: The Legal Aspects of Doing Business,** 5th edition, Toronto: Pearson Canada Inc., 2017, p. 418.

[94] Will Kenton and Margaret James(reviewer), "Tangible Asset", *Investopedia*, 28 June 2020, https://www.investopedia.com/terms/t/tangibleasset.asp#:~:text=A%20tangible%20asset%20is%20an%20asset%20that%20has,though%20the%20liquidity%20of%20different%20markets%20will%20vary. (Accessed 27 August 2020)

[95] Levitt has commented on the use of terms intangibles and tangibles as follows: "*distinguishing between companies according to whether they market services or goods has only limited utility. A more useful way to make the same distinction is to change the words we use. Instead of speaking of services and goods, we should speak of intangibles and tangibles."* See Theodore Levitt, Marketing Intangible Products and Product Intangibles, *Harvard Business Review*, May 1981. https://hbr.org/1981/05/marketing-intangible-products-and-product-intangibles (Accessed 9 June 2020)

[96] To the International Valuation Standards Council, "an *intangible asset is a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner."* See International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, 2016, https://www.ivsc.org/files/file/view/id/647 (Last visited 17 July 2020), para. 20.1.

[97] "Intangible Assets." *Gale Encyclopedia of E-Commerce*, https://www.encyclopedia.com/economics/encyclopedias-almanacs-transcripts-and-maps/intangible-assets#:~:text=Knowledge-based%2C%20intangible%20assets%20are%20sometimes%20referred%20to%20as,and%20find%20ways%20to%20capture%20and%20preserve%20them.,(Last visited 26 August 2020)

[98] "Intangible Assets." *Gale Encyclopedia of E-Commerce*.

[99] "Intangible Assets." *Gale Encyclopedia of E-Commerce*.

identifying the activities that have a significant influence on the value of the intangibles is essential for any valuation."[100]

In the context of transfer pricing, defining the term intangible either too narrowly or broadly may result in difficult circumstances.[101] Dziwiński and Peng have suggested that "*it may be argued by either tax authorities or by taxpayers that a specific item that would normally be treated as an intangible under the specific conditions of the transaction falls out of the scope of the definition."*[102] If an intangible is broadly defined, on the other hand, an item that normally would not be thought of as an intangible under comparable circumstances is to be considered an intangible and thus needed separate remuneration.[103]

To the OECD, the term *" "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."*[104]

With this definition of intangible, the OECD put an emphasis on the arm's length principle's application to transactions involving intangibles, which is occurred between related entities.

Lagarden has listed significant features associated with intangibles as follows[105]:

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[100] Michael Lang, Alfred Storck, Raffaele Petruzzi and Robert Risse (Eds.), **Transfer Pricing and Intangibles: Current Developments, Relevant Issues and Possible Solutions**, Linde, Wien 2019, p.145. [hereinafter *"Lang et al."*] See also Margaret Critzer (presenter), DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg (Accessed 3 August 2020) or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf, p.4, referring to statistics derived from Ocean Tomo, LLC. See Appendix II.

[101] The OECD TP Guidelines, para. 6.5.

[102] Lang et al. (Eds.), p.5.

[103] Lang et al. (Eds.), p.5

[104] The OECD TP Guidelines, para. 6.6. See also Stefaab de Baets, Episode 35 of PwC TP Podcast Series- Special Edition- Big data and global value chain, https://www.pwc.com/gx/en/services/tax/transfer-pricing/podcasts/big-data.html (Accessed 19 June 2020)

[105] Martin Lagarden, "Intangibles in Transfer Pricing Context: Where Does the Road Lead?", IBFD, *International Transfer Pricing Journal*, (September/October 2014), https://www.ibfd.org/sites/ibfd.org/files/content/pdf/itpj_2014_05_int_1-free-article.pdf, (Accessed 1 May 2020), p.335.

- *Lack of physical substance:* This can be regarded as the most significant distinction between tangibles and intangibles.
- *Non-monetary character:* As expressly indicated in the Guidelines, intangibles are non-financial assets.[106]
- *Identifiability*: Whether an item is identifiable is important in terms of its transferability.
- *Separability:* Separability is a prerequisite for transferability. Yet, in determining whether an item is thought of as an intangible, *"separate transferability does not constitute an indispensable element of an intangible."*[107]
- *Controllability*: Owner exercises control over an intangible.
- *Future economic relevance/utility:* Intangibles are expected to bring economic benefits.
- *Different conceivable forms of ownership*.[108]

2.1.1.1 Hard-to-Value Intangibles

Intangibles announce themselves with their uniqueness, and therefore *"potentially comparable uncontrolled transactions are in fact effectively not comparable."*[109] Where the subject intangible is "*unpatented or unbranded*"[110], the valuation even becomes more burdensome. Similarly, the issue gets more complicated when the subject intangible asset has no reliable internal or external comparables, and intangible's value may be difficult to estimate because of the uncertainty of expected future benefits. Or, it may be hard to calculate

[106] The OECD TP Guidelines footnote that *"a financial asset is any asset that is cash, an equity, instrument, a contractual right or obligation to receive cash or another financial asset or to exchange financial assets or liabilities, or a derivative. Examples include bonds, bank deposits, stocks, shares, forward contracts, futures contracts, and swaps."* See also James Chen(author) and Margaret James(reviewer), "Financial Asset", *Investopedia,* 10 July 2020 https://www.investopedia.com/terms/f/financialasset.asp (Accessed 19 June 2020)
[107] Lang et al. (Eds), p.6. See also the OECD TP Guidelines, para.6.8.
[108] Note that in his article "Intangibles in Transfer Pricing Context: Where Does the Road Lead?" Lagarden talks about four different ownership concepts: legal ownership, economic ownership, contractual ownership and beneficial ownership.
[109] Yves Herve & Susann van der Ham, Germany: *Hypothetical Arm's Length Testing and Intellectual Property,* Int'l Tax Review, 27 June 2012, Quoted in (Tian, p.56)
[110]Visconti, p.30.

the amount of profit derived from the exploitation of intangibles since the uncertainty in reference to valuation parameters. Against this background, in the Guidelines, hard-to-value intangibles (HTVI) are described as follows:

> *"The term hard-to-value intangibles covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises,*
> *(i) no reliable comparable exist, and*
> *(ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."*[111]

For example, in cases where an intangible is partially-developed *at the time of the transfer,* this partial development can be associated with hard-to-value intangibles.[112]

2.1.2 Classification of Intangibles

2.1.2.1 General

There are many classifications of intangibles. For example, intangibles can be categorized as "*soft intangibles* and *hard intangibles,"* "*routine intangibles* and *non-routine intangibles*," or "*marketing intangibles* and *trade intangibles."*[113] These categorizations, however, do not reflect an exhaustive list, and *"the catalogue of possible classifications is*

[111] The OECD TP Guidelines, para. 6.189.
[112] The OECD TP Guidelines, para. 6.190. The same paragraph of the Guidelines gives more example of facets regarding HTVI as follows: *"transactions involving the transfer or the use of HTVI […] may exhibit one or more of the following features: […] The intangible is not expected to be exploited commercially until several years following the transaction; the intangible does not itself fall within the definition of HTVI in paragraph 6.189 but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI; the intangible is expected to be exploited in a manner that is novel at the time of the transfer and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain; the intangible, meeting the definition of HTVI under paragraph 6.189, has been transferred to an associate enterprise for a lump sum payment; the intangible is either used in connection with or developed under a CCA or similar arrangements."*
[113] Roberto Moro Visconti, "The Valuation of Intangible Assets: An Introduction", *SSRN Electronic Journal,* 2019, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3413524 (Accessed 3 July 2020), p.3.

much longer."[114] The selection of classification, for practitioners, may be useful in *"the estimate of trendy parameters"*[115] in conducting functional analysis.

2.1.2.2 OECD's Approach

The OECD has asserted in the Guidelines that it is not attempted to *"delineate with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories."*[116] With this in mind, the Guidelines have referred to as *marketing intangibles* and *trade intangibles* on many occasions, and these are included in the Glossary of the Guidelines.[117] This classification refers to *"the kind of activity" which* brings about intangibles' creation.[118] In this regard, marketing intangible is defined as "*an intangible that relates to marketing activities, aids in the commercial exploitation of the product or service and/or has an important promotional value for the product concerned."*[119] Trade intangible is determined as an intangible other than marketing intangible.[120] It has been said that the development of trade intangibles requires risky and costly research and development activities.[121] In light of this background, trade intangibles include[122] patent, industrial design, know-how, and trade secret. On the other hand, marketing intangibles include trademarks, trade names, and customer lists.[123]

2.1.2.3 IVSC's Approach

The International Valuation Standards Council (IVSC) has divided intangibles into five major categories, introduced below. [124]

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[114] Lang et al. (Eds), p.7.
[115] Visconti, p.3.
[116] The OECD TP Guidelines, para. 6.15. See also the UN Manual, para. B.5.2.5.
[117] The OECD TP Guidelines, para. 6.16. See also the UN Manual, para. B.5.2.11.
[118] Evers, p.7.
[119] The OECD TP Guidelines, p.27.
[120] The OECD TP Guidelines, p.33.
[121] Evers, p.7. See also the following in terms of patents: OECD, Guidance on Transfer Pricing Aspects of Intangibles, OECD/G20 Base Erosion and Profit Shifting Project, 2014, http://dx.doi.org/10.1787/9789264219212-en, p.33
[122]Ever's list contains: *"…in particular comprises patents, software, designs, models, and trade secrets".*
[123] Ever listed the followings: *"trademarks and trade names, customer lists, and distribution channels among others".* See also the UN Manual, para. B.1.6.9.
[124]International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3. See also Visconti, p.23.

- Marketing-related intangibles are mainly utilized in marketing or advertising *"products or services."* Trademarks, *"unique trade design,"* and domain names are counted in this category.[125]
- Customer-related intangibles include *"customer lists,"* business' backlog, and contractual and non-contractual relationships with customers.[126]
- Artistic-related intangibles stem from the right to make use of artistic works that can be associated with *"books, films, and music,"* among others.[127]
- Contract-related intangibles constitute *"the value of rights"* caused by inter alia contractual arrangements, *"service or supply contracts,"* lease contracts, *"non-competition agreements,"* and contracts enabling a party to benefit from natural resources.[128]
- Technology-related intangible assets are affiliated with rights to employ *"patented technology, unpatented technology, databases, […] software,"* [129] and so forth.

2.1.2.4 Other Approaches

Lagarden's approach towards the classification of intangibles covers intellectual capital, intangible assets, and intellectual property (IP).[130]

- The term *intellectual capital* indicates such things as *"company reputation and social capital, innovation; human capital; tacit knowledge or knowledge/information capital; organizational synergies; and non-contractual relations to customers or suppliers."*[131] Those are not legally-

[125] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3
[126] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3
[127] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3
[128] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3
[129] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para 20.3
[130] Lagarden, p.334.
[131] Lagarden, p.334.

codified yet can be used as comparability factors in transfer pricing analysis.[132]

- *Intangible assets* include but not limited to *"corporate culture; know-how; operational guidelines; best practices; internal process set-ups or process-embedded technology; training and personnel development measures; and a successful management team."*[133] Those are not legally-codified; however, they can be used in comparability analysis amidst conducting transfer pricing.[134]

- As the last cluster, *intellectual property*(IP) covers intangibles such as *"patents, (trade)marks, different types of rights […] covering the utilization of patents, of literary works, databases, exploration of natural resources or trade secrets or designs.*"[135] IP is *a "sub-set of intangible assets"*[136]*,* which is a "*product of the mind"*[137] or one's "*mental activity"*.[138] The distinctive feature of IP lies in the fact that they are legally protected, meaning that IP rights are legally enforceable rights.[139] Typically, IP rights can be a matter of registration.[140] As well, IP can be transferred from one entity to another through *"acquisition, sale or licensing."*[141]

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[132] Lagarden, p.334.
[133] Lagarden, p.334.
[134] Lagarden, p.334.
[135] Lagarden, p.334.
[136] World Intellectual Property Organization, Module 11: IP Valuation, https://www.wipo.int/export/sites/www/sme/en/documents/pdf/ip_panorama_11_learning_points.pdf(Accessed 24 June 2020), p.5. To prevent possible confusions stemming from the use of different terms, here the term *intangible asset* may be regarded as the umbrella term "intangibles."
[137] McInnes, Kerr and VanDuzer, p.419.
[138] Smyth et al., p. 441.
[139] World Intellectual Property Organization, Module 11: IP Valuation, p.5.
Please note that the source of legal protection may vary from jurisdiction to jurisdiction. In some, it may be common law rules. For instance, trademark can be protected under the tort of passing-off. In some cases, the creation of IP, in itself, is enough for a given right to be legally protected. Typically, copyright protection, for instance, occurs at the time of creation of relevant work without the need for being registered at a relevant body. Sources for this note: Smyth et al, p. 441, 443, 445.; McInnes, Kerr and VanDuzer, p. 420.
[140] Lagarden, p.334.
[141] Lagarden, p.334.

Another classification of intangibles can be based on "*the nature of the benefits"* that they can create.[142] They can be either revenue-increasing or cost-reducing.*[143]* In the case of marketing intangibles, *"future economic benefits"* are generated in the nature of *"increased revenues."[144]* In reference to trade intangibles, they can either lead to an increase in revenues or savings in costs,[145]as the case may be.

2.1.3 Specific Characteristics of Intangibles

To the Guidelines, the followings can be mentioned, among others, as peculiar features of intangibles that can be useful while conducting comparability analysis[146] or in the application of transfer pricing methods based on comparables[147]:

(i) *Exclusivity:* It may be regarded as an important comparability issue if *"the rights in intangibles […] are exclusive or non-exclusive."*[148] For example, in the case of patent-relevant circumstances, exclusive licenses refer to the transfer of *"all the patent rights to a single licensee for the agreed period of time with only title remaining with the patent holder."[149]* Non-exclusive licenses are *"granted to one or many licensees on a variety of different terms."[150]* While having an exclusive rights relevant to a particular intangible may mean that the enjoyment of *"a high degree of market power or market influence,"* non-exclusive rights in most cases do not provide the same extent of power in the market.*[151]*

[142] Evers, p.7.
[143] Monica Boos, **International Transfer Pricing: The Valuation of Intangible Assets**, Hague: Kluwer Law International, 2003, cited in Evers, p.7.
[144]Evers, p.7.
[145] Evers, p.7. (Here, the author refers to terms of product-related intangibles and process-related intangibles.)
[146] The OECD TP Guidelines, pp. 287-290. See also Lang et al. (Eds.), p.112.; the UN Manual, para. B.2.3.2.2. and OECD, Comparability, para. 23.
[147] The OECD TP Guidelines, para. 6.116.
[148] The OECD TP Guidelines, para. 6.118.
[149]McInnes, Kerr and VanDuzer, p. 439.
[150]McInnes, Kerr and VanDuzer, p. 439.
[151] The OECD TP Guidelines, para. 6.118.

(ii) *Extent and duration of legal protection:* This is another crucial comparability element that needs to be taken into consideration. Related to some intangibles, legal protection in a market may be a preventative for others willing to enter into the same market.[152] The legal-protection period may vary from intangible to intangible. For instance, under *the Agreement on Trade-Related Aspects of Intellectual Property Rights*("the TRIPS Agreement"), in reference to the trademark-protection term, it is noted that *"initial registration, and each renewal of registration, of a trademark shall be for a term of no less than seven years,"* which shall be prolonged until forever.[153] Patent protection *"shall not end before the expiration of a period of twenty years counted from the filing date."*[154] Against this background, having a long or short protection period left for an intangible is an important comparability parameter.

(iii) Geographic scope: As indicated in the Guidelines, intangibles' (or rights in intangibles) geographical extent is to be a significant comparability consideration. Granting rights at an international scale may refer to a more valuable situation than granting them confined in *"one or a few countries."*[155]

(iv) Useful life: The useful life of a specific intangible can be associated with *"the nature and the duration of the legal protections,"* and the speed of technological development in relevant sector,[156] among others. In examining an intangible for comparability analysis, its anticipated useful life needs to be taken into account.[157]

(v) Stage of development: For some intangibles, when they become a matter of comparability analysis, it can be important to take their development stage into account. The Guidelines illustrate an example related to a pharmaceutical sector in

[152] The OECD TP Guidelines, para. 6.119.
[153] WTO, "Agreement on Trade-Related Aspects of Intellectual Property Rights," Article 18. Came into effect on January 1, 1995. https://www.wto.org/english/docs_e/legal_e/27-trips.pdf (Accessed 4 August 2020)
[154] WTO, "Agreement on Trade-Related Aspects of Intellectual Property Rights," Article 33.
[155] The OECD TP Guidelines, para. 6.120.
[156] The OECD TP Guidelines, para. 6.121.
[157] The OECD TP Guidelines, para. 6.121.

which *"chemical compounds may be patented, and patents (or right to use the patents) transferred"* between related entities prior to *"further research, development and testing demonstrates that the compound constitutes a safe and effective treatment"* for a specific medical issue.[158] In such circumstances where the transfer takes place in the early stage of intangible's development, it is crucial, in comparability analysis, to examine the probability which subsequent development will cause economically considerable benefits in the future.[159]

(vi) *Expectation of future benefit:* In cases where disparities in forecasted future benefits between two intangibles exist, absent *"reliable comparability adjustments,"* it would be difficult to say the subject intangibles are *"sufficiently-comparable."*[160] In the OECD's words, *"intangibles that provide a basis for high profit products or services are not likely to be comparable to intangibles that support products or services with only industry average profits."*[161]

2.1.4 Illustrated-Items in the OECD Transfer Pricing Guidelines

The Guidelines illustrate eight different items/groups that the first five of which, shown below, are recognized as intangibles.[162] The OECD indicates that illustrated-items are given for clarification purposes.[163] Apart from those illustrated items, others may be considered intangibles for conducting transfer pricing.[164] In that sense, the Guidelines do not deliver a complete list of intangibles.

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[158] The OECD TP Guidelines, para. 6.123.
[159] The OECD TP Guidelines, para. 6.124.
[160] The OECD TP Guidelines, para. 6.127.
[161] The OECD TP Guidelines, para. 6.127.
[162] Lang et al. (Eds.), p.7. See also the OECD TP Guidelines, pp. 253-257
[163] The OECD TP Guidelines, para. 6.18.
[164] The OECD TP Guidelines, para. 6.18. The OECD has suggested that *"the illustrations are not intended to be comprehensive or to provide a complete listing of items that may or may not constitute intangibles. Numerous items not included in this listing of illustrations may be intangibles for transfer pricing purposes*."

Some business components, such as location savings, market features, and group synergies cannot be regarded as intangibles since they cannot be owned and transferred on their own. Despite being not regarded as intangibles, they may be significant value sources for business and impact the arm's length price. Hence, they ought to be considered in transfer pricing analysis. [165]

To the Guidelines, the illustrated items and their qualifications for transfer pricing purposes as follows[166]:

- patent (intangible),
- know-how and trade secrets (intangibles),
- trademarks, trade names, and brands (trademark and trade names are intangibles, and brand may represent intangibles.)
- rights under contracts and government licenses (intangibles),
- licenses and similar rights in intangibles (those rights are intangibles.),
- goodwill and ongoing concern value,
- group synergies (not intangibles),
- market-specific characteristics (not intangibles).

2.2 Items

2.2.1 General

Below, some items will be defined, which may be considered intangibles or, depending upon facts and circumstances of the case, can be important as comparability factors for transfer pricing purposes. It is essential to note that illustrations given below are not intended to be comprehensive and must not be considered *"a substitute"* for an in-depth

[165] Verlinden and Bakker (Eds.), p.22. See also the OECD TP Guidelines, para. 6.9. Besides, Dziwiński and Peng have touched upon the status of goodwill, ongoing concern value, group synergies, and market-specific characters, saying that *"in certain situations, they can affect the determination of an arm's length price and, hence, they should be taken into account in a comparability analysis." This quote is derived from* Lang et al. (Eds.), p.7.
[166] Lang et al. (Eds.), p.7. See also the OECD TP Guidelines, pp. 253-257.

examination.[167] Besides, bear in mind that each country may have particular rules that prevail in its jurisdiction, [168] and these must be considered, where necessary.

2.2.2 Trademark

A trademark is a form of intellectual property, which is used to distinguish one's goods and services from goods and services of others.[169] So, the term trademark refers to marks or names and covers *"two-dimensional and three-dimensional shapes[170], sounds, colours, and other features associated with […] product names."*[171] That is not to say, however, every shape, sound or color can be trademarkable. There are so many cases in which businesses' trademark claims about the shapes of their products are rejected.[172]

It can be said that the distinctive feature of a trademark lies in that it safeguards the related business and its reputation. In that sense, *"reputational assets are usually protected by trademarks."*[173] In other words, *"trademark protects the image and reputation of the business, its brand recognition, and the goodwill that it has developed."*[174] From the business's viewpoint, trademark protection is incredibly vital since customer behavior is fundamentally related to a business's reputation.

The symbol ™ or ® are used to address that a mark is registered. That said, it is not a necessity for a trademark owner to use the mentioned symbols. In other words, as is the case

[167] The OECD TP Guidelines, para. 6.18.
[168] The OECD TP Guidelines, para. 6.18.
[169] The OECD TP Guidelines, para. 6.21. To Article 15(1) of the TRIPS Agreement, "*any sign, or any combination of signs, capable of distinguishing the goods or services of one undertaking from those of other undertakings, shall be capable of constituting a trademark. Such signs, in particular words including personal names, letters, numerals, figurative elements and combinations of colours as well as any combinations of such signs, shall be eligible for registration as trademarks."*
[170] For example, the description posted back to the mouthwash bottle produced by Johnson & Johnson says that "*The LISTERINE® bottle design is a registered trademark of Johnson & Johnson."*
[171] Verlinden and Bakker (Eds.), p.14.
[172] Scheherazade Daneshkhu, "Why you can trademark a Toblerone but not a KitKat: Colour and shape are not always enough for intellectual property protection", *Financial Times*, 27 June 2017, https://www.ft.com/content/16351d98-46d9-11e7-8d27-59b4dd6296b8 (Accessed 2 July 2020)
[173] Verlinden and Bakker (Eds.), p. 14.
[174] McInnes, Kerr and VanDuzer, p.429.

with the use of registered trademarks, *"[…]there is no need to indicate that it is registered in order to obtain the benefits of registration, but it has become common practice, on labels and in advertisements, to use the symbol ™ or ® …"*[175]

To the widely-used classification, trademarks can be categorized as follows[176]:

- *ordinary marks,*
- *certification marks, and*
- *distinguishing guises.*

An ordinary mark refers to as *"any visual characteristic of goods and their presentation."*[177] A certification mark is deemed a reference to the particular quality standard of given goods and services.[178] For instance, if the Tax Law course offered by Marmara University is recognized by the Istanbul Bar Association, a mark addressing this particular recognition is to be considered a certification mark. A distinguishing guise is often associated with "*the shaping of goods or their containers"* in which goods are offered, or how it is packaged.[179] One classic example can be a chocolate bar[180], which is sold in a unique and distinctive package. A given shape may help businesses build and/or increase the value of its reputation.

Consequently, a trademark is a widely-used intangible asset. It provides legally enforceable rights for its owner. As indicated in the Guidelines, *"the registered owner of a trademark may exclude others from using the trademark in a manner that would create confusion in the marketplace."*[181]

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[175] Smyth et al, p.445.
[176] McInnes, Kerr and VanDuzer, p. 430. For quite similar classification, see also Smyth et al., p. 442.
[177] Smyth et al., p. 442.
[178] Smyth et al., p.442.
[179] Smyth et al., p. 442.
[180] For further details, see the following media coverage: Kameron Virk, "Kit Kat case: The food and drinks with trademarked shapes", *BBC News*, 25 July 2018, https://www.bbc.com/news/newsbeat-44953460 (Accessed 8 July 2020)
[181] The OECD TP Guidelines, para. 6.21.

2.2.3 Brand

A brand name is a name that can be a reminder of a business's commercial significance. Although it is not the same as the term "trademark", these terms may be used interchangeably from time to time.[182] As mentioned in the Guidelines, a brand may constitute many *intangibles and/or other items*[183], depending on circumstances. Those may include inter alia *"trademarks, trade names, customer relationships […] and goodwill."*[184] In this respect, sometimes it may be challenging to distinguish components of *brand value, i.e.,* intangibles and/or comparability factors, from one to another.[185]

2.2.4 Patent

The OECD describes a patent as *"a legal instrument"* granting exclusive rights[186] to its owner to use a patented invention for a specified time and within a geographical area.[187] Similarly, the World Intellectual Property Organization (WIPO) defines a patent as an exclusive right with respect to an invention.[188] It is significant to mention that patentability requires the disclosure of relevant information with regard to the subject invention.[189] The Guidelines associates a patent with *"a physical object or a process."*[190] In doctrine, it has been suggested that a patent is obtainable only in cases where the subject invention is:

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[182] The OECD TP Guidelines, para. 6.23.
[183] The OECD TP Guidelines, para. 6.23.
[184] The OECD TP Guidelines, para. 6.23.
[185] The OECD TP Guidelines, para. 6.23.
[186] To Article 28(1) of the TRIPS Agreement, *"a patent shall confer on its owner the following exclusive rights: a) where the subject matter of a patent is a product, to prevent third parties not having the owner's consent from the acts of: making , using, offering for sale, selling, or importing for these purposes that product; b) where the subject matter of a patent is a process, to prevent third parties not having the owner's consent from the act of using the process , and from the acts of: using, offering for sale, selling, or importing for these purposes at least the product obtained directly by that process."*
[187] The OECD TP Guidelines, para. 6.19.
[188] World Intellectual Property Organization, Patents, https://www.wipo.int/patents/en/ (Accessed 3 June 2020)
[189] R. Polk Wagner, "The Patent Document I: Enablement and Written Description", 2014, https://youtu.be/FBgcGuJiYng (Accessed 7 July 2020)
[190] The OECD TP Guidelines, para. 6.19.

"*patentable subject matter, novel, non-obvious, and useful*."[191] Accordingly, it can be put forward that the patented invention produces a unique *"solution to a problem."*[192]

Developers of the patented invention may have invested a considerable amount of time and money prior to the invention comes into being. When an intellectual knowledge is transformed into an invention, the developer may want to recover its costs and further generate income mainly by means of several ways.[193] These are[194]: *"(i)the sale of products covered by the patent,(II) by licensing others to use the patented invention, or (III) by an outright sale of the patent."*

Consequently, a patent is a legal instrument that provides exclusive right to exploit the invention. The registration[195] through national and/or international bodies is also what distinct patents from such intangibles and/or comparability factors as know-how, goodwill, group synergies.

2.2.5 Copyright

Copyright is among intellectual property, which provides its owner exclusive right to copy of his work. Copyright is not about protecting an idea, but instead *"the manner"* wherein the idea is conveyed.*[196]* Accordingly, as noted by Verlinden and Bakker, copyright spring from *"the simple fact of expressing a creation, whether it be a literary, artistic or*

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[191] McInnes, Kerr and VanDuzer, p. 435. For similar information, see also Smyth et al., p. 464

[192] World Intellectual Property Organization, Patents, https://www.wipo.int/patents/en/ (Accessed 3 June 2020) To Article 27(1) of the TRIPS Agreement, *"subject to the provisions […], patent shall be available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step and are capable of industrial application."* Furthermore, the footnote of the article suggests that the *"inventive step"* can be considered the synonym of the term "non-obvious." And, the phrase *"capable of industrial application"* may be thought of as the synonym of the term *"useful."* This information is sourced from Article 27 of the TRIPS Agreement.

[193] The OECD TP Guidelines, para. 6.19.

[194]The OECD TP Guidelines, para. 6.19. See also McInnes, Kerr and VanDuzer, pp. 439-440.

[195] Food for thought: Verlinden and Bakker wrote that *"the report shows that the pharmaceutical and chemical companies consistently appear among the top trademark-registering companies, whereas information and communication technology (ICT) companies are more active in the field of patents."* The mentioned report is the following: Daiko T., Dernis H., Dosso M., Gkotsis P., Squicciarini M., Vezzani A., World Corporate Top R&D Investors: Industrial Property Strategies in the Digital Economy, A JRC and OECD common report, 2017. Luxembourg: Publications Office of the European Union.

[196] McInnes, Kerr and VanDuzer, p. 420.

other type of work."[197] In order for a work to be a subject of copyright protection, it should fulfill the requirements of *"originality," "fixation,"* and author's link to relevant state.[198]

Copyright law's development have a lengthy historical background. At first, it originated to preserve *"the written word after the invention of the printing press."*[199] As time moved on, the scope of protection was widened. Now, copyright protects inter alia drawings, paintings, movies, television broadcasting, and computer software.[200] Relevant international treaties, the Berne Convention and the Universal Copyright Convention, are important to mention.

Copyright protection is associated with the two forms of rights: (i) *economic rights* and (ii) *moral rights*.[201] Economic rights belong to the copyright owner and can be a matter of sale or license agreements. In other words, economic rights are transferable.[202] Moral rights, on the other hand, are separate from economic rights, which also means they are not affected by the transfer of the economic rights.[203] In this regard, moral rights stick to the original author, and always stay with him.[204]

The examples of economic rights include "*right of reproduction and related rights, performing rights, recording rights, motion picture rights, broadcasting rights, and translation and adaption rights."*[205] As it turns out moral rights, a reference is made to article 6^{bis} of the Berne Convention wherein the author's moral rights are illustrated as follows:

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[197] Verlinden and Bakker(eds.), p.275.
[198] McInnes, Kerr and VanDuzer, p. 421.
[199] Smyth et al., p.451.
[200] Smyth et al., p.451. See also Article 2 of the Berne Convention for the Protection of Literary and Artistic Works. https://www.wipo.int/edocs/lexdocs/treaties/en/berne/trt_berne_001en.pdf (Accessed 9 June 2020)
[201] McInnes, Kerr and VanDuzer, pp. 422-424.
[202] Smyth et al., p.454.
[203] Article 6^{bis} (1) of the Berne Convention.
[204] Verlinden and Bakker(eds.), p.278.
[205] Verlinden and Bakker(eds.), p.279.

- *"the right to claim the authorship of the work,*
- *the right to object any distortion, mutilation or other modification of other derogatory action in relation to the work that would be prejudicial to the author's honour or reputation."*[206]

The symbol © indicates copyright.[207] Copyright notice is used to notify users about the creation of the work, copyright ownership, and the work's initial-release year.[208] The said declaration may be useful for risk management purposes. In some cases, for example, it may be used as prima facie evidence.[209] Informing the public about the creation of work may diminish the likelihood of copyright being infringed. Thus, although it may not be compulsory in most instances[210], it is recommended to give the copyright notice where possible.

2.2.6 Confidential Information

Confidential information can be regarded as a source of commercial value for businesses.[211] Building a reputation in a highly competitive market can be so difficult, and

[206] Article 6[bis] (1) of the Berne Convention. See also the following media coverage indicating a case in which the author's moral rights were examined: Star staff, "Dec.3.,1982: Red ribbons removed from Eaton Centre geese after uproar", *The Star*, 7 December 2018, https://www.thestar.com/life/2018/12/07/dec-3-1982-red-ribbons-removed-over-uproar-flashbackfriday.html (Accessed 18 March 2020)

[207] With respect to whether the use of the symbol is mandatory, the Berne Convention and the Universal Copyright Convention have different approaches. To the article (5)2 of Berne Convention, *"the enjoyment and exercise of…rights shall not be subject to any formality; such enjoyment and such exercise shall be independent of the existence of protection in the country of the origin of the work."* Hence, one can state that the convention does not require making use of a copyright notice. To the Universal Copyright Convention, Contracting States may set certain formalities concerning copyright protection. As such, Article 3 has suggested that *"any Contracting State which, under its domestic law, requires, as a condition of copyright, compliance with formalities shall regard these requirements as satisfied with respect to all works protected in accordance with this Convention."*

[208] Verlinden and Bakker (Eds.), p. 277.

[209] Verlinden and Bakker (Eds.), p. 277.

[210] Apart from the above footnote addressing international treaties, Verlinden and Bakker (Eds.) noted that *"many countries that used to expressly require the use of a copyright notice or any other formality, abandoned this when they became party to the Berne Convention."* Also, it has been noted, *"the absence of formalities to comply with in order to benefit from copyright protection is enshrined in several international conventions; today, only a small number of countries are not signatories to at least one of these."* For quotes in this footnote, see the following source: Verlinden and Bakker (Eds.), p. 276.

[211] Smyth et al., p.469.

sometimes it may be so valuable not to release some ideas to outsiders.[212] Against this background, *"confidential information is material exchanged in a relationship that prohibits its recipient from sharing it or otherwise using it to take advantage of the person who communicated it."* [213]

What would happen if a party, who was obligated not to disclose confidential information to the public, goes against this agreement? Well, in these circumstances, one falls short of the non-disclosure requirement. *A breach of confidence* occurs where a party, who was burdened with keeping the respective information secret, uses this information not in accordance with agreed non-disclosure terms by the parties.[214]

As it turns out customer lists, it is important to emphasize their confidential nature. They are usually regarded as confidential information and ought to be protected via contract.[215]

Trade secrets[216] have been deemed a type of confidential information[217], which is critical for business' economic activities in the relevant market. Business, knowing or using trade secrets, is to be "*obtained an advantage over competitors*."[218] Trade secrets may be protected by means of non-disclosure agreements.[219]

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[212] McInnes, Kerr and VanDuzer, p.441.
[213] McInnes, Kerr and VanDuzer, p.441.
[214] McInnes, Kerr and VanDuzer, p.441
[215] McInnes, Kerr and VanDuzer, p. 442
[216] Pursuant to Article 39(2) of the TRIPS Agreement, *"natural and legal persons shall have the possibility of preventing information lawfully within their control from being disclosed to, acquired by, or used by others without their consent in a manner contrary to honest commercial practices so long as such information: (a) in secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question; (b) has commercial value because it is secret; and (c) has been subject to reasonable steps under circumstances , by the person lawfully in the control of the information, to keep it secret."*
[217] McInnes, Kerr and VanDuzer, p. 442
[218] McInnes, Kerr and VanDuzer, p. 442
[219] A non-disclosure provision in the employment contract may be a mean to protect trade secrets of business. Alternatively, business may insert a non-disclosure provision to *contracts for services*. See the following source for this footnote: McInnes, Kerr and VanDuzer, p. 442.

2.2.7 Know-how

The OECD has described know-how as *"proprietary information or knowledge that assist or improve a commercial activity."*[220] One significant feature of know-how is that it is not being registered at a relevant body. Despite that, know-how may be a significant contributor to *"the success of the enterprise."*[221]

Similar to trade secrets, know-how makes reference to the notion of unrevealing valuable information to outsiders, which can be associated with inter alia *"manufacturing*[222]*, marketing, research and development"*[223] functions of a business. The concept of know-how is established on its confidential nature, and it may be protected by means of *"(i)unfair competition or similar laws, (ii)employment contracts, and (iii)economic and technological barriers to competition."*[224]

As mentioned earlier, know-how may be valuable for businesses. In this sense, the origin of marketing term *horizontal segmentation*[225] may provide a captivating food for thought. It illustrates how changing the way of operating business can have a considerable impact on business' profitability and suggests that research and development and marketing, if used efficiently, can play a significant role in the commercial activities of a business.

In his presentation, Malcolm Gladwell tells the story of Moskowitz, whose intellectual knowledge fundamentally led to the changeover, particularly for food business, in a number of industries. His story is as to grasping customer behavior through a number of experiments

[220] The OECD TP Guidelines, para. 6.20.
[221] The UN Manual, para. B.5.2.8.
[222] See Smyth et al., p.469. for the following example: *"a secret manufacturing process […] may be more valuable not patented than patented. And a uniquely efficient way of operating a business, though not capable of being patented at all, may be worth millions in extra profits to its owners."*
[223] The OECD TP Guidelines, para. 6.20.
[224] The OECD TP Guidelines, para. 6.20.
[225] Malcolm Gladwell, *"Choice, Happiness and Spaghetti Sauce"*, 2004, TED Conference, https://www.ted.com/talks/malcolm_gladwell_choice_happiness_and_spaghetti_sauce/transcript (Last visited 7 July 2020)

and then transforming this cumulative set of information into an incredibly valuable practice for business' commercial activities. To Gladwell, Moskowitz's discoveries in the food industry can be seen as "*one of the most brilliant breakthroughs."*[226] Instead of looking for only the kind of most delicious dish, can of coke, or a cup of coffee, understanding the power of variety and offering products according to the clusters in which different tastes provided for different customers can be deemed a result of research and development activities, which leads businesses to make profits of billions of dollars within the short period of time.

2.2.8 Goodwill and Ongoing Concern Value

The term goodwill has many definitions. Also, its meaning may vary from field to field.[227] The OECD has suggested that "*it is not necessary…to establish a precise definition of goodwill or ongoing concern value for transfer pricing purposes or to define when goodwill or ongoing concern value may or may not constitute an intangible."*[228] Simply, it may be considered another value-driver for a business associated with its reputation and brand awareness.[229] In short, goodwill may be described as *"the benefit and advantage of the good name, reputation, and connection of a business."*[230]

To the IVSC, *"goodwill is any future economic benefit arising from a business, an interest in a business or from the use of a group of assets which has not been separately recognized in another asset."*[231] That being said, in the field of accounting, for example, it

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[226] Malcolm Gladwell, *"Choice, Happiness and Spaghetti Sauce*", 2004, TED Conference, https://www.ted.com/talks/malcolm_gladwell_choice_happiness_and_spaghetti_sauce/transcript (Last visited 7 July 2020)
[227] Lang et al. (Eds.), p.8.
[228] The OECD TP Guidelines, para. 6.28. See also the UN Manual, para. B.5.2.22.
[229]Marshall Hargrave and Amy Drury (reviewer), "Goodwill", *Investopedia,* 30 April 2020 https://www.investopedia.com/terms/g/goodwill.asp (Accessed 20 June 2020)
[230] Inland Revenue Commissioners v. Muller, [1901] A.C.217 at 223, quoted in (Smyth et al., p.443.)
[231]International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 20.6. See also the following for quite similar definition of goodwill: the OECD TP Guidelines, para. 6.27. Besides, see the following on non-separable nature of goodwill and ongoing concern value: the UN Manual, para. B.5.2.21.

may be suggested that the value of goodwill is materialized through the figures found on a business's balance sheet.[232]

A goodwill's value is most of the time realized via merger and acquisitions. The IVSC has asserted that *"the excess of the price paid in a real or hypothetical acquisition of a company over the value of the company's other identified assets and liabilities"*[233] indicates the value of goodwill. Ongoing concern value is considered *"the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets."*[234] Overall, it can be said that goodwill [and ongoing concern value], for transfer pricing purposes, ought to be considered in calculating the remuneration for the transaction under examination.[235]

2.2.9 Group Synergies

The OECD has suggested that under some situations, group synergies may be contributors to "*the level of an income"* generated by MNEs.[236] Such synergies are associated with *"central procurement"*[237] and include inter alia:

- "*streamlined management,*
- *elimination of costly duplication of effort,*
- *integrated systems,*
- *purchasing or borrowing power."*[238]

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[232] To paragraph B.2.27 of the UN Manual, *"when a multinational enterprise acquires a company, group of companies or business it may prepare a Purchase Price Allocation for financial accounting purposes."* It provides *"a financial valuation of identified underlying tangible and intangible assets."* To paragraph B.5.6.22. of the UN Manual, "*valuation of intangibles contained in PPAs performed for accounting purposes are not determinative for transfer pricing purposes and should be used with caution and careful consideration of the underlying assumptions."* See also the following source for similar warning: Jon Vine and Greg Smith, "Acquisitions- Are you ready for transfer pricing complexity?", in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.4.

[233] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 20.6.

[234] The OECD TP Guidelines, para. 6.27.

[235] The UN Manual, para. B.5.2.24.

[236] The OECD TP Guidelines, para. 6.30.

[237] The UN Manual, para. B.5.2.29.

[238] The OECD TP Guidelines, para. 6.30.

To the Guidelines, because such synergies cannot be owned or controlled by a business, they are not thought of as intangibles.[239] However, they are regarded as comparability factors in conducting transfer pricing analysis.[240]

2.2.10 Market Specific Characteristics

Market-specific characteristics may be significant factors in calculating the arm's length price of transaction under examination. Given that they cannot be owned or controlled, they are not considered intangibles.[241]The OECD and the UN have given examples of such characteristics as follows:

- *"the high purchasing power of households in a particular market*,
- *low prevailing labor costs*,
- *favourable weather conditions"* [242] , and
- *"raw material costs, transportation costs,*
- *rent and infrastructure costs."*[243]

[239] The OECD TP Guidelines, para. 6.30.
[240] The OECD TP Guidelines, para. 6.30.
[241] The OECD TP Guidelines, para. 6.31.
[242] The OECD TP Guidelines, para. 6.31.
[243] The UN Manual, para. B.2.3.2.51.

3. SPECIAL ISSUES ASSOCIATED WITH INTANGIBLES

3.1 Research and Development(R&D)

In cases where R&D activities are performed by one single entity, the process is referred to as *"independent development of an intangible,"* or the said activities can be carried out by more than one entity coming together, referring to *"joint development of an intangible."*[244] In this regard, relevant several variations can be listed as follows[245]:

- an entity within an MNE group may engage in all R&D activities completely on its own charge by performing all functions needed, using assets, and bear all risks with respect to the R&D activities. Then, the developer-entity gets involved in a contractual relationship via license agreements with other related entities of the MNE; [246]
- *the developer* may enter into *contract R&D* with another related entity and conduct R&D activities on behalf of that related entity;[247]
- entities may enter into a cost-sharing arrangement.[248]

As is the case with independently-developed intangible, one sole entity within the group takes all responsibility for developing the intangible. The entity alone bears all relevant costs and risks, and accordingly, it is entitled to the legal and economic ownership status of the developed intangible.[249] As noted, *"in practice, it often happens that the intangible asset is developed by the parent company, which then grants licences to the various subsidiaries."*[250] Or, it can be seen that R&D-subsidiaries of the *parent company* carry out

[244] Verlinden and Bakker (Eds.), pp. 250-251.
[245] Verlinden and Bakker (Eds.), pp. 247-248.
[246] Verlinden and Bakker (Eds.), p.247.
[247] Verlinden and Bakker (Eds.), p.248.
[248] Alternatively, a Cost Contribution Arrangement can be used.
[249] Verlinden and Bakker (Eds.), p.250
[250] Verlinden and Bakker (Eds.), p.250

development activities of the intangible and then license the intangible to the parent and/or other affiliates.[251]

Where an intangible is developed independently, for transfer pricing purposes, calculating the arm's length price of a transaction may not be complicated because, in such cases, *"legal and economic property in the intangible lies with one single company."*[252]

Jointly-developed intangible, on the other hand, refers to a concept in which the development activities are conducted through the collaboration of more than one entity. Such collaboration is preferred by many businesses in numerous sectors. For instance, pharmaceutical companies commonly participate in joint-development mechanisms to obtain *"specialty know-how."*[253] Accordingly, it has been asserted that *"as the complexity of pharmaceutical R&D has increased significantly, collaborations are increasingly used to get access to the required enlarged set of skills and technologies."*[254] As one may have easily assumed, in this concept, determining an ownership status of each respective contributor requires detailed analysis.

One alternative appearance of joint development is the use of "*contract R&D*."[255] Associated enterprise, as a service provider, conducts R&D activities in exchange for *"service fees"*[256] paid by another entity in the same group, namely the *principal*.[257] The principal bears *"all the costs and risks"*[258] in the development process. Provided that the intangible comes into being, the principal will benefit from the exploitation of the

[251] Verlinden and Bakker (Eds.), p.250
[252] Verlinden and Bakker (Eds.), p.251
[253] Verlinden and Bakker (Eds.), p.251
[254] Verlinden and Bakker (Eds.), p.251 See the following media coverage: Pushkala Aripaka, "AstraZeneca teams up with Oxford University to develop COVID-19 vaccine", *Reuters,* 30 April 2020, https://www.reuters.com/article/us-health-coronavirus-astrazeneca-oxford-idUSKBN22C0UK (Accessed 30 August 2020)
[255] Verlinden and Bakker (Eds.), p.254 See also the following for more comments on contract R&D: Prita Subramanian, Ten Questions on the OECD's DEMPE Concept and Its Role in Valuing Intangibles, 2017, https://tax.kpmg.us/content/dam/tax/en/pdfs/2017/dempe-ten-questions-tmtpr-060117.pdf (Accessed 24 August 2020), pp. 3-4.
[256] Verlinden and Bakker (Eds.), p.254
[257] Verlinden and Bakker (Eds.), p.254
[258] Verlinden and Bakker (Eds.), p.254

intangible.[259] Verlinden and Bakker have noted that the aforementioned contract-based method may result in disputes.[260] Accordingly, the parties to the contract must be careful in formulating the context of it. They are advised to incorporate followings in the contract:

- *"the scope of the services to be provided,*
- *the principal's intention of bearing all risks and costs with respect to the research and development,*
- *the identity of the asset's owner, and*
- *the remuneration to which the researcher is entitled."*[261]

[259] Verlinden and Bakker (Eds.), p.254
[260] Verlinden and Bakker (Eds.), p.254
[261] Verlinden and Bakker (Eds.), p.255.

3.2 Cost Contribution Arrangements

3.2.1 General

The term Cost Contribution Arrangement[262] (CCA) refers to a contractual relationship entered into among affiliate enterprises of the group[263], to define relevant participants' contributions to the value of the subject asset or services. The UN has pointed out that CCAs are created to *"jointly develop, produce or obtain rights, assets or services."*[264]

CCAs have been widely used among MNEs, in relation to the creation of various assets and performing service activities.[265] Accordingly, Dziwiński and Peng have noted, *"[…]CCAs have proven to be a valuable tool among MNEs with decentralized business models in order to develop diverse assets including intangibles by way of joint efforts of specific group entities."*[266] In this regard, CCAs are useful to identify *"the interest of each participant in the intangibles to be developed."*[267]

Pursuant to the Guidelines, the commonly seen CCAs are "*development CCAs"* and "*services CCAs*."[268] The fundamental difference between these two is that while the former is *"expected to create ongoing, future benefits for participants,"* the latter creates *"current benefits only."* [269]

The primary characteristic of a CCA is regarding *"the sharing of contributions.*"[270] Principally, where a CCA containing *"the development, production or obtaining of*

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[262] To Para. 8.3. of the Guidelines, *"cost contribution arrangement (CCA) is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of the intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants."*
[263] The UN Manual, para. B.1.6.26. As noted in para. B.6.11. of the UN Manual, *"CCAs may also include independent parties."*
[264] The UN Manual, para. B.1.6.26.
[265] Lang et al. (Eds.), p.19.
[266] Lang et al. (Eds.), p.19.
[267] The UN Manual, para. B.6.1.1.
[268] The OECD TP Guidelines, para.8.10.
[269] The OECD TP Guidelines, para.8.10.
[270] The OECD TP Guidelines, para. 8.5.

intangibles […]*"*[271], there are to be consequences with respect to the parties' ownership status and/or their *"rights to use or exploit those intangibles."*[272]

With the information gained through the CCA, one can kick off analyzing "*how the responsibilities, risks, and anticipated outcomes were intended to be allocated"* between participants. [273] Bear in mind, however, that looking only at the said arrangement can be misleading under some circumstances. In cases, for example, where there are mismatches between the conduct of participants and the terms of the arrangement, the former also ought to be taken into consideration. Similarly, as declared in the Guidelines, *"the evidence of the conduct of the parties may clarify or supplement aspects of the agreement."*[274]

In cases where insufficient contributions assumed or made by a party/parties to a CCA, the arrangement needs to be adjusted through balancing payments.[275] By doing that, the non-arm's length CCA can be transformed into the arm's length CCA. Similarly, under certain situations, it is also possible to expect, while entering into the CCA, to make periodic adjustments in the future.[276]

3.2.2 Development CCAs

To the Guidelines, *"under a development CCA, each participant has an entitlement to rights in the developed intangible(s)*[…] *such rights often take the form of separate rights to exploit the intangible in a specific geographic location or for a particular application.*" [277] In this regard, the rights may represent legal ownership. Or, one of the participants becomes a legal owner while the others are entitled to rights to benefit from the property.*[278]*

[271] The OECD TP Guidelines, para. 8.5.
[272] The OECD TP Guidelines, para. 8.5. Accordingly, paragraph B.6.2.3. of the UN Manual suggests that *"a participant in a CCA involving intangibles is entitled to use its interest in the intangibles in accordance with its share of the intangible and cannot be required to pay a fee or royalty to use its interest in the intangible."*
[273] The OECD TP Guidelines, para.8.9.
[274] The OECD TP Guidelines, para.8.9.
[275] The UN Manual, para. B.6.6.2.
[276] The UN Manual, para. B.6.6.3. See also Lang et al. (Eds.), pp.102-103.
[277] The OECD TP Guidelines, para.8.11.
[278] The OECD TP Guidelines, para. 8.11.

Development CCAs frequently incorporate a substantial degree of risks stemming from the situation of uncertainty.[279] R&D activities and performing marketing functions are considered among the forms of contributions to the development CCA.[280]

Having a CCA entered into may annihilate the complexity of multiple transactions. [281] To the OECD, "a *CCA … can eliminate the need for complex cross-licencing arrangements and associated allocation of risk, and replace them with a more streamlined sharing of contributions and risks, with ownership interests of the resulting intangible(s) shared*" in compliance with the provisions of the arrangement. [282]

With regard to jointly-conducted R&D activities[283], Lagarden uses the term *"pooling concept"*[284] by illustrating potential challenges as follows:

- "*the valuation and pricing of pre-existing relevant IP (and/or intangibles) when an R&D pool is formed for the first time,*
- *the pricing of entry or exit fees for…pool participants over time,*
- *the establishment of (an) arm's length allocation key(s) for ongoing R&D expenses incurred by pool members,*
- *and also the question of ownership of the IP that is newly created in the pool."*[285]

3.2.3 Participants of CCAs

The OECD has emphasized in the Guidelines that a CCA must be built upon "*the concept of mutual benefit."*[286] That is, a party without actual expectation of benefit out of the

[279] The OECD TP Guidelines, para.8.10.
[280] The UN Manual, para. B.6.4.2.
[281] The UN Manual, para. B.6.1.3. See also Lang et al. (Eds.), p.92.
[282] The OECD TP Guidelines, para.8.7.
[283] In the course of development and/or the use of IP that *"potentially bundled together with, or linked to other IP and/or intangibles.",* said Lagarden.
[284] Lagarden, p.333.
[285]Lagarden, p.333.
[286] Lang et al. (Eds.), p.93.

CCA may not be regarded as a participant.[287] By noting that, the OECD tries to prevent artificial collaborative activities among related entities.[288]

Likewise, Simone and Sansing have noted that *"the share of development costs paid by…subsidiary should be proportional to its expected share of benefits generated by the IP."*[289]Also, the UN has mentioned, *"a CCA will fail the arm's-length test if the contributions of the participants are inconsistent with their share of expected benefits."*[290] Sometimes, it is possible to see that associated enterprises may enter into a well-designed contractual relationship to override the arm's length principle. In such cases, it would not have served the arm's length purpose had the reviewer merely look at what was written in the contract. In determining whether a party to the CCA is actually a participant, the OECD has given more importance to *"actual contributions instead of contractual contributions."*[291]*"The rule is substance is key"*[292]*,* and the arrangement is assumed to be built upon an economically-valid basis.

In reference to valuing each participant's contribution to the arrangement, the OECD puts an emphasis on the arm's length principle.[293] In this regard, the base of calculation will be what unrelated parties *"would have agreed to contribute under comparable circumstances given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement."*[294] In other words, it is assumed that what a participant has agreed to put into the CCA must be commensurate with what the participant expects to benefit out of that arrangement.[295]

[287] The OECD TP Guidelines, para. 8.13.
[288] More specifically, to para 8.15 of the Guidelines, *"a party would not be a participant in a CCA if it does not exercise control over the specific risks it assumes under the CCA and does not have a financial capacity to assume these risks."* See also Lang et al. (Eds.), p.93 and p.94.
[289] De Simone and Sansing, p.7.
[290] The UN Manual, para. B.1.6.28. See also the OECD TP Guidelines, para. 8.5.
[291] Lang et al. (Eds.), p.19.
[292] Verlinden and Bakker (Eds.), p.255
[293] The OECD TP Guidelines, para.8.12.
[294] The OECD TP Guidelines, para.8.12.
[295] Lang et al. (Eds.), p.93.

3.2.4 Similar Concept: Cost Sharing Agreements

Sometimes, it is possible to encounter different terms such as *"cost sharing agreement (CSA)"*[296] or *"cost sharing arrangement (CSA)."*[297] The idea of CSA goes back to 1966, in which the Internal Revenue Service and the US Treasury made an announcement of new regulations containing rules for CSAs.[298] The notion of CCAs, however, came into being in 1997, through the OECD Guidance.[299]

In Okten's words, "*a CSA may be entered into only with regard to joint intangible property development, whereas a CCA may be entered into for joint intangible property development as well as service arrangements that do not lead to intangible property."*[300] In other words, the significant distinction lies in their scopes.[301] However, as indicated, two concepts have commonalities.

In practice, an MNE may use a CSA as part of its tax planning strategy.[302] The concept of cost-sharing is established upon the notion that *"an MNE would not know in advance whether the R&D activities would be successful or not."*[303]As Ting noted, *"if the research turns out to be unsuccessful, the MNE lose the deduction of the R&D costs borne by the subsidiary."*[304] Moreover, *"the cost sharing regime provides a legal mechanism or a MNE to shift offshore profits from intangibles to low-tax countries."*[305] Keep in mind, however, that developments in relation to transfer pricing and cost contribution mechanisms

[296] Fedan, p.8.
[297] Tian, pp.53-55.
[298] Rezan Okten, "A Comparative Study of Cost Contribution Arrangements: Is Active Involvement Required to Share in the Benefits of Jointly Developed Intangible Property?", January/February 2013, IBFD, *International Transfer Pricing Journal*, https://www.ibfd.org/sites/ibfd.org/files/content/pdf/itpj011301.pdf, (Accessed 11 July 2020), p.4.
[299] Okten, p.4.
[300] Okten, p.4.
[301] Yariv Brauner, Changes? BEPS, Transfer Pricing for Intangibles, and CCAs (March 8, 2016). Global Transfer Pricing Conference - WU - Proceedings, 2016, https://ssrn.com/abstract=2744730 (Accessed 11 July 2020), p.15.
[302] Tian, p.53.
[303] Antony Ting, iTax - Apple's International Tax Structure and the Double Non-Taxation Issue (March 19, 2014). British Tax Review 2014 No.1, Available at SSRN: https://ssrn.com/abstract=2411297 (Last visited 11 July 2020), p. 48. See also the UN Manual, para. B.6.2.1.
[304] Ting, p. 48.
[305] Ting, p. 48.

may require MNEs to restructure their previously-entered cost sharing or cost contribution arrangements.[306]

3.2.5 Termination

When a CCA is terminated, each participant ought to be awarded their share of interest in the subject matter of the arrangement.[307] In cases where a participant giving up its share of interest in the CCA, respective payment ought to be made by other participants to the leaving-party.[308]

[306] Jon Vine and Greg Smith, "Acquisitions- Are you ready for transfer pricing complexity?", in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.5.
[307] The UN Manual, para. B.6.7.7.
[308] The UN Manual, para. B.6.7.7.

3.3 Ownership of Intangibles

3.3.1 General

In doctrine, Lagarden describes the term ownership as *"a comprehensive bundle of rights and duties over a certain property or economic good."*[309] Ownership, in this respect, refers not only rights but also duties. It is worth mentioning the distinction between ownership and possession. Possession makes reference to "*a practical control of a person"* over specific "*property or economic good."*[310] One can be an owner of a thing, but this does not always mean that he must be in possession of a given thing, and vice versa.

For transfer pricing purposes, the subject intangible and ownership status of each party to the respective transaction needs to be identified. Identification is necessary prior to allocate profits derived from the exploitation of the subject intangible.[311] In this respect, the determination allows a reviewer to proceed with transfer pricing analysis towards arriving at arm's length price/profit allocation in reference to the transaction under review.

Two fundamental ownership concepts are legal ownership and economic ownership. Broadly speaking, while the former is not a source of disagreements, there are various understandings stemming from the concept of the latter.[312] Apart from these two concepts, in doctrine beneficial ownership is discussed. The mentioned concept is premised upon *"economic perspective"* as is the case with economic ownership.[313]

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[309] Lagarden, p.336.
[310] Lagarden, p.336.
[311] Lang et al. (Eds.), p.9.
[312] Lang et al. (Eds.), p.9.
[313] Lagarden, p.336. To Lagarden, the notion of beneficial ownership is frequently explained by referring to that *"the beneficial owner may be bearing costs and economic risks of certain intangibles. […] This interpretation is very similar, if not identical, to the concept of economic ownership […] In another interpretation, the legal owner of an intangible asset is acting according to instructions received from undisclosed 'true owner', i.e. the beneficial owner."*

3.3.2 Legal Ownership

Generally speaking, the concept of legal ownership is built upon a recognition by relevant national public authority.[314] In this aspect, the ownership status is provided for an applicant through *"application, enrolment or registration at, and/or issuance*"[315] by the respective body. In Lagarden's words, *"depending on the IP item under consideration and the desired legal title, this may not only be a formal administrative act."*[316] Under some circumstances, the process to be granted legal ownership status may require different actions or can be more complicated.[317] As is the case with copyright, for example, the endowment of the ownership status does not happen at the time of recognition made by a relevant organization but rather happens through the author's mere declaration.[318] On the other hand, as is the case for patents, a legal ownership status may be granted by an authorized body after a detailed assessment procedure.[319]

With respect to some intangibles, the right to exploit respective intangible can be protected by relevant laws and registration systems[320], and the legal owner, accordingly, can be identified by those systems. For instance, WIPO's Madrid System in reference to trademark registrations[321] and the International Patent System under the Patent Cooperation Treaty[322] with the Patentscope[323] can be mentioned here. In the case of other intangibles such as trade secrets and know-how, where there exists "*unauthorized appropriation or imitation,"* the identification of the legal owner can be established via "*unfair competition legislation, other enforceable laws, or by contract."*[324] Contrary to this statement, sometimes it might not be possible to identify the legal owner of the subject intangible by means of

[314] Lagarden, p.336.
[315] Lagarden, p.336.
[316] Lagarden, p.336
[317] Lagarden, p.336.
[318] Lagarden, p.336
[319] Lagarden, p.336
[320] The OECD TP Guidelines, para. 6.37.
[321] WIPO, "Madrid-The International Trademark System", https://www.wipo.int/madrid/en/ (Accessed 17 June 2020)
[322] WIPO, "PCT-The International Patent System", https://www.wipo.int/pct/en/ (Accessed 3 June 2020).
[323] WIPO, "Patentscope", https://www.wipo.int/pct/en/faqs/faqs.html (Accessed 17 July 2020)
[324] Lang et al. (Eds.), pp. 9-10. See also the OECD TP Guidelines, para. 6.38.

"relevant laws or written contracts."[325] In such cases, the identification is established by looking at *"the entity that effectively controls decisions concerning the exploitation of the intangible and has the de facto capacity to restrict others from using it."*[326]

For an item to be considered an intangible in the context of transfer pricing, legal protection is not a must. In other words, even though an item is not legally protected, it can be regarded as an intangible for transfer pricing purposes.[327] That being said, when an intangible gets benefits from legal protection, it is to be useful in determining legal owner[328] and accordingly proceeding with transfer pricing analysis.

A legal owner is the one who "*has the sole right to use the intangible at stake and prevent others from consuming it for commercial reasons."*[329] That being said, being granted a legal ownership status does not always mean the legal owner deserves all remuneration arising out of the exploitation of the intangible.[330] In different words, *"the mere ownership of the intangibles does not indicate that the legal owner should be entitled to automatically to all of the returns…generated by the intangible."*[331] Likewise, the UN has suggested that *"it is not the case that legal owner of an intangible, purely by virtue of its ownership, is entitled to the returns associated with the intangible."*[332]

For example, Company A, a parent company of MNE group, is the legal owner of the Software Program A. If Company B and Company C, subsidiaries of the parent company A, contribute to the development of a given software program by means of functions performed,

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[325] Lang et al. (Eds.), p.10.
[326] Lang et al. (Eds.), p.10. See also the UN Manual, para. B.5.3.9. and the OECD TP Guidelines, para. 6.40.
[327] P. Ludovici, Transfer Pricing and Intangibles, in: Transfer Pricing Fundamentals: A Practical Guide, M.Lang, G. Cottani, R. Petruzzi, A. Storck (Ed.), Kluwer Law International B.V., 2019, p.421, Quoted in Lang et al. (Eds.) , p.9. See also Ronald van den Brekel(moderator), OECD BEPS Project Outcomes Part 5: Transfer Pricing and Actions 8-10, EY Global Tax Webcast, 2015, https://youtu.be/AECVmy9_PeE (Accessed 7 August 2020)
[328] Lang et al. (Eds.), p.9.
[329] Lang et al. (Eds.), p.9.
[330] Verlinden and Bakker (Eds.), p.33. See also the UN Manual, para. B.1.6.13.
[331] Verlinden and Bakker (Eds.), pp.249-250.
[332] The UN Manual, para. B.5.3.10. See also Gowling WLG, p.11. and the OECD TP Guidelines, para. 6.42., suggesting that ""*for transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible."*

assets utilized, and risk assumed, the effort of subsidiaries must be compensated, in accordance with the arm's length principle. In other words, although the parent company is the legal owner of the software program, the other two subsidiaries, as economic owners, ought to benefit from the exploitation of a given intangible to the extent of their respective contributions.

3.3.3 Economic Ownership

Economic ownership is a concept associated with an entity contributing to the development, enhancement, maintenance, protection, and exploitation of the subject intangible and assuming the relevant risks.[333] The concept of economic ownership is related to the idea of *"economic fairness."*[334] If an entity participates in the value of respective intangible, from the economic fairness standpoint, the entity's contribution needs to be compensated.[335] Similarly, Dziwiński and Peng have noted that *"...an entity that makes economic sacrifices to the R&D activities is entitled to a fair share of intangible-related returns."*[336] In other words, the entity's efforts need to be remunerated in proportionate to its contribution to the value of the intangible. The form of contribution may take many forms, such as funding and bearing risks of R&D activities.[337]

To sum up, it is important to recall, "*legal and economic ownership do not necessarily have to belong to the same company."*[338] For transfer pricing purposes, the consideration must be given to the determination of the owner(s) of the intangible under examination. Accordingly, the benefit derived from exploiting the subject intangible is deemed to have split on a pro-rata basis.

[333] Verlinden and Bakker (Eds.), p. 250.
[334] Lagarden, p.337.
[335] Lagarden, p.337.
[336] Lang et al. (Eds.), p.10.
[337] Lang et al. (Eds.), p.10.
[338] Verlinden and Bakker (Eds.), p.248.

3.4 Transfer of Intangibles

3.4.1 General

In doctrine, *acquisition or sale* and *licensing* are counted among major cross-border intangible-related intra-group transactions.[339] Sometimes, intangibles are transferred between affiliates together with other intangibles.[340] That makes it harder for one to identify subject intangibles, ownership status of relevant parties, and accordingly, conducting transfer pricing. Besides, in cases where intangibles' transfer occurs in a combined manner with other transactions[341], conducting transfer pricing may be challenging.[342] In this respect, *IP Service Agreements* will also be illustrated below.

3.4.2 Acquisition or Sale

In the first variation, *acquisition or sale*, the ownership of the subject IP is transferred from one related entity to another in the same group. Camargo has noted on sale activity , *"an outright sale of an intangible[…] generally involves the transfer of all substantial rights and obligations in the intangible, including the exclusive right to use, develop, or otherwise exploit in an unencumbered manner[…]"*[343] The transfer price of such sale is assumed to be set in compliance with the arm's length principle. In other words, prior to finalizing the transaction, the arm's length price is to be set by means of transfer pricing methods and, if needed, valuation techniques.[344]

As noted by Fedan,

"… strategy usually includes selling the intellectual property assets for a lower price to a company located in a country which does not tax full income

[339] Lagarden, p.333.
[340] The OECD TP Guidelines, para 6.92.
[341] The OECD TP Guidelines, para. 6.98.
[342] The term "package deal" refers to the agreement containing *"a number of elements including leases, sales and licenses all packaged into one deal."* This information is derived from the UN Manual, para. B.2.3.1.13.
[343] Bruno A de Camargo, "Outright sale of IP: practical considerations post-BEPS" in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.17.
[344] Lagarden, p.333.

from royalties, and using related companies(to the subsidiary) to conduct the business activities to transfer the royalties' payment in order to deduct paid royalties from the income and to reduce the total tax burden of the whole group of the companies."[345]

Implementing non-traditional strategies, companies utilizing cloud computing, for example, prefer to relocate affiliate service providers in low-tax jurisdictions rather than transferring IP ownership between related entities, from one jurisdiction to another.[346]

Accordingly, Tian noted, *"...with current CC technology, the MNEs IT infrastructure, such as servers, data centers, and other facilities, can be located almost anywhere with little to no effect on business activity."*[347] *[...] "The implementation of cloud computing technology significantly changed the landscape of traditional Transfer Pricing strategies adopted by MNEs for intangibles."*[348]

3.4.3 Licensing

As is the case with *licensing*[349], rights in intangibles are transferred from one entity to its affiliate. In such circumstances, the rights are regarded as intangibles for transfer pricing purposes.[350] Transfer price in this transaction must be set in accordance with the arm's length principle.[351] The difference between the acquisition or sale activities and licensing lies in that the latter does not involve the transfer of ownership among entities. But rather, a licensor

[345] Fedan, p.10.
[346] Tian, pp. 48, 52.
[347] Tian, p.49.
[348] Tian, p.55
[349] For example, on trademark-licensing, Article 21 of the TRIPS Agreement has suggested that *"members may determine conditions on the licensing and assignment of trademarks, it being understood that the compulsory licensing of trademarks shall not be permitted and that the owner of a registered trademark shall have the right to assign the trademark with or without the transfer of the business to which the trademark belongs."* As is the case with the transfer of patents or patent-related licensing, Article 28(2) of the TRIPS Agreement has noted that *"patent owners shall also have the right to assign, or transfer by succession, the patent and to conclude licensing contracts."*
[350] The OECD TP Guidelines, para. 6.26.
[351] Ditz, p.133.

provides *"the contractual right to use"*[352] specific IP[353] for the licensee.[354] In other words, the transfer of rights in intangibles, in that respect, would not have to affect the intangible's legal ownership, instead, it brings "*a separate right of use"* into existence for the transferee.[355]

3.4.4 Added Complexity: IP Service Agreements

Intellectual Property (IP) service agreement is an agreement through which not only an IP are transferred[356] between associated enterprises but also support services are included in the agreement.[357] In such cases, *"arriving at a 'proper' transfer price is a complex task because of the difficulty in identifying intangibles and services which were transferred or provided and the price at which they are to be valued."*[358] Increased complexity of the intangible-related transaction makes it difficult to conduct transfer pricing. Accordingly, as noted by Tian, *"bundling the IP with related support services makes the transaction price difficult to estimate, and it becomes more difficult for a tax authority to review in accordance with the ALP."* [359]

When "*intangibles or rights in intangibles'"*[360] transfer occurs along with other business transactions[361], how should the transfer price be set? Should the pricing be conducted on *a transaction-by-transaction basis*? Or, is it possible to price the transaction as a whole? With the OECD's general approach towards the arm's length principle, one can argue that the principle's application will be on "*a transaction-by-transaction basis*."[362]

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[352] Lagarden, p.333.
[353] Lagarden footnotes this may be *"potentially bundled together with, or linked to other IP and/or intangibles."*
[354]Lagarden, p.333.
[355] The UN Manual, para. B.5.3.8.
[356] Probably with other intangibles and/or rights in intangibles.
[357]Tian, p.52.
[358] United Nations, Working Draft Chapter 1: An Introduction to Transfer Pricing, para. 1.9.
[359] Song Haining, "How to Deal With the use of Intellectual Property Tax Avoidance by Multinational Companies?" , Patent Expresso, 2014, Quoted in (Tian, p.52.) The abbreviation "ALP" refers to the arm's length principle.
[360] The OECD TP Guidelines, para. 6.88.
[361] Lang et al. (Eds.), p.118.
[362] Lang et al. (Eds.), p.118.

Notwithstanding the foregoing statement, in cases where *"separate transactions are so closely linked or continuous that they cannot be valued adequately on a separate basis. "*[363]

As mentioned in the Guidelines[364], franchising arrangements[365] may be used for the *"transfers of intangibles or rights in intangibles"*[366] along with other transactions. Franchising refers to a contractual relationship through which one party, a franchisor, *"employs the assistance of other persons or business* [a franchisee] *entities to reach out to a wider public."*[367] The franchisor grants a license to the franchisee in exchange for consideration. Typically, the agreement enables the franchisee to sell franchisor's products and use franchisor's *name and trademark* in his operations.[368]

> Andree and Liebchen have suggested by referring to the Guidelines that *"Under such an arrangement* [franchising]*, one member of an MNE group licenses various intangibles such as trademarks, know-how, and recipes and provides consulting, supervision, training, commissioning, and other support services […]. In such a case, the interaction between various intangibles and services enhances the value of both so that the combination of services and intangibles cannot be valued adequately on a separate basis."*[369]

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[363] Lang et al. (Eds.), p.118. See also the following in which the authors commented on the case in which separately valuation of transactions/items may not reflect accurate value of the whole transfer. Yutaka Kitamura and Jun Sawada, "Moving away from traditional methods: lessons from recent Japanese TP cases" in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.23.

[364] The OECD TP Guidelines, para. 6.100.

[365] With regard to the use of franchising industry in North America, Statista has suggested that "*in 2018, it is estimated that there will be some 759,200 franchise establishments in the United States, outputting some 760 billion US dollars and employing over eight million people."* See the following for this note: E. Mazareanu, Franchising in the U.S. – Statistics & Facts, 2019, https://www.statista.com/topics/5048/franchising-in-the-us/(Accessed 23 June 2020) Similarly, as noted by Smyth et al., in Canada, franchising is associated with a large fraction-approximately fifty percent of total retail sales. For this note see Smyth et al., p.375. A large portion of the franchising industry is made of fast-food restaurants. Apart from this, real estate, commercial services, and residential services are to be considered important sectors in the industry. See E. Mazareanu,
https://www.statista.com/topics/5048/franchising-in-the-us/ (Accessed 23 June 2020)

[366] The OECD TP Guidelines, para. 6.88.

[367] Smyth et al., p.375.

[368] Smyth et al., p.375.

[369] Lang et al. (Eds.), p.119.

One other relevant example given in the UN Manual is where *"the case of transactions involving the licensing of know-how to associated manufacturers together with the supply to the licensed associated manufacturers of components needed to exploit such know-how."*[370]

Overall, the transfer of intangibles or rights in intangibles may come together with the transfer of other assets or services.[371] It goes without saying that when this is the case, the conducting transfer pricing and ultimately arriving at the right arm's length price will be more challenging for both taxpayers and tax authorities.

[370] The UN Manual, para. B.2.3.1.12.
[371] To para.B.2.3.2.17. of the UN Manual, the term *"intelligence loading refers to the process of loading software and other intelligence features on the manufactured meter."*

4. ANALYSING TRANSACTIONS INVOLVING INTANGIBLES

4.1 Six-Step Approach

The approach indicated in the Guidelines for delineating intangible-related transactions for transfer pricing purposes can be sketched out as follows: [372]

i) Identification of the subject intangibles and *"economically significant risks"* with regard to development, enhancement, maintenance, protection and exploitation (DEMPE) of the subject intangibles.

ii) Determination of contractual arrangements and a legal owner, as well as contractual assumption of risks.

iii) Conducting functional analysis to discover parties and their DEMPE-related contributions to the subject intangibles, and finding out parties controlling outsourced functions[373] and "*specific, economically significant risks."*

iv) Verifying that contractual arrangements entered into reflect the actual conducts of the parties, as well as finding out economically-significant-risk-assuming party meets the requirements set out in paragraph 1.60 of the Guidelines.

v) Delineation of the subject transaction by taking into account the intangible's legal ownership, other respective contractual arrangements and actual conduct of the parties.

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[372]The OECD TP Guidelines, para. 6.34. See also Taxand, Global TP Conference: DEMPE of Intangibles, 2018, https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), pp. 9-10. and Subramanian, p.2.

[373] Outsourcing is described as *"a strategy by which an organization contracts out major functions to specialized and efficient service providers who ultimately become valued business partners."* This information is derived from Marty Pine, "Why Companies Outsource", 2019.https://www.thebalance.com/why-do-companies-outsource-2553035 (Accessed 28 June 2020). See also the following source indicating outsourcing activities of pharmaceutical industry through *Contract Research Organizations:* Kathlyn Stone, "What Are Contract Research Organizations- CRO?", 2019. https://www.thebalancesmb.com/contract-research-organizations-cro-2663066 (Accessed 28 June 2020) Nowotny has noted by referring to the Guidelines that the owner would not necessarily have to perform all respective functions by himself. Outsourcing-activity is possible. Yet, if this is the case, *"the crucial question relating to the allocation of return is whether the IP owner is controlling the outsourced function. In this respect, the OECD refers to the control-over-risk concept...the final conclusion is that if an IP owner does not perform function or control function, he should not be entitled to any return which is related to the function."* See the following for this quote: Clemens Nowotny, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg (Accessed 3 August 2020) See also Gowling WLG, p.14.

vi) Arm's length pricing of the subject transaction in line with respective parties' contributions to it.

Verlinden and Bakker have suggested, *"legal rights and contractual arrangements form the starting point, based on written contracts, public records, or other correspondence and communications."*[374] In the absence of such arrangements or in cases where the actual behaviour of parties to the transaction does not match what was written in the contract, *"the transaction will be delineated on the actual facts, including the conduct of the parties."*[375]

Similar perspective as to the importance of contracts in delineating a transaction under examination has been given by Camargo as follows: *"contracts are paramount in defining the parameters of the transfer. It is also important to understand the commercial rationale for the transfer, ascertain the realistically available options of both buyer and seller […]"*[376]

4.2 Functional Analysis[377]

4.2.1 General

In conducting functional analysis for cases involving intangibles, the overriding objective is to allocate profits derived from the exploitation of the subject intangible at arm's length. When determining entities' share of contribution to the value of a relevant intangible/transaction for arm's length profit allocation, functions performed, assets used, and risks assumed by related entities will be examined. In this regard, the distribution of

[374] Verlinden and Bakker (Eds.), p.33.
[375] Verlinden and Bakker (Eds.), p.33.
[376] Bruno A de Camargo, "Outright sale of IP: practical considerations post-BEPS" in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.18.
[377] Some refer to Value Chain Analysis (VCA) in determination of functions performed, assets used and risk assumed by the parties. See the followings for example: Sanjay Kumar(presenter), Profit Split Method: New OECD Guidance and practical applications, Deloitte Dbriefs Transfer Pricing Series, 2018, https://youtu.be/7QI5WdRBeqw (Accessed 3 August 2020) Furthermore, it has been asserted, by referring to *"public comments to the 2016 Discussion Draft"*, that *"value chain analysis was synonymous with the functional analysis."* For quotes mentioned, see Mayer|Brown, Transfer Pricing: The New Frontier, Value Chains and Supply Chains in a Post-BEPS World, 5 March 2019, https://www.youtube.com/watch?v=zhWDv0Z9J3I or https://www.mayerbrown.com/-/media/files/perspectives events/events/2019/03/valuechainsandsupplychainsinapostbepsworld.pdf (Accessed 29 August 2020), p.10.

"intangible-related returns"[378] may incorporate complexity and requires a detailed review process.

From an international taxation perspective, the question is how to split relevant intangible-related returns among associated enterprises located in different tax jurisdictions.[379] This is an important issue at stake, especially for tax authorities and countries wherein MNEs operate business since taxable intangible-relevant income is the revenue source. Besides, it is argued that relevant tax administrations became strongly-interested in transfers of intangibles[380] now that the transfer is likely to have consequences related to profit allocation between various jurisdictions.

4.2.2 DEMPE Concept

4.2.2.1 General

The OECD puts an emphasis on some functions that can be associated with, in the light of each party's respective contributions, the determination of ownership status of relevant parties, and the arm's length profit allocation.[381] These functions reiterated in the Guidelines are *"development, enhancement, maintenance, protection and exploitation"* (DEMPE) of relevant intangible. The DEMPE functions are used to manage and control the IP[382] as well as other intangible assets, depending upon circumstances. The UN Manual has pointed out that *"while DAEMPE[383] activities might seem to be limited to functions, in fact they often*

[378] With regard to intangible-related returns, a distinction can be made between ex-ante remuneration and ex-post remuneration. While the former makes reference to *"the future income expected to be derived by a member of the MNE group"*, the latter is related to *"the income actually earned by a member of the group through the exploitation of the intangible."* This information is sourced from paragraph 6.44 of the OECD TP Guidelines.
[379] Evers, p.17.
[380] Ditz, p.138.
[381] Tracee Fultz(presenter), OECD BEPS project outcomes Part 5: Transfer Pricing and Actions 8-10, EY Global Tax Webcast, 2015, https://youtu.be/AECVmy9_PeE (Accessed 7 August 2020)
[382] Christine Saliba, Episode 23 of PwC TP Podcast Series: US Tax reform and the impact on operating models, https://www.pwc.com/gx/en/services/tax/transfer-pricing/podcasts/us-tax-reform-and-the-impact-on-operating-models-episode-23.html (Accessed 16 June 2020)
[383] Note that the UN prefers to use the acronym DAEMPE, standing for *"development, acquisition, enhancement, maintenance, protection, and exploitation"* of relevant intangible. The term *acquisition* refers to cases where intangible is acquired from third parties. See the UN Manual, para. B.5.3.13.

reflect contributions of assets and the assumption of risks as well."[384] In other words, while conducting intangible-related transfer pricing, assets and risks also need to be taken into account.[385]

Prior to the OECD introduced the DEMPE concept, the legal owner, by itself, was able to have all relevant income derived from the exploitation of the subject intangible. However, this is no longer the case. Now, the relevant income is to be divided between respective entities, in line with the share of their DEMPE-related contributions.[386]

Despite not defining *"the concept of ownership of intangibles in an overly comprehensive way"*[387], the OECD has put an emphasis on the need for identification of each associated entity's contribution to the value of the intangible, which makes it possible to split the income derived from the exploitation of the subject intangible among the entities, in accordance with the arm's length principle.[388]

> Verlinden and Bakker have stated the following:
> *"While the legal owner may receive proceeds, other group members may have performed functions, used assets and/or assumed risks that may contribute to the value of the intangible in question and so should be compensated with an arm's length renumeration for such efforts."*[389]
>
> Similarly, the UN has noted, *"various entities within an MNE group may participate in intangibles development through functions like research, development, marketing, providing funding for acquisition and development*

[384] The UN Manual, para. B.5.3.14.
[385] The UN Manual, para. B.1.6.12.
[386] Kris(Kestutis) Rudzika, "DEMPE explained", Linkedln, 25 August 2017, https://www.linkedin.com/pulse/dempe-explained-kestutis-rudzika/ (Accessed 24 August 2020) See also Gowling WLG, pp.14-15, suggesting that *"in a post-BEPS world, less emphasis is placed on legal ownership and more on economic aspects of substance."*
[387] Verlinden and Bakker (Eds.), p.249.
[388] The OECD TP Guidelines, para. 6.32. See also Subramanian, p.1.
[389] Verlinden and Bakker (Eds.), p.249.

of intangibles, and exploiting intangibles in a wide range of business activities. These activities should be rewarded on an arm's length basis."[390]

In Taxand's Global TP Conference, DEMPE functions have been introduced as follows[391]:

- Development refers to *"everything associated with coming up with ideas for intangibles, and putting plans and strategies in place for their creation."*
- Enhancement means *"continuing to work on aspects of intangibles to make sure they can perform well at all times and continue to be improved."*
- Maintenance is as to *"actions that ensuring intangibles continue to perform well and generate revenue."*
- Protection is associated with *"ensuring that the value of the intangible remains strong."*
- Exploitation is related to *"the way in which intangibles are used to generate profits."*

4.2.2.2 Functions and Assets

The OECD has given following examples in the Guidelines as DEMPE-related important functions that can be examined in functional analysis:

"… design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings including determining the course of "blue-sky" research[392], control over strategic

[390] The UN Manual, para. B.5.1.2.
[391] Taxand, Global TP Conference: Dempe of Intangibles, 2018, https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), p.6.
[392] The term blue-sky research refers to *"research that is done without a particular end or application in mind." This information is derived from blue-sky research. (n.d.)* Farlex Dictionary of Idioms. 2015. https://idioms.thefreedictionary.com/blue-sky+research(Accessed 20 August 2020)

decisions regarding intangible development programmes, and management and control of budgets."[393]

The Guidelines further exemplify other significant functions that can be considered in functional analysis. Those are: *"important decisions regarding defence and protection of intangibles, ongoing quality control over functions performed by independent or associated enterprises that may have a material effect on the value of the intangible."*[394]

To the Guidelines, *"…assets may include, without limitation, intangibles used in research, development and marketing, […]physical assets, or funding."*[395] In reference to funding activities, Subramanian addresses the OECD's standpoint by suggesting that *"funding of the intangible in itself has little or no claim on the returns from the intangible, if that funding is not provided by an entity having people controlling that funding and making important decisions related to the DEMPE of the intangible."*[396]

4.2.2.3 Risk-Assumption

4.2.2.3.1 General

Despite having been defined in various ways, risk, for transfer pricing purposes, can be regarded as "*the effect of uncertainty"* related to the business objectives.[397] As noted in the Guidelines, *"in all of a company's operations, every step taken to exploit opportunities, every time a company spends money or generates income, uncertainty exists, and risk is assumed."*[398]

The OECD has noted specific risks associated with intangibles as follows:[399]

[393] The OECD TP Guidelines, para. 6.56.
[394] The OECD TP Guidelines, para. 6.56.
[395] The OECD TP Guidelines, para. 6.59.
[396] Subramanian, p.3. See also Gowling WLG, p.14.
[397] The OECD TP Guidelines, para. 1.71.
[398] the OECD TP Guidelines, para. 1.71.
[399] The OECD TP Guidelines, para. 6.65. See also Visconti, p.15.

(i) "risks related to development of intangibles […];[400]

(ii) the risk of product obsolescence […];[401]

(iii) infringement risk […];[402]

(iv) product liability and similar risks related to products and services based on the intangibles; and

(v) exploitation risks, uncertainties, in relation to the returns to be generated by the intangible."

In examining risks related to DEMPE functions of the subject intangible, the OECD refers to the general risk assessment procedure that can be found in Chapter 1 of the Guidelines. In this regard, Nowotny has summarized the risk-assessment procedure as follows[403]:

(i) Identification of *"economically significant risks;"*

(ii) Determination of "*contractual assumption of risks;"*

(iii) Conducting *functional analysis* in reference to *"assumption and management of risks;"*

(iv) Determining if *"the contractual assumption of risks"* is in line with parties' actual conducts*;*

(v) "If party assuming risk does not exercise control over risk or have the financial capacity to assume the risk> allocate risk to party having most control and having financial capacity to assume risk"; and

(vi) Pricing stage.

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[400] To paragraph 6.65 of the Guidelines, those include*"[…] the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-away through the development process, or at a late stage will impact the level of the underlying investment risk)"*

[401] To paragraph 6.65 of the Guidelines, this includes "*[…] the possibility that technological advances of competitors will adversely affect the value of the intangibles."* Maron has suggested that *"new products are always killing old ones."* There is a high probability of that as is the case with intangibles. As further noted, *"technological advances and innovative production methods are just two forces of change that see companies rise and others fall."* See the following source for the aforesaid quotes: Donald Marron (Ed), **30-Second Economics: The most thought-provoking economic theories, each explained in half a minute**, Toronto: Prospero Books, 2017, p.76-77.

[402] To paragraph 6.65 of the Guidelines, this includes "*[…] the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming, costly and/or unavailing."*

[403] Clemens Nowotny, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), p.14. See also the OECD TP Guidelines, para. 6.66, 6.67, and 1.60.

4.2.2.3.2 Control over Risk

In reference to the assumption of risks, a distinction can be made between the concepts of control-over-risk and risk management[404]. The OECD has differentiated these two in chapter 1 of the Guidelines.

The assumption of risk necessitates the control-over-risk as well as being financially capable of assuming relevant risk.[405] Then the question is what the control-over-risk concept requires. The answer lies in paragraph 1.65 of the Guidelines, asserting that the control-over-risk concept calls for the first two components of risk management, but not the third one.

> That is, a party assuming DEMPE-related risks must have *"(i)the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function."* [406]

Consequently, through functional analysis, DEMPE contributions must be examined in order to determine the share of each contributor to the value of the intangible. It is a daunting task and requires a detailed functional analysis. Accordingly, Paumier addresses the significant source of difficulties in conducting DEMPE analysis: *"within a MNE, this difficulty resides in the decision making process that spread across all the hierarchical layers*

[404]The OECD TP Guidelines, para.1.61. Accordingly, the risk management is made of following three components: *"(i)the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function; (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function; and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation."* See also Gowling WLG, p.13.
[405] Lang et al. (Eds.), p.13.
[406] The OECD TP Guidelines, para. 1.65.

of a given organization or unit."[407] Nowotny has elaborated on the delineation of the aforesaid process as follows: *"By breaking down the major functions to sub-processes…, you find out that it's really on a case-by-case basis[...]"*[408]

4.2.2.4 RACI Concept

The RACI is a concept that is used by businesses in determining *"roles and responsibilities"*[409] of parties in relation to primary duties.[410] The term RACI stands for *"responsible, accountable, consulted, and informed"*[411] in connection with the foregoing duties and process. The concept is to be considered a significant tool while conducting value chain analysis[412] by making it possible to identify the weight of respective entities' contributions to, for example, intangible development.

> Dziwiński and Peng have indicated the RACI concept as follows[413]:
> *""Responsible" describes those employees who do the work to complete a task. "Accountable" represents the employees who are held accountable for a given task and who delegate the work to the "responsible." "Consulted" refers to those employees whose opinions are sought, typically subject matter experts, and with whom there is a two-way communication. Finally, "informed" are those who are kept updated on the progress of the given task (often only a completion of the task) and with whom there is only one-way communication."*

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[407] Phillipe Paumier, "TP aspects of intangibles: How deep should DEMPE be?", 2020, https://www.internationaltaxreview.com/article/b1kblpstc76wl3/tp-aspects-of-intangibles-how-deep-should-dempe-be (Accessed 24 August 2020)
[408] Clemens Nowotny, DEMPE of Intangibles Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg (Accessed 3 August 2020)
[409] Lang et al. (Eds.), p.14.
[410] Lang et al. (Eds.), p.14.
[411] Lang et al. (Eds.), pp. 14-15.
[412] Lang et al. (Eds.), p. 15.
[413] Lang et al. (Eds.), pp. 14-15.

Likewise, Storm mentioned about the RACI concept through which *"the degree of involvement in business processes is identified."*[414] When applying RACI concept in reference to DEMPE contributions, *"you have to make scales of involvement,"*[415] she said. In this regard, the concept is useful to make a distinction between strongly-involved parties and weakly-involved parties to the relevant process.[416]

Storm has asserted 5-step approach in analysing the relevant contributions/process through the RACI concept.[417] Those are:

(i) Identification of *"the mega processes;"*[418]

(ii) Fractionating *"the mega processes"* into smaller *"sub-processes;"*[419]

(iii) Determining *the sub-processes'* weight in terms of *"the overall value chain;"*

(iv) Determining *"contribution to the mega processes"* via the RACI concept*;*

(v) Determining the fraction of contributions to *"the mega-process"* via the RACI concept.

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[414] Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg (Accessed 3 August 2020)

[415] Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg (Accessed 3 August 2020)

[416] Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf.(Accessed 3 August 2020), p.23.

[417] Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), pp.24-26. See also Mayer|Brown, p.22.

[418] The term mega process refers to *"main processes (series of activities)"* in value generation within the enterprise. *"Research and development," "production,"* "sales and after-sales" activities are examples of mega processes. The information is sourced from Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), p.24.

[419] Sub-processes are considered significant, making it possible to identify key success elements with regard to value chain in the enterprise. In this step, the identification of the most important value drivers-such as *know-how and project management* is established. For the source of this information and examples of sub-process, see Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf (Accessed 3 August 2020), p.24.

To the RACI concept, the extent of involvement is greatest for those who is "responsible" for the respective process. The responsible party is followed by those who is *accountable*, *consulted* and *informed*, in terms of *the degree of involvement*.[420] Against this background, one can suggest that the RACI concept could be useful in measuring the DEMPE contributions of relevant entities to business processes associated with intangibles.

[420] Christina Storm, DEMPE of Intangibles, Taxand's Global TP Conference, 2018, https://youtu.be/eOVo_dUmvjg or https://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf(Accessed 3 August 2020), p.26.

4.3 Transfer Pricing Methods

4.3.1 General

In reference to the application of the arm's length principle and accordingly conducting transfer pricing analysis, the OECD provides five methods in the Guidelines.[421] These are clustered as traditional transaction methods and transactional profit methods. [422]

The traditional transaction methods are:

(i) Comparable Uncontrolled Price Method,
(ii) Resale Price Method, and
(iii)Cost-Plus Method.

The transactional profit methods are:

(i) Transactional Net Margin Method and
(ii) Transactional Profit Split Method.

Depending upon facts and circumstances of the case, one works towards finding the most appropriate method[423] by considering a number of factors,[424] which also means that there is no clear-cut and sole applicable method for every case.[425]

For intangible-related transfer pricing matters, generally, feasible methods are the comparable uncontrolled price method and the transactional profit split method.[426] The

[421] The OECD TP Guidelines, pp. 101-145.
[422] The OECD TP Guidelines, pp. 97-100.
[423] The OECD TP Guidelines, pp. 97-100.
[424] According to paragraph 2.2 of the OECD TP Guidelines, those are: "*the respective strength and weaknesses of the OECD recognized methods; the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or methods; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.*"
[425] The UN Manual, para. B.1.5.1.
[426] Lang et al. (Eds.), p.21. See also the UN Manual, para. B.5.6.32 and Ditz, p.136.

Guidelines have noted that *"one-sided methods, including the resale price method and the TNMM, are not generally reliable methods for directly valuing intangibles."*[427]

4.3.2 Traditional Transaction Methods

4.3.2.1 General

The traditional transaction methods are thought of as "*the most direct means of establishing conditions in the commercial and financial relationships between associated enterprises are at arm's length."*[428] Because of that, in appropriate circumstances in which both "*a traditional transaction method and a transactional profit method can be applied in an equally reliable manner,"* the former's application takes precedence over the latter's use.[429] As an example of the aforesaid notion, in Germany, the appropriate method for transfer pricing must be selected pursuant to the hierarchy of transfer pricing methods wherein traditional transaction methods are '*the highest-ranked in the hierarchy*."[430] If those are not suitable for the individual case, then other transfer pricing methods can be examined in terms of their appropriateness.[431]

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[427] The OECD TP Guidelines, para. 6.141. In the same way, Foley has mentioned, while talking about his practical experiences, that *"the idea of one-sided analysis is getting more and more difficult to sustain."* This information is sourced from Sean Foley, Transfer Pricing Implications in a post-BEPS and post-US tax environment, 19th Annual NYU/KPMG Tax Symposium, 2019, https://youtu.be/Bx8T8SRKNks (Accessed 4 August 2020)

[428] The OECD TP Guidelines, para. 2.3. See also Stefano Simontacchi, Rethinking International Tax Law: Video 4.3 of Module 4: "Traditional Transaction Methods", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/z9ssH/traditional-transaction-methods (Accessed 23 May 2020)

[429] The OECD TP Guidelines, para. 2.3.
See also Stefano Simontacchi, Rethinking International Tax Law: Video 4.3 of Module 4: "Traditional Transaction Methods", LeidenUniversity|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/z9ssH/traditional-transaction-methods(Accessed 23 May 2020)

[430] Richard Schmidthe, Bjorn Heidecke and Oskar Glaser, "The hypothetical arm's-length test: Germany's way of calculating the ALP for IP", in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.11.

[431] Richard Schmidthe, Bjorn Heidecke and Oskar Glaser, "The hypothetical arm's-length test: Germany's way of calculating the ALP for IP", in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.11. The authors further noted that *"if none of the aforementioned methods is applicable […], the so-called hypothetical arm's-length test must be performed."* See also p.12 of the same source for detailed analysis as to the hypothetical arm's length principle.

4.3.2.2 Comparable Uncontrolled Price Method (CUPM)

According to the OECD TP Guidelines, the core of comparison under the CUP method is made of analyzing *"the price charged for property or service transferred in a controlled transaction and the price charged or services transferred in a comparable transaction either internal or external, under comparable circumstances."*[432] In conducting comparability analysis, the comparison between a controlled transaction and an uncontrolled transaction is made depending upon the availability and reliability of information regarding those transactions.

Where appropriate, the comparable uncontrolled price method is preferred over other transfer pricing methods.[433] It has been delivered in the Guidelines that *"where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply to the arm's length principle."*[434]

Where the CUP method is applied with reference to intangible-related transactions, an analyst must pay attention to the comparability factors. In this respect, the comparability analysis is conducted by reference to the intangible in the controlled transaction and the intangible in a comparable uncontrolled transaction.[435]

In certain circumstances, an MNE group acquires an intangible from independent enterprise. Without further ado, the intangible is transferred between associated enterprises of the same group. In this case, for example, the CUP method may be the appropriate transfer pricing method since the price paid by the MNE to the independent enterprise for the

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[432] The OECD TP Guidelines, para. 2.14. See also the UN Manual, para. B.1.5.4. and Stefano Simontacchi, Rethinking International Tax Law: Video 4.3 of Module 4: "Traditional Transaction Methods", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/z9ssH/traditional-transaction-methods (Accessed 23 May 2020)

[433] The OECD TP Guidelines, para. 2.3.
See also Stefano Simontacchi, Rethinking International Tax Law: Video 4.3 of Module 4: "Traditional Transaction Methods", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/z9ssH/traditional-transaction-methods" (Accessed 23 May 2020)

[434] The OECD TP Guidelines, para. 2.14.

[435] The OECD TP Guidelines, para. 6.146.

acquisition of the intangible may be a reliable comparability factor because of the short time lag between two transactions.[436]

Lagarden has argued *"as comparability requirements are most comprehensive[437] in the case of the CUP method, in many cases involving unique and valuable intangibles[438], the CUP method may not be applicable[…]"*[439] In this respect, the OECD's approach towards the reliability of application of the CUP method can be found in the following words: *"the[…]method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises."*[440]

4.3.2.3 Resale Price Method (RPM)

In the application of the RPM, an analysis is premised upon that *"the price of which the product purchased from a related party is resold to an independent party"*.[441] Whether the RPM is suitable for transfer pricing matters involving intangibles, it has been asserted, *"the conditions for applying this method are met only in exceptional sublicensing cases when the intangibles are licensed intra-group and sublicensed to third-party licensees."*[442]

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[436] The OECD TP Guidelines, para. 6.147.

[437] To paragraph 2.15 of the OECD TP Guidelines, "*if one of the two conditions is met, an uncontrolled transaction is comparable to a controlled transaction: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or b) reasonably accurate adjustments can be made to eliminate the material effects of such differences."*

[438] Pursuant to paragraph B.5.2.15 of the UN Manual, unique and valuable intangible is *"an intangible which is not present in otherwise comparable uncontrolled transactions(unique) and; leads to significant expected premium value in business operations(valuable)."* In the same way, paragraph 6.17 of the OECD TP Guidelines has qualified *unique and valuable intangibles* as follows: *"i) that are not comparable to intangibles used by or available to parties to potentially comparable transactions, and ii) whose use in business operation (e.g. manufacturing, provision of services, marketing, sales or administration) is expected to yield greater future economic benefits than would be expected in the absence of the intangible."* It has been noted that "*intangibles are very often unique, and adequate comparables are rarely available."* This quote is derived from Lang et al. (Eds.), p.22.

[439] Lang et al. (Eds.), p.62. See also Ditz, p.135, noting that *"the scope of application of the comparable uncontrolled price method for the purposes of determination of appropriate royalties is normally limited due to the fact that the intangible property involved in any given case is likely to be of a unique nature."*

[440] The OECD TP Guidelines, para. 2.24.

[441] Stefano Simontacchi, Rethinking International Tax Law: Video 4.3 of Module 4: "Traditional Transaction Methods", Leiden University|Coursera, 2015, https://www.coursera.org/learn/international-taxation/lecture/z9ssH/traditional-transaction-methods(Accessed 23 May 2020)

[442] Lang et al. (Eds), p.113. See also Ditz, p.135.

4.3.2.4 Cost-Plus Method (CPLM)

Due to the limited relationship[443] *between "the cost of developing intangibles and their value contribution"*[444], this method is unlikely to be plausible for transfer pricing matters involving intangibles. Notwithstanding the foregoing statement, in some cases, the use of the cost-based method[445] is possible. Where accessing reliable data through internal comparables, especially for those intangibles that are not unique and valuable, the application of cost-based methods may produce a reliable outcome.[446]

4.3.3 Transactional Profit Methods

4.3.3.1 General

Under some circumstances, transactional profit methods are most likely to provide accurate arm's length calculation. When the case involves intangibles, the application of the transactional profit split method, deserves further attention. Visconti has indicated that *"the use of profitability parameters is usually considered to be the most representative of company dynamics."*[447] With *"the growing acceptance of the practical importance of the profit-based methods,"*[448] the transactional profit split method is frequently used by taxpayers and tax administrations.

4.3.3.2 Transactional Net Margin Method (TNMM)

In the application of this method, a comparison is made *between "the net profit margin […] that the tested party earns in the controlled transactions"* and *"the same net profit*

[443] To paragraph 6.142 of the OECD TP Guidelines, *"the use of transfer pricing methods that seek to estimate the value of intangibles based on the cost of intangible development is generally discouraged. There rarely is any correlation between the cost of developing intangibles and their value or transfer price once developed. Hence, transfer pricing methods based on the cost of intangible development should usually be avoided."*
[444] Lang et al. (Eds.), p.113. See also Ditz, p.134, suggesting that "*in actual practice […] the amount of royalties will regularly be determined not so much on the basis of costs incurred by the licensor as on the basis of the future benefit to the licensee."*
[445] The Guidelines refer to terms of *reproduction cost* and *replacement cost.*
[446] The OECD TP Guidelines, para. 6.143.
[447] Visconti, p.16.
[448] The UN Manual, para. B.1.5.12.

margins earned" in a comparable uncontrolled transaction.[449] The UN has addressed the TNMM's use under the residual analysis of transactional profit split method. It suggests *"in practice, TNMM is used to determine the appropriate return in Step 1 of the residual analysis."*[450] Hence, the residual analysis is to be discussed in detail in the following chapter, for the time being, no need exists to mention about the application of it.

4.3.3.3 Transactional Profit Split Method (TPSM)

4.3.3.3.1 General

Under the TPSM, the objective is to ascertain that profits derived from controlled transaction is allocated between related entities in line with the arm's length principle.[451] In this regard, the term *arm's length profit allocation* refers to dividing relevant profits among associated enterprises as though it was split between independent enterprises. The crucial question is how the relevant profit allocation would have been done between independent enterprises under comparable circumstances.[452] Accordingly, to the UN Manual*, "external market data (e.g. profit split percentages among independent enterprises performing comparable functions) should be used to value each enterprise's contribution, if possible […]"*[453]

One of the concerns raised in practice and touched upon by the OECD in the revised guidance is that since the TPSM is seldomly applied between unrelated entities, the method's use between related entities ought to be rare accordingly.[454] However, in the event that the

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[449] The UN Manual, para. B.3.3.2.2. See also the UN Manual, para. B.1.5.8, suggesting that this method "*determines the net profit margin relative to an appropriate base realized from the controlled transaction by reference to the return realized by the comparable independent enterprise*."
[450] The UN Manual, para. 3.3.14.4.
[451] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, 2018, http://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf (Accessed 26 July 2020), para. 2.114.
[452]OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.114. To this provision, the TPSM *"first identifies the profits to be split from the controlled transactions- the relevant profit- and then splits them between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length."* See also the UN Manual, para. B.1.5.9.
[453] The UN Manual, para. B.3.3.13.3.
[454] David Bell(moderator), Profit Split Method: New OECD Guidance and practical applications, Deloitte Dbriefs Transfer Pricing Series, 2018, https://youtu.be/7QI5WdRBeqw (Accessed 3 August 2020)

TPSM is to be identified as the most appropriate, the aforesaid argument does not seem reasonable given that transfer pricing methods would not necessarily be meant to duplicate *"arm's length behaviour, but rather to serve as a means of establishing and/or verifying arm's length outcomes for controlled transactions."* [455]

The use of transactional profit split method is generally appropriate in cases:[456]

- where there are "*highly integrated operations"*[457] among parties to a controlled transaction,
- where parties to the transaction *"make unique and valuable contributions,"*[458]
- when parties to the transaction *"share the assumption of one or more of the economically significant risks in relation to that transaction,"*[459] or in situations where parties to the transaction separately assume *"the economically significant risks"*, however, those risks are so closely connected each other.[460]

[455] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.124.
[456] David Bell(moderator), Profit Split Method: New OECD Guidance and practical applications, Deloitte Dbriefs Transfer Pricing Series, 2018, https://youtu.be/7QI5WdRBeqw (Accessed 3 August 2020) See also OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.127, asserting that in circumstances where *"one party to the transaction performs only simple functions, does not assume economically significant risks in relation to the transaction and does not otherwise make any contribution which is unique and valuable, a transactional profit split method typically would not be appropriate since a share of profits…would be unlikely to represent an arm's length outcome for such contributions or risk assumption."*
[457] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, p.9. and para. 2.120. See also para. 2.133 of the same Guidance for the following reference: The term *highly integrated operations* refers to "*the way in which one party to the transaction performs functions, uses assets and assumes risks is interlinked with, and cannot reliably be evaluated in isolation from, the way in which another party to the transaction performs functions, uses assets and assumes risks."*
[458] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, p.9, para. 2.119., and 2.126. See also the UN Manual, para. B.1.6.16. and para. B.3.3.13.1. See also Lang et al. (Eds), p.114. and p.117. As addressed by Andree and Liebchen, we talk about the existence of unique and valuable contributions *"if they are not comparable to contributions made by uncontrolled parties in comparable circumstances and if they represent a key source of actual or potential economic benefits in the business operations that are concerned."*
[459] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para.2.139.
[460] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para.2.140.

Functional analysis goes hand in hand with the application of transactional profit split method. The relevant profit derived from the controlled transaction must be split between the related parties in accordance with economic realities.[461] For instance, assume that a case where a parent of an MNE group and its two subsidiaries participate in the development of new intangible. A remuneration derived from the exploitation of the intangible must be allocated to the extent each of the parties' contributions to the development activities employing DEMPE-related functions performed, assets used, and risk assumed.

Accepting the existence of many ways for splitting the profits, the OECD has given detailed information about two approaches, namely *Contribution Analysis* and *Residual Analysis*.[462] As noted, the primary goal shall be *"to approximate as closely as possible"* the way profits would have been allocated if the parties had not been related to each other.[463]

4.3.3.3.2 Contribution Analysis

To the OECD, contribution analysis is *"an analysis used in the profit split method […], supplemented where possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances."*[464] Contribution analysis is conducted by *"a full split of the relevant profit"* between relevant contributors throughout *"the entire supply chain."*[465] It has been argued that applying to the contribution analysis is not easy since *"external market data"* representing profit distribution made by unrelated entities under similar situations is generally not accessible.[466]

[461] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.114.
[462] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.149. See also the UN Manual, para. B.3.3.14.1.
[463] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para.2.146.
[464] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.150. See also the following for the similar definition of contribution analysis: the UN Manual, para. B.3.3.14.2.
[465] Lang et al. (Eds), p.116.
[466] The UN Manual, para. B. 3.3.17.4.

4.3.3.3.3 Residual Analysis

As noted in the UN Manual, *"the residual analysis is typically applied to cases where both sides of the controlled transaction contribute valuable intangible property to the transaction."*[467] Under the analysis, related entities, firstly, are remunerated *"based on their routine activities, risks and assets."*[468] What is left, then, is divided among the entities in proportionate to their contributions to the intangible's value. [469] Andree and Liebchen noted, *"categorizing expenditures into routine and non-routine for determining routine returns based on the routine expenditures and for splitting the residual profit based on the ratio of the non-routine expenditures is often used in practice."*[470]

The profit allocation through the residual analysis is conducted in two steps.[471] Firstly, the routine contributions of related entities involved in a controlled transaction are remunerated on an arm's length basis. Routine contributions, in this regard, are *"typically less complex contributions for which reliable comparables can be found."*[472] For instance, the determining and distributing relevant profit for "*manufacturing activities"* can be considered here.[473] In this initial stage, the allocated remuneration does not contain *"a return for possible valuable intangible assets owned by the associated entities."* [474] As well, this initial allocation is made by means of *"one of the traditional transaction methods or a transactional net margin method."*[475] Upon the step-1 allocation, the residual amount of profits is split between related entities in a commensurate manner with each party's respective contribution to the transaction. For example, where the remaining amount

[467] The UN Manual, para. B. 3.3.14.5.
[468] De Simone and Sansing, p. 6.
[469] De Simone and Sansing, pp. 6-7. See also Lang et al. (Eds.), p.62.
[470] Lang et al. (Eds.), p.115.
[471] Yutaka Kitamura and Jun Sawada, "Moving away from traditional methods: lessons from recent Japanese TP cases" in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), p.22.
[472] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.152.
[473] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, p.42.
[474] The UN Manual, para. B. 3.3.14.4.
[475] OECD, Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS Action 10, para. 2.152.

stemmed from intangibles, this residual amount is to be split pro rata respective entities' contributions.[476]

The UN has addressed two reasons why the use of residual analysis is preferred more than the use of contribution analysis.[477] The first lies in that the residual analysis is conducted in two steps, transforming complex analysis mechanism into the easier one. Secondly, the application of residual analysis, due to splitting the profits generated via routine functions in the first step, decreases "*the amount of profit"* allocated in the probable *"more controversial second step",* which also gives rise to diminishing the likelihood of having a conflict with tax authorities.[478]

4.3.4 Economic Valuation and Transfer Pricing[479]

4.3.4.1 General

An asset's value is related to *"the value of the future economic benefits"*[480] derived from it. It is possible to estimate the value of an asset through the use of indicators, known as valuation parameters. In this respect, the estimation suggests *"the process of…measuring…the value or worth of an asset."*[481]

A great deal of emphasis is put on the possible use of economic valuation techniques in transfer pricing matters involving intangibles. For instance, in 2016, the European

[476] The UN Manual, para. B. 3.3.14.4. See also para. B.3.3.14.5 of the UN Manual for the relevant example: *"Company X manufactures components using valuable intangible property and sells these components to a related Company Y which uses the components and also uses valuable intangible property to manufacture final products and sells them to customers. The first step of a residual analysis would allocate a basic (arm's length) return to Company X for its manufacturing function and a basic (arm's length) return to Company Y for its manufacturing and distributing functions. The residual profit remaining after this step is attributable to the intangible properties owned by the two companies. The allocation of the residual profit is based on the relative value of each company's contributions of intangible property."*
[477] The UN Manual, para. B. 3.3.14.7.
[478] The UN Manual, para. B. 3.3.14.7.
[479] Please note that economic valuation is a very broad subject and necessitates an in-depth analysis. In this regard, the relevant chapters of this study should not be seen as comprehensive for a detailed analysis.
[480] World Intellectual Property Organization, Module 11: IP Valuation, p.6.
[481] World Intellectual Property Organization, Module 11: IP Valuation, p.6.

Commission released its report in which intangible's valuation in the context of transfer pricing was examined.[482]

In 2017, European Union Joint Transfer Pricing Forum published its report stating that *"[…] when the economic valuation relates to an asset which yields cash flows, transfer pricing method may be embedded into the economic valuation techniques as part of their application."*[483] Similarly, the Guidelines have asserted that *"valuation techniques that estimate the value of projected future cash flows derived from the exploitation of the transferred intangible or intangibles can be particularly useful when properly applied."*[484]

4.3.4.2 Valuation Approaches

There are *"empirical approaches"* based upon *"the practical observation of the market prices"*[485] of the subject intangible and *"analytical approaches"*, which are *"accepted by theory and consolidated by practice."*[486] Depending upon facts and circumstances of the case, one selects the most appropriate technique and then applies it to the case for figuring out the value of intangible under review.

Verlinden and Bakker have given the classification of valuation approaches as follows: "*market approaches, asset or cost approaches, and discounted income stream of cash flow methods."*[487] Similarly, Lang et.al. have grouped applicable valuation approaches as: *"discounted cash flow (DCF), replacement/replication cost, and market approach."*[488]

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[482] Deloitte and European Commission, the Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, 2016, https://op.europa.eu/en/publication-detail/-/publication/e7dbd290-c682-11e6-a6db-01aa75ed71a1, (Accessed 6 July 2020), pp. 62-94.
[483] European Union Joint Transfer Pricing Forum, Draft Report on the Use of Economic Valuation Techniques in Transfer Pricing, 2017, https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf003rev2017enecovaldraft_en.pdf *(Accessed 6 July 2020),* para. 5.
[484] The OECD TP Guidelines, para. 6.153. See also the UN Manual, para. B.5.6.29 and Verlinden and Bakker (Eds.), p.86.
[485] Visconti, p.2.
[486] Visconti, p.2.
[487] Verlinden and Bakker (Eds.), p.86
[488] Lang et al. (Eds.), p.22.

Likewise, Schaffers and Vanluydt have grouped valuation approaches into three categories: cost approach, market approach and income approach.[489]

In this regard, three valuation approaches can be listed as follows:

- Cost-Based Approach: Typically, it's discouraged since intangible's value *"may have no or limited connection to the costs incurred in its development."*[490] This approach is often associated with the cost-plus method.[491]

- Market-Based Approach: Valuation based on this approach envisages the value of the subject intangible in relation to "*market prices."*[492] The market-based approach may not be plausible for the valuation of intangibles. The reason can be the lack of *"available (or disclosed) market price for the…transfer of such assets."*[493] This is so in most cases because of the uniqueness of intangibles and *"less frequent nature of such outright transfers between unrelated parties."*[494] Market-based approach is often associated with the CUP method.[495]

- Income-Based Approach: Valuation premised upon this approach is discussed below.

[489] André Schaffers and Filip Vanluydt, "Embedded IP" in Intangibles (4th edition), International Tax Review published in partnership with Deloitte, 2018. https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-ITR-2018-intangibles-guide-noexp.pdf, (Accessed 5 July 2020), pp.27-28.
[490] Deloitte and European Commission, The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, p.64. See also the UN Manual, para. B.5.6.7.
[491] Schaffers and Vanluydt, p.27.
[492] Deloitte and European Commission, The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, p.64
[493] Deloitte and European Commission, The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, p.64
[494] Deloitte and European Commission, The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, p.64
[495] Schaffers and Vanluydt, p.27. See also Ditz, p.137.

4.3.4.3 Income-Based Valuation Techniques

Through income-based techniques, the valuation of an intangible is conducted "*by reference to the present value of income, cash flows or costs savings attributable to the intangible asset over its economic life."*[496] As referred to the remaining useful life of the intangible, one needs to discover what amount of income the intangible can generate in this period. The valuation, in that sense, requires a forward-looking analysis. The main feature of income-based valuation techniques is to determine expected future benefits that will be deriving from the subject intangible. The projected value of future benefits is then to *be "adjusted to its present-day value."*[497]

In considering when, principally, the income approach ought to be used, the IVSC indicates following two criteria, saying that only if the said two are met, the income approach is to be deemed the fundamental basis in the valuation of intangibles:

> *"(a)the primary economic benefit associated with ownership of the subject intangible asset is the ability to generate income, additional income, or reduce costs, and*
> *(b)those future economic benefits can be reasonably forecast."* [498]

Income-based valuation techniques are commonly applied in below intangibles' valuation:

- *"technology-based intangibles*;
- *customer-related intangibles;*
- *tradenames, trademarks, brands;*
- *operating licenses;*
- *non-competition agreements*."[499]

[496] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 40.1.
[497] World Intellectual Property Organization, Module 11: IP Valuation, p.22
[498] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 40.2.
[499]International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 40.4.

Although there have been various income-based valuation methods[500], the commonly-used[501] method is Discounted Cash Flow Method.

4.3.4.3.1 Discounted Cash Flow Method (DCFM)

The term "discounting" refers to *"the mathematical/financial approach of estimating the present value of a payment or a stream of payments that is to be received in the future."*[502] Taking the time value of money and various risk factors into account, the reviewer conducts valuation under the DCF method. The essence of the DCF method may be combined with other valuation methods. It has been said that *"such techniques measure the value of an intangible by the estimated value of future cash flows it may generate over its expected remaining lifetime."*[503] The said future economic benefits are to be adjusted to *"the present value at a discount rate representing the cost of capital, such as the interest rate."*[504] Simply put, an expected cash flows (economic benefits) is to be transformed into a present-value.[505]

The OECD introduces some of the underlying assumptions and valuation parameters that need to be taken into account in the application of the valuation method. Accordingly, the valuation under this method should be carried out through, inter alia,

- *"the defining realistic and reliable financial projections,*
- *growth rates,*
- *discount rates,*
- *the useful life of intangibles, and*
- *the tax effects of the transaction."*[506]

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[500] International Valuation Standards Council, IVS 210: Intangible Assets Exposure Draft, para. 50.1.
[501] Dr. William F. Finan and Susan Launiau, "Valuation of Intangibles for Transfer Pricing Purposes: Convergence of Valuations for Transfer Pricing Purposes with Valuation for Other Purposes", 2011, http://www.oecd.org/ctp/transfer-pricing/47429988.pdf, (Accessed 27 June 2020), p.1.
[502] Deloitte and European Commission, The Study on the Application of Economic Valuation Techniques for Determining Transfer Prices of Cross Border Transactions between Members of Multinational Enterprise Groups in the EU, p.66.
[503] The OECD TP Guidelines, para. 6.157.
[504] Akhilesh Ganti, reviewed by Gordon Scott, Investopedia Website, Terminal Value, (Accessed 30 June 2020) https://www.investopedia.com/terms/t/terminalvalue.asp
[505] World Intellectual Property Organization, Module 11: IP Valuation, p. 23.
[506] The OECD TP Guidelines, para 6.157.

Under some circumstances, the application of the DCF method requires the account of terminal value.[507] Terminal value is described as *"the value of a business or project beyond the forecast period when future cash flows can be estimated."*[508]

It is important to acknowledge that the estimated value of the subject intangible asset may be drastically affected from minor changes in valuation parameters or selected valuation methods.[509] Given that the reliability of the valuation of the subject intangible asset is heavily based on assumptions and valuation parameters, particular attention ought to be exercised in *"the reasonableness of such assumptions and valuation parameters."*[510]

[507] The OECD TP Guidelines, para 6.157. See also The UN Manual, para. B.5.6.17.
[508] Akhilesh Ganti, reviewed by Gordon Scott, Investopedia Website, Terminal Value, https://www.investopedia.com/terms/t/terminalvalue.asp (Accessed 30 June 2020)
[509] To paragraph 6.158 of the OECD TPGuidelines, *"A small percentage change in the discount rate, a small percentage change in the growth rates assumed in producing financial projections, or a small change in the assumption regarding the useful life of the intangible can each have a profound effect on the ultimate valuation. Moreover, this volatility is often compounded when changes are made simultaneously to two or more valuation assumptions or parameters."*
[510] The OECD TP Guidelines, para. 6.160.

4.4 Examples

4.4.1 Embedded IP

The term *"embedded IP"* is described as the type of IP which, *"contributes to the value of a tangible asset, financial asset or service, or personal service. Its value is charged in a bundled price along with that of the property in which it is embedded."*[511]

Here is an example that is built upon the instance given by Schaffers and Vanluydt[512]:

Assume that an MNE having two associated enterprises, Company A and its subsidiary B. Company A is a furniture manufacturer, and the Subsidiary B is performing distribution functions for the MNE. Company A is a well-known manufacturer, and its brand awareness is very high in the eyes of public, which is recognized as one of the Fortune 1000 companies in the US. Company A is the legal owner of the trademark *furnitired*; Subsidiary B purchases the furniture from Company A. For transfer pricing purposes, we know that the price of that transaction has to be established on the arm's length basis. Now that the trademark *furnitired*, owned by Company A, is embedded in the transferred good, conducting transfer pricing may be remarkably difficult. The issue at stake is as to how to arrive at the arm's length price for such transactions?

Suppose that Company A enters into comparable transactions with unrelated parties. That is, it sells the same good with embedded IP to the independent enterprises. In such circumstances, internal comparables can be taken into account in pricing the controlled transaction entered into between two affiliates- Company A and Subsidiary B. The manufacturer Company A's sale of furniture to unrelated entities can provide an internal comparable that can be used in transfer pricing of the controlled transaction. In this case, since having internal comparables, it can be said the CUP method is to be applied in a reliable manner, and needless to separately *"determine the arm's length value of the embedded*

[511] Schaffers and Vanluydt, p.25
[512] Schaffers and Vanluydt, p.25

IP."[513] In different words, the application of the CUP method founded on internal comparability seems to be a proper method to arrive at the arm's length price for the transaction given above.

In cases, however, where no internal comparables exist, how is the proper arm's length price determined? Let us assume that no buyers exist rather than related entity Subsidiary B. In these circumstances, the arm's length price can be determined with the use of external comparables such as *"the profit generated by independent […] distributors performing broadly comparable functions, using broadly comparable assets, and assuming broadly comparable risks as the related distributor."*[514]

4.4.2 Research and Development(R&D), Cost Contribution Arrangements, Arm's Length Profit Allocation

Company X, a parent of an MNE group, is located in the US. It has been developing computer programs. Subsidiary Y, wholly owned by the parent, performs the group's marketing and distribution functions in Europe. Also, it has an R&D center.

The parent Company X and Subsidiary Y have entered into a Cost Contribution Arrangement (CCA) concerning creating a new software program. To that agreement, the parent and the subsidiary equally participate in R&D of the development of new software through functions performed and assets used. Besides, in reference to the risks-assumption, the parent and the subsidiary together bear development risks and other relevant risks including, product liability. The question that needs to be answered regarding the risk-assumption is whether parties to the CCA exercise control over the risk and financial ability to assume such risks.

[513] Schaffers and Vanluydt, p.25.
[514] Schaffers and Vanluydt, pp. 25-26.

Provided that the parent maintains the substantial degree of control over its subsidiary with regard to the development process of the intangible against the agreed terms and conditions, and/or the subsidiary is not financially capable of assuming risks it contractually bore[515], the legitimacy of the CCA would be questionable in the eyes of relevant tax authorities. To put it another way, in the light of the criteria set by the OECD, a party to the CCA, the subsidiary, is not to be considered a participant within the sphere of the Guidelines since the actual conducts of the parent and the subsidiary does not match the content of the CCA.

Overall, for transfer pricing purposes, the relationship between parties must be carefully examined. Accordingly, the remuneration derived from the exploitation of the new software program is going to be divided between the parent and its subsidiary per the arm's length principle, taking parties' actual behaviors into account and employing the transactional profit split method.

[515] See the OECD TP Guidelines, para. 1.65.

CONCLUSION

The transfer pricing of cross-border controlled transactions is one of the most significant international taxation subjects. Although transfer pricing, in itself, is not against the law, it becomes questionable when it is utilized by an enterprise as a profit-shifting tool, leading to tax avoidance and even double non-taxation. From the ethical viewpoint, one may argue that MNEs are obligated with Corporate Social Responsibility; therefore, they must pay their fair share of taxes in countries where they operate. Others, however, may suggest that managers own fiduciary duties to their shareholders, which requires minimizing the enterprise's costs and increasing profitability.[516] It could be argued that BEPS-related activities, including transfer pricing implementations as part of aggressive tax planning strategies of enterprises, cost many stakeholders, i.e., individuals, society, small and medium-sized businesses, and even in the long run, possibly those avoiding taxes by themselves. This could be so since when an enterprise avoids paying taxes, the overall tax burden would be levied on other individuals and businesses. That also means that non-avoiding parties spend their earnings/savings in paying taxes, leaving less source for purchasing goods and services and/or entering into a contract with those large enterprises.

The OECD's BEPS initiative, composed of 15 points, aimed at *"realigning the location of profits and the location of activities."*[517] Transfer pricing and intangible-relevant BEPS was also addressed in the OECD's work. Relevant action point 8 is specifically concerning intangibles. In this regard, the definition of intangibles, proper profit allocation being in compliance with value creation, the state of hard-to-value intangibles, and cost contribution arrangements are key aspects of the said action point.

[516] See https://www.coursera.org/learn/international-taxation/home/week/6 (Accessed 9 June 2020)
[517] Pascal Saint-Amans, interviewed by Sjoerd Douma, Rethinking International Tax Law: Module 6-Tax planning & ethical dimensions, Leiden University | Coursera,2015, https://www.coursera.org/learn/international-taxation/lecture/zjGc0/interview-pascal-saint-amans (Accessed 5 June 2020)

The essence of conducting transfer pricing is the arm's length principle. To the principle, a transaction occurred between associated enterprises must be priced as though the transaction was carried out between independent enterprises.

Intangible's transfer pricing has become a crucial issue that is a source of disagreements between taxpayers and tax authorities. In this regard, two major issues at stake can be given as follows. The first is that the intangible-related income must be properly taxed, which refers to preventing double-non taxation or the so-called stateless income. The second is about which tax authority/authorities are going to tax that intangible-related income. In that sense, transfer pricing regulations and proper application of relevant rules are to be served as a means to arrive at arm's length price/profit allocation.

In transfer pricing of intangibles, the subject transaction can be accurately delineated by applying the OECD-recognized 6-step approach.[518] Those steps can be centered around identifying the subject intangibles, intangible ownership, and accordingly conducting transfer pricing that brings about arm's length price for a controlled transaction under review or arm's length profit allocation among respective entities.

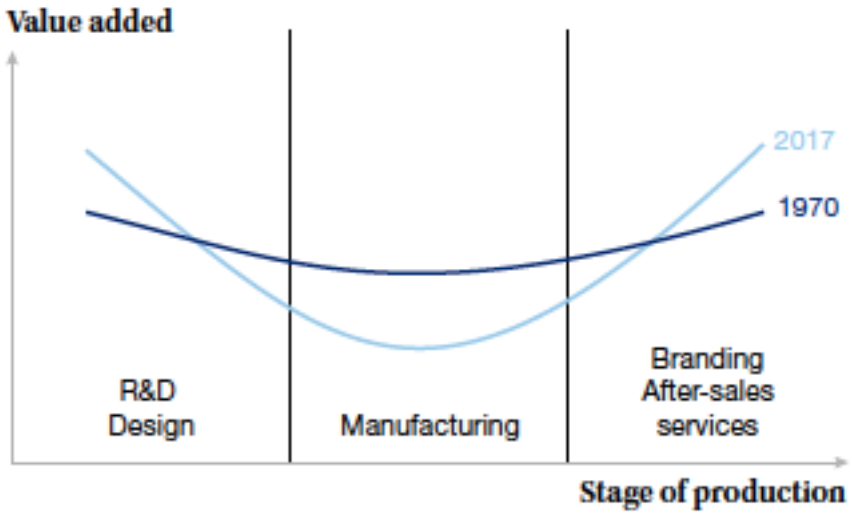
In examining intangible-related transactions for transfer pricing purposes, relevant parties' DEMPE-contributions to the transaction must be analyzed. The OECD refers to these on many occasions in the Guidelines. In this regard, under functional analysis, development, enhancement, maintenance, protection, and exploitation-related functions performed, assets utilized, and risk assumed by parties to a controlled transaction will be analyzed. In reference to assuming relevant risks, the OECD has suggested the control-over-risk concept. Also, being financially capable of assuming the relevant risks is vital in determining if the subject risk is genuinely assumed, and accordingly, this assumption is legitimate within the sphere of the Guidelines.

[518] The OECD TP Guidelines, para. 6.34.

For intangible-related transfer pricing, it can be suggested that the use of two methods is encouraged, scilicet the comparable uncontrolled price method and the transactional profit split method. As mentioned by the UN, the application of TPSM through residual analysis seems to be more plausible and commonly applied in practice since it is established in two steps, separating routine and non-routine contributions made by parties to a transaction under review. Concerning the use of economic valuation methods in transfer pricing involving intangibles, the application of income-based methods is generally accepted as the most appropriate.

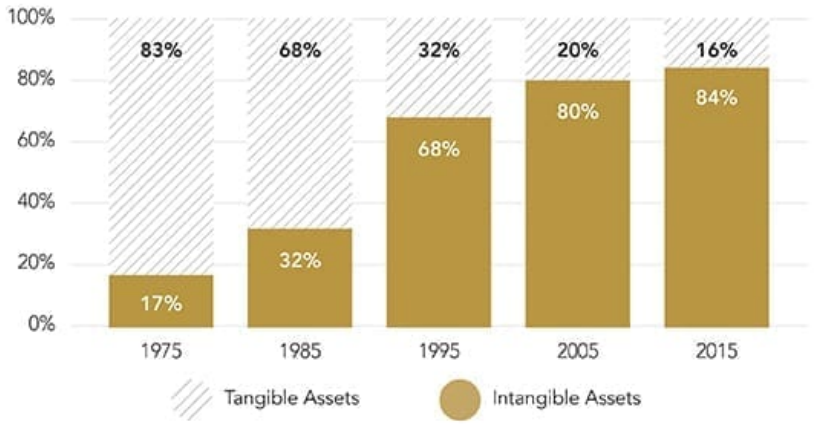
APPENDIXES

APPENDIX I- ***"Production in the 21st century - a growing smile"***



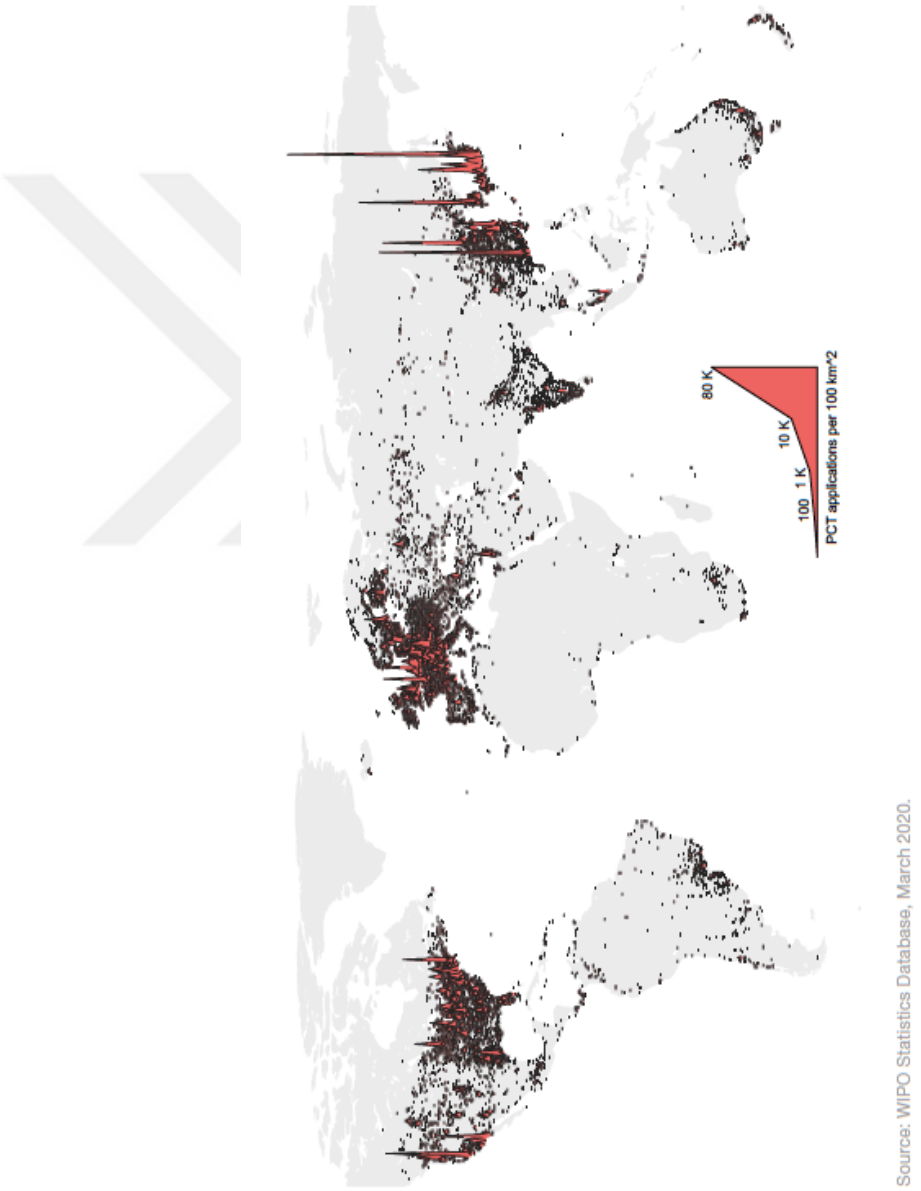
Source: WIPO, Intangible Capital in Global Value Chains, 2017
https://www.wipo.int/edocs/pubdocs/en/wipo_pub_944_2017.pdf (Accessed 31 May 2020), p.10.

APPENDIX II- *"Components of S&P 500 Market Value"*



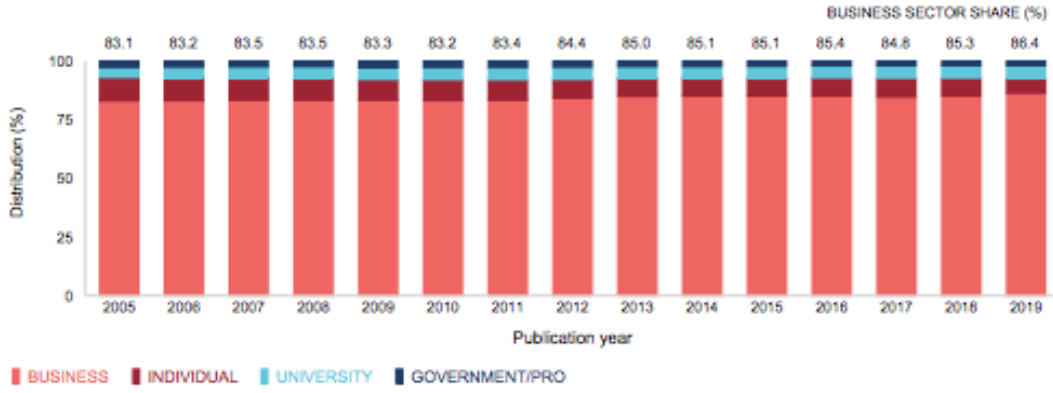
Source: Ocean Tomo, LLC, Intangible Asset Market Value Study, 2017, https://www.oceantomo.com/intangible-asset-market-value-study/ (Accessed 5 August 2020).

APPENDIX III- "*PCT application density per 100 square kilometers, 2014-2018.*"



Source: WIPO, Patent Cooperation Treaty Yearly Review, 2020, https://www.wipo.int/edocs/pubdocs/en/wipo_pub_901_2020.pdf (Accessed 26 August 2020), p.8.

APPENDIX IV- *"PCT applications by applicant type."*



Note: The government and public research organizations (PROs) sector includes private non-profit organizations and hospitals. The university sector includes all educational institutions. For confidentiality reasons, data are based on the publication date.

Source: WIPO Statistics Database, March 2020.

Source: WIPO, Patent Cooperation Treaty Yearly Review, 2020, https://www.wipo.int/edocs/pubdocs/en/wipo_pub_901_2020.pdf (Accessed 26 August 2020), p.30.

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