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Abstract

This paper highlights the increasing importance of intangibles in the international dealings of multinational enterprises. Focussing on fiscal regulations in the United States and in OECD member countries, particularly Australia, it critically reviews the arm's length principle and related issues in their application to intangible property. It examines the complexities associated with the various methodologies that have been developed for determining arm's length consideration for transfers of intangibles, and puts forward some suggestions for developing an appropriate typology.

Keywords

intangibles, fiscal regulations, United States, Australia, transfer pricing

THE TAX TREATMENT OF INTANGIBLES IN THE CONTEXT OF TRANSFER PRICING

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This paper highlights the increasing importance of intangibles in the international dealings of multinational enterprises. Focussing on fiscal regulations in the United States and in OECD member countries, particularly Australia, it critically reviews the arm's length principle and related issues in their application to intangible property. It examines the complexities associated with the various methodologies that have been developed for determining arm's length consideration for transfers of intangibles, and puts forward some suggestions for developing an appropriate typology.

In the sixteenth century, the Spanish Empire was larger and "more powerful than any other European state since the Roman Empire". A historian of that time period said, "[t]he sun never sets on the dominion of the King of Spain." Tax historian Charles Adams asserted that Imperial Spain's failure to reform its tax system significantly contributed to its demise. Oxford's leading scholar on Imperial Spain described Spain's taxes as follows:

[S]panish industry was strangled by the most burdensome and complicated system of taxation that human folly can devise ... The taxpayer, overburdened with imposts, was entangled with a network of regulations to prevent evasion ... He was thus crippled at every step by the deadly influence of the anomalous and incongruous accumulation of exactions.

Today's international transfer pricing rules resemble Imperial Spain's tax system. Although no modern nation can boast that the sun never sets on its domain, many multinational enterprise ("MNE") groups can. MNE groups are the engine of global commerce and local prosperity. Imperial Spain's fate admonishes nations to balance their sovereign right to tax with uniform and predictable tax treatment of MNE groups.¹

¹ Lester EE, "International Transfer Pricing Rules: Unconventional Wisdom" (1995) 2 *ILSA Journal of International and Comparative Law* 283 at 284.

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1 INTRODUCTION

As we enter the 21st century, the spiraling increase in cross-border flows of intangible property has become a major international taxation issue, and arguably the main issue facing revenue authorities, multinational enterprises ("MNEs") and tax practitioners around the world. Not only is an increasingly significant role being played by transactions involving intellectual property in the ever-expanding global economy, but the manifold complexities associated with identifying, valuing and transferring intangibles make this an issue requiring a creative review of existing transfer pricing methodologies and techniques.

With an estimated 60% of world trade being conducted between multinational enterprises:

The rapid growth in the global information infrastructure, which includes the Internet, virtually eliminates geographic boundaries for certain transactions. The impact of computer technology and in particular, the Internet, is, and will be, an important factor in the growth of globalization and the way services are provided within a multinational.²

In fact, the move from an industrial society to an information society has been identified as the No 1 "Megatrend", with the transformation from a national economy to a world economy ranking as the No 3 "Megatrend".³

The United States is a nation at the forefront in transnational dealings (due, in part, to its high concentration of MNEs). It has, arguably, promulgated the most sophisticated, comprehensive and aggressive transfer pricing rules, but it is generally acknowledged that the business environment has undergone dramatic changes vis-à-vis the importance of intangibles assets in international dealings during the last two decades. James Mogle, a former international tax counsel for the United States Department of the Treasury, recently stated that:

Much of the recent controversy over intercompany transfer pricing has focused on transfers of intangible property. Nearly half of all adjustments proposed by the Internal Revenue Service under section 482 have involved the use or transfer of intangibles by or among controlled taxpayers. The appropriate pricing for intangibles has been an issue in many of the transfer pricing courts in recent

² Anderson P, *Transfer Pricing – An International Guide* (1997 Euromoney Publications PLC) at 9. Note: In November 1999 Microsoft announced the release of Venus computer - an electronic device retailing for \$US 300 which turns a television into a PC monitor, has no hard drive, and enables anyone to surf the Internet and send and receive e-mail.

³ Naisbitt J, *Megatrends* (1982 Warner Books) 11, cited in Tang R, *Transfer Pricing in the 1990s* (1993 Quorum Books) at 5.

years. Congressional concern over the ability of the IRS to effectively enforce the arm's length standard in the context of transfers of intangible property resulted in the addition of the "commensurate with income" standard to s 482.

Determining an appropriate transfer price for intangibles has been particularly problematic because of the difficulty in identifying comparable uncontrolled transactions that provide a reasonable benchmark of an arm's-length price. The problem of identifying comparables is increased when intangibles are transferred simultaneously with, or used in connection with, the transfer of tangible property or the provision of services.⁴

The Organisation for Economic Cooperation and Development (OECD)⁵ facilitates the increasing economic interdependence of the developed countries by harmonising as far as possible their systems of business taxation. In response to growing concern about the tax treatment of intangibles in international transactions, in March 1996 the OECD issued Chapter VI of its *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("The Guidelines"). Chapter VI deals with Special Considerations for Intangible Property and addresses the difficulties of evaluating intangible property transactions for transfer pricing purposes. In August 1997 the OECD released Chapter VIII of the Guidelines. It deals with Cost Contribution Arrangements - arrangements which affect the legal and economic ownership of intangible property arising out of research and development expenditures by associated enterprises.

Likewise, in the 1990s Australia realised the importance of a competitive high technology industry to its future economy and the need to ensure the adequate taxation of the cross-border supply of intangibles. There is also a need for a more in-depth analysis of the methodologies for the taxation of intangibles.

Some of the most difficult transfer pricing issues have always been in the area of intangible property. The ATO has been particularly concerned to determine which entities have added value to the property before assessing arm's-length royalty rates...

⁴ Mogle JR, "Intercompany Transfer Pricing for Intangible Property" (1997) 6 *Tax Management Transfer Pricing Special Report* 2. All § 482 references are to § 482 of the US Internal Revenue Code of 1986, as amended.

⁵ The OECD is a vehicle for international cooperation among industrialised member countries on economic and social policies, the functions of which include: to achieve the highest sustainable economic growth in member countries while maintaining financial stability, to contribute to sound economic expansion in member as well as non-member countries, and to contribute to the expansion of world trade on a multilateral, non-discriminatory basis.

Butterworths Business and Law Dictionary (1997 Butterworths) 339. Australia is a member of the OECD.

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There are reasonable grounds to believe that valuable intellectual property will become increasingly important in global commerce...with contributions to the development of such property coming from different parts of the group, it will become even more difficult to assess economic contributions and hence determine arm's-length pricing for the use of property.⁶

In short,

Transfer pricing, source of income and determination of legal and economic ownership of group intangible assets represent the tax problem with which authorities around the world are now wrestling. Traditional methods of taxation, developed in a different technological era, will have to be adapted to take into account the changing nature of undertaking business in a virtually borderless world.⁷

1.1 Australia, the US and the OECD

During the 1990s the United States, the OECD and Australia turned the fiscal spotlight on intangible assets. They developed various methodologies for dealing with the international transfer of intangibles.

In the US, final s 482 regulations⁸ were issued in 1994, and final regulations on cost sharing in 1995 (with minor modifications introduced in 1996) ("the final regulations"). The new OECD Guidelines on Intangible Property and Cost Sharing were issued in 1996 and 1997 respectively. In Australia, taxation ruling TR 97/20, released in 1997, outlines the Commissioner's views on acceptable arm's length methodologies.

There has been greater cooperation on transfer pricing issues amongst governments in recent years. This is evidenced by increasing recourse to the mutual agreement procedure⁹ (where the mutual agreement procedures in tax treaties are invoked in order to resolve instances of double taxation arising from transfer pricing) and to bilateral Advance Pricing Agreements/Arrangements.¹⁰ It is therefore valuable to assess Australian developments in the treatment of transfer pricing and intangibles in the light

⁶ Anderson P, above n 2 at 12.

⁷ Ibid at 9.

⁸ Regs § 1.482-1-6. S 1.482-8 (the final regulations, TD8552. Fed Reg 34971, 7 August 1994). The final regulations are generally effective for tax years beginning after 6 October 1994.

⁹ Almost all double taxation treaties adopt provisions similar to those set out in Art 25 (Mutual Agreement Procedure) of the OECD Model Income Tax Convention of 1977 or 1992.

¹⁰ An APA is a prospective agreement entered into between taxpayer/s and revenue authority/s as to the transfer pricing methodology to be used to determine arm's length prices in respect of one or more cross-border transactions.

of corresponding developments in the United States. In addition, although the OECD Guidelines are not legally binding on member countries, they are encouraged to follow them, and there can be no doubt that they have greatly influenced transfer pricing regulations in both member and non-member countries. Australian tax authorities have acknowledged that they generally accept the principles outlined in the Guidelines.¹¹ They therefore deserve careful consideration in an analysis of intangibles and transfer pricing.

2 THE ARM'S LENGTH PRINCIPLE

An examination of any transfer pricing issue must, of necessity, include an examination of the arm's length principle. To date, it has been generally accepted as the best way to avoid double taxation on international business.¹² The concept is enshrined in Article 9 of the OECD Model Tax Convention. Although the words "arm's length" never actually appear in this Article, Chapter I of the OECD Guidelines describes it as "the authoritative statement of the arm's length principle".¹³ Although the term "arm's length" appears in Division 13 of the Australian Income Tax Assessment Act 1936 ("Division 13") which contains the Australian transfer pricing regulations for transnational transactions, the term is not defined. An acceptable definition of an "arm's length" transaction may be:

A transaction in which the parties act severally and independently in forming the bargain and in which neither of the parties has the ability to exert personal influence or control over the other.¹⁴

2.1 Problems encountered with the arm's length principle

No one knows what arm's-length means. This is especially true because there are simply no comparable transactions for many of these companies. The arm's-length standard exists in a world of smoke and mirrors. The arm's-length standard pretends that related companies behave as if they are unrelated, and assumes that in each market place there are willing buyers and sellers. This assumption clearly does not work where the market is controlled ... no one knows or can agree on what exactly is an arm's length standard.¹⁵

¹¹ For example, TR 97/20 at para 1.13.

¹² In the United States, some people have suggested that the arm's length principle be abandoned in favour of formulary apportionment. This issue is dealt with at 5.1 below.

¹³ OECD Guidelines at para 1.6.

¹⁴ *Butterworths Business and Law Dictionary*, above n 5 at 32.

¹⁵ Quoted in McCormack J, "Getting What You Pay For: Transfer Pricing and Division 13" (1992) *NSW Intensive Seminar* 29.

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It is interesting that this statement is made not by the CEO of a beleaguered MNE, but former Internal Revenue Service ("IRS") International Examiner Ms Frances Zuniga, giving evidence at recent hearings on international profit shifting before the US House of Representatives Oversight Sub-committee. Revenue authorities and taxpayers alike admit that the practical application of the principle is fraught with difficulty. This criticism raises various issues concerning the arm's length principle that need to be addressed.

2.1.1 Lack of comparable transactions, and other problems associated with determining an arm's length "open market" price

The Australian approach to comparability is outlined in a recent Australian Tax Ruling:

Conceptually, the arm's length principle requires a calculation of the taxable income that might reasonably be expected if the parties were dealing at arm's length with one another. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from the interaction of the forces of supply and demand in a comparable open market ... this uses the open market results or the behaviour of the independent parties dealing at arm's length as a benchmark.

The concept of comparability is therefore central to the application of the arm's length principle.¹⁶

The US regulations and the Guidelines also advocate determining the arm's length character of a particular transaction by comparing either prices or profits of a controlled transaction with those achieved in comparable uncontrolled transactions. Yet one of the most frequent criticisms of the arm's length principle's application to transfer pricing transactions is the lack of "comparable transactions" This lack is especially evident in transactions relating to intangible property.

Chapter VI of the OECD Guidelines recognises that difficulties may arise in applying the arm's length principle to controlled transactions involving intangible property.¹⁷ This is because such property may have a special character that complicates the search for comparables. Impediments to establishing an arm's length price based on a comparable centre around the fact that the value of intangibles frequently lies in their difference or even uniqueness. In addition, in some cases value will be difficult to determine at the time of the transaction. An intangible, because of its particular nature as an item of intellectual, scientific or artistic property, has problems of uncertainty and risk attached to its value. Its commercial success will be

¹⁶ TR 97/21 at paras 2.1 and 2.2.

¹⁷ OECD Guidelines at para 6.13.

difficult to evaluate at the outset, and the price may include an attempted recoupment of years of research.

Losses related to “market penetration” strategies may occur. The Guidelines (and likewise the US and Australian revenue authorities) realise these may be justified on an arm’s length basis, but perimeters are set for the application of such strategies. Exchange rate fluctuations also need to be taken into account.

Chapter VI requires that royalty rates or other compensation for the transfer of intangibles must be evaluated from the point of view of both the transferor and the transferee. For the transferor, an arm’s length price would be what a comparable independent enterprise would be willing to receive for the transfer of the property. The transferee may or may not be willing to pay such a price, depending on its value and usefulness to the transferee.¹⁸ For example, factors such as the geographic market of the transferee and the use to which the intangible is put may influence the price they are willing to pay: a brand name may have little value in a foreign market where the reputation for quality and value for money attached to the brand may be unknown to potential customers. This analysis ensures that an associated enterprise is not required to pay an amount based on the highest or most productive use when in fact the property is of more limited usefulness to the associated enterprise.¹⁹

In calculating the arm’s length consideration, the Guidelines propose that certain special factors relevant to the comparability between controlled and uncontrolled transactions be taken into account. These include: the expected benefits from the intangible property (possibly determined through a net present value calculation), limitations on the geographic area in which rights may be exercised, export restrictions, the exclusive or non-exclusive character of any rights transferred, capital investment required, etc.²⁰ The analysis of comparability for a patent should take into account the nature of the patent (for example, product or process patent) and the degree and duration of protection offered under the laws of the relevant countries. The Guidelines acknowledge that an entirely new and distinctive “breakthrough” patent may make existing patents obsolete and will command a higher price than one designed to improve a process already governed by an existing patent, or one for which substitutes are readily available.²¹

Even a brief evaluation of some of the variables that need to be taken into account in establishing an arm’s length price demonstrates the difficulties of applying the arm’s length principle in today’s sophisticated economic environment. (“[Y]ou have to be somewhat of a rocket scientist to figure all [the transfer pricing rules] out,” according to Kevin Dolan, a partner at Weil,

¹⁸ Ibid at para 6.14.

¹⁹ Ibid at para 6.15.

²⁰ Ibid at para 6.20.

²¹ Ibid at para 6.21.

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Gotschal & Manges and former IRS Associate Chief Counsel.)²² It is not surprising Ms Zuniga stated that, “no one knows or can agree on what exactly is an arm’s length standard”.

It is therefore rather disconcerting to discover that the former Australian Commissioner of Taxation, Mr Trevor Boucher has stated that:

There are, as indicated by the OECD, a number of methods of determining arm’s length price and it could be said to follow from that and from other considerations that application of the different methods would throw up a range of prices, any one of which could be represented to be an arm’s-length price.

I would maintain that the search for an answer does not end there – that when account is taken of the particular circumstances of the industry in which a firm is operating, and of the firm’s own circumstances, the seeming variety of methods and possible range of prices would boil down to one appropriate method and one most appropriate price.²³

Bearing in mind the substantial amount of time, effort and expense involved in finding acceptable comparables for intangible property transactions, it can be argued that this standard is too high, and indeed, impractical.

2.1.2 *Treating related companies as if they were unrelated*

Another criticism of the arm’s length principle is that it depends on treating associated or related enterprises as if they were unrelated, but, at the same time, all other aspects of the relationship were to remain unchanged. The basis of this simulation is of necessity hypothetical, ie, fictitious.

The essential advantages of a corporate group are that fixed costs can be jointly shared, and that a successfully integrated firm generates synergy profits, or additional returns attributable to the organization as a whole rather than any particular unit. The Arm’s Length approach based on transactional analysis entails attempting to dissect this unity.²⁴

According to the Guidelines, associated enterprises may, for valid and legitimate business reasons, structure an intercompany transfer of intangibles in a manner that independent enterprises would not contemplate.²⁵ This implies that the OECD accepts such structures as permissible and justifiable, even under an arm’s length analysis.

²² Lester, above n 1 at 298.

²³ McCormack, above n 15 at 28.

²⁴ Piciotto S, *International Business Taxation* (1992 Greenwood Publishing Group, Inc) at 193.

²⁵ OECD Guidelines at para 6.13.

2.1.3 *Theory and practice*

The criticisms levelled above, which are by no means exhaustive, indicate that there is a chasm between the idea of “arm’s length” as a theoretical principle, and its practical application.

Reliance on market prices has provided at best a partial solution, principally because experience has shown that the criterion of comparable uncontrolled prices is an inadequate one. In a high proportion of cases, the internal transactions of an integrated firm are not comparable with those of independent firms. Furthermore, effective verification of prices by reference to comparables requires a sophisticated administrative bureaucracy, which must grow in proportion to the importance of TNCs in the economy Significantly, it was the largest state, the US, which made the most determined efforts to operationalize the arm's length criterion based on comparables, and which has been forced to develop alternatives.²⁶

2.2 **Overcoming problems with the arm’s length principle**

2.2.1 *Using an arm’s length range*

The key to overcoming many of the problems encountered in applying the arm’s length principle would appear to be to adopt a flexible approach, whereby revenue authorities do not demand absolute precision in reaching an arm’s length price. This approach appears to be finding increasing favour with both the US and Australian tax administrators, as well as with the OECD.²⁷

²⁶ Piciotto, above n 24 at 221. TNC is an abbreviation for “Transnational Corporation”.

²⁷ The OECD Guidelines, like the US regulations, provide that no adjustments should be made to a taxpayer’s transfer pricing results if those results are within an arm’s length range. The Guidelines do not provide specific rules for establishing the arm’s length range, but state at para 1.45 that “because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are relatively equally reliable”. In some cases, application of a methodology produces a single outcome (eg, price, margin or profit) that is the most reliable measure of an arm’s length outcome. In other cases, because transfer pricing is not an exact science, application of the most appropriate method/s may produce more than one result. TR 97/21 para 2.83.

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Utilising an arm's length range is a particularly apt device in resolving the problems associated with reaching a market price for intangible asset transactions. Even a confirmed critic of the arm's length principle has stated:

A market price is the outcome of unique negotiations. It may be possible to know the price range, but it is impossible to know the actual market price unless a market transaction occurs. As the price range narrows, there is a greater probability that the arm's length price will approximate the market price. The arm's length principle will generally fail to achieve a comparable market price for "intangible" transactions because they are unique. The unique nature of these transactions creates a wide price range which makes the market price uncertain.²⁸

Thus, while discovering the actual market *price* may prove "impossible", it may be possible to know the price *range*.

In the United States, tax practitioners have welcomed the arm's length range as "one of the most positive aspects of the 1994 final s 482 transfer pricing regulations".²⁹ The arm's length range has been used to resolve transfer pricing disputes in a number of US court cases. For example, in *Seagate Technology Inc v Commissioner*,³⁰ the issue was whether Seagate Singapore paid Seagate Scotts Valley arm's length royalties for the use of certain intangibles. The IRS claimed that the arm's length rate was between 6% and 12%, while the taxpayer argued a range of between 1% and 3%. Both parties provided a range.

Judge Thomas B Wells used the range concept in reaching his decision:

We accept as reasonable Dr Chandler's [who gave "expert testimony"] conclusion that royalty rates for disk drive or computer accessory technology ranged generally between 1% and 5%. We do not agree, however, that 1% to 3% is a reasonable range of royalty rates for all of the intangibles involved in this case...From our review of the record as a whole, we believe that royalty rates in a range of 3% to 5% are more reasonable for the intangibles involved in the instant case Consequently, using our best judgment, we conclude that a royalty rate of 3% of the disk drive sales price is reasonable arm's length consideration for the intangibles in issue.³¹

The arm's length range approach acknowledges the problems inherent in discovering "one most appropriate price" for a transfer pricing transaction involving intangibles. A corollary of applying a range is that it is much more likely that taxpayers and tax authorities will be able to reach a consensus. In

²⁸ Lester, above n 1 at 296.

²⁹ Cheng DK, "The Arm's Length Range" in Feinschreiber R (ed), *Transfer Pricing Handbook* (2nd ed 1998 John Wiley & Sons Inc) at 8-1.

³⁰ 102 TC No 9 (1994).

³¹ Cheng, above n 29 at 8-3 - 8-4.

an increasingly complex global business environment, it satisfies both equitable principles and sound business sense.

2.2.2 *Using a profit split methodology*

The use of some form of comparable profits analysis to confirm intercompany pricing has been advocated, and will be examined at 4.3 below.

3 ISSUES RELATED TO ACHIEVING AN ARM'S LENGTH ANALYSIS

To analyse accurately whether a transfer pricing transaction relating to intangibles has been conducted at arm's length, it is necessary to define what category of intangible is in question, to analyse the ownership of the intangible, and to examine the mode of transfer utilised.

3.1 Definition of intangibles

In the United States, for purposes of s 482, the term "intangible" refers to any item included in one of six broad categories specified in the regulations, provided the item has substantial value independent of the services of any individual. These categories of intangible property include:

- Patents, inventions, formulas, processes, designs, patterns or know-how;
- Copyrights and literary, musical, or artistic compositions;
- Trademarks, trade names, or brand names;
- Franchises, licenses, or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
- Any other similar item that derives its value from its intellectual content rather than its physical attributes.

The final s 482 regulations do not contain the limitation, included in the temporary regulations, that taxpayers were required to charge an arm's length consideration only when there was a transfer of a "commercially transferable interest".³²

³² The omission of this limitation is much regretted by James R Mogle, former International Tax Counsel for the US Department of Treasury, especially in relation to its adverse effect on corporate "going concern" attributes and transfers of employees. See Mogle, above n 4 at 5-6.

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The OECD Guidelines contain a generally consistent definition of intangible property. For the purposes of Chapter VI of the OECD Guidelines, “intangible property” includes rights to use industrial assets, such as patents, trademarks, trade names, designs or models, literary and artistic property rights, and intellectual property such as know-how and trade secrets. The chapter focuses on commercial intangibles - assets that may have considerable value, although perhaps no book value in the company’s balance sheet.³³ This is an interesting recognition of the fact that, despite their absence from the balance sheet, intangible property often accounts for a significant portion of a company’s value.

The OECD splits “commercial intangibles” into “trade” and “marketing” intangibles.³⁴ Trade intangibles include patents, know-how, designs and models used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of a business, for example, computer software.³⁵ Trade intangibles are often created through risky and costly research and development (“R & D”), with expenditures generally being recovered through product sales, service contracts or licence agreements.

Marketing intangibles include trademarks, trade names, customer lists, distribution channels and unique names, symbols and pictures that have an important promotional value for the product concerned.³⁶ The OECD recognises that the value of marketing intangibles depends on many factors, such as the historical quality and services provided under the name or the mark, the degree of quality control and ongoing R & D, the availability of the goods or services being marketed as well as the extent and success of promotional expenditures.

Intellectual property such as know-how and trade secrets can be trade or marketing intangibles. They are proprietary information or knowledge that assists or improves a commercial activity, but are not registered for protection. Know-how is acknowledged to be a rather imprecise concept, including secret processes, formulas or information that play a significant role in an MNE group’s commercial activities.³⁷

Evaluating whether or not an intangible exists in an intercompany transaction is challenging, and the OECD warns that care must be taken here.³⁸ There are no guarantees that costly research will result in the development of a valuable trade intangible. For example, millions of dollars are spent in researching a cure for various types of cancer, and for the AIDS virus. In the

³³ OECD Guidelines at para 6.2.

³⁴ Ibid at para 6.3.

³⁵ Ibid.

³⁶ Ibid at para 6.4.

³⁷ Ibid at para 6.5.

³⁸ Ibid at para 6.6.

pharmaceuticals industry, it is apparently necessary to identify and investigate 10,000 compounds to identify one successful product.³⁹ Likewise, not all marketing activities, which may encompass a wide range of business activities, may result in the creation of a valuable marketing intangible.

Expenditures and activities may have either a short-term or a long-term effect, or both.⁴⁰ Whether such activities are expensed or capitalised is important in any functional analysis carried out in order to establish comparability for the purposes of transfer pricing.⁴¹

The Guidelines compare patents and trademarks to illustrate the differences between trade and marketing intangibles, in terms of the creation of rights, time periods of use, uniqueness, costs involved in creation, modes of transfer, etc.⁴²

It can be difficult to distinguish between income from trade and marketing intangibles.⁴³ In research-oriented industries the trademark and name are vital components in securing sufficient income to reward past research and undertake new projects, particularly as patents are time-limited. Brand confidence and trademark recognition are therefore vitally important to ensure that the product continues to be commercially viable after the patent expires or even in cases where no patent was developed. Intangibles that can be classified either as a trade or a marketing intangible are commonly referred to as “hybrid” intangibles. Many trademarks derive value from both marketing and manufacturing activities, and the determination of the correct arm’s length royalty rate depends upon an evaluation of which type of activity carries the most weight.

In Australia, Division 13 does not cover the definition of intangibles as exhaustively as the OECD, or even to the extent of s 482.⁴⁴ Instead, s 136AA defines “property” as including “any estate, interest, right or power, whether at law or in equity, in or over property”. Property also includes services, which are broadly defined as including “any rights, benefits, privileges or facilities”. This linking of property and services means:

³⁹ Wright DR, “OECD Rules for Intangible Property” in Feinschreiber, above n 29 at 25-4.

⁴⁰ OECD Guidelines at para 6.7.

⁴¹ A functional analysis involves the identification and evaluation of the functions performed, assets used and risks and responsibilities assumed by the controlled and uncontrolled parties involved in the transactions under review.

⁴² OECD Guidelines at para 6.8.

⁴³ Ibid at para 6.12.

⁴⁴ A more comprehensive description of things covered by the term “property” may be found in TR 94/14 at para 238.

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the definition will pick up hybrids where intangible property is associated with commercial activities such as marketing activities. An intangible is therefore essentially a broader concept than what is commonly thought to be intellectual property.⁴⁵

In defining an intangible in an arm's length investigation, it is important to note that the various types of intangibles may be differently defined in different jurisdictions. Foreign countries may also employ different rules regarding the use of technology and its transfer.⁴⁶ The OECD notes that a know-how contract and a service contract may be dealt with differently in a particular country according to its internal tax legislation or double taxation treaties ("DTAs").⁴⁷

Finally, in the United States much attention has recently been directed at so-called "super-intangibles". These are intangibles which produce a monopoly or near-monopoly in their product area. Such a degree of market control is extremely rare, although it was found to exist for a pharmaceutical preparation developed by Eli Lilly.⁴⁸ The US temporary regulations attempted to differentiate between "routine" and "non-routine" intangibles, although they provided no definition of such terms. "Valuable", "high profit potential" and "unique" are terms often used in descriptions of non-routine intangibles, with the *White Paper*⁴⁹ offering "an intangible that is of major importance to the enterprise, and which few unrelated parties possess".⁵⁰ It follows that it is more difficult to find comparable uncontrolled transactions in the case of non-routine intangibles.

However, because the IRS was unable to express an adequate definition of "non-routine intangible", and because it could not rule out the possibility that even here, uncontrolled comparables could be found, the final regulations do not provide any explicit rules concerning such intangibles.⁵¹ The Guidelines recognise the difficulties in finding comparable uncontrolled transactions where highly valuable intangible property is involved, and concludes that in

⁴⁵ Quinn R, "Intangibles in Transfer Pricing" (June/July 1996) *The CCH Journal of Australian Taxation* 31.

⁴⁶ "The Andean Pact countries in Latin America, for example, do not allow patents for many proprietary products brought in by MNEs, and these countries do not allow local subsidiaries to pay royalties to parent companies for the use of technology". Grosse R and Kujawa D, *International Business – Theory and Managerial Implications* (1988 Irwin) at 545.

⁴⁷ OECD Guidelines at para 6.19.

⁴⁸ See *Eli Lilly & Co v Comr*, 84 TC 996 (1985).

⁴⁹ The White Paper is officially titled *A Study of Intercompany Pricing Under Section 482 of the Code*, 18 October 1988.

⁵⁰ 1988-2 CB at 489.

⁵¹ See Mogle, above n 4 at 7.

such cases the profit split method may be used, even though there may be practical problems in its application.⁵²

3.2 Analysing the ownership of an intangible

3.2.1 *Legal versus economic ownership*

Under s 482, the arm's length character of consideration paid for the transfer of an intangible asset between associated enterprises is evaluated by utilising certain prescribed pricing methods. Such an evaluation cannot, however, take place until one member of the controlled group has been established as being the "owner" of the asset.⁵³ Only one member will be considered to be the owner, and if another member of the controlled group assists the owner in developing or enhancing the value of the intangible, they must receive arm's length consideration from the owner for such assistance.

Up until the final regulations, intangible property was treated, in terms of the transfer pricing rules, as being owned by the party that had borne the largest share of the cost of its development (the "economic ownership" test). In a radical shift, the final regulations now provide that in the case of a legally protected intangible (for example, a trademark or a patent), the "legal owner" will be considered to be the owner (the "legal ownership" test).⁵⁴ This change was brought about by a desire to mirror a normal commercial relationship in the open market, which would be more consistent with the arm's length principle. Where intangible property is not legally protected (for example, know how), the former test still applies and the party bearing the largest share of the costs would generally be considered to be the owner of the intangible.⁵⁵

This new provision is likely to cause problems for taxpayers accustomed to the previous economic ownership criteria. Economic realities are effectively ignored, as royalties would presumably be required for trademarks and patents registered in the name of the US parent corporation, even though the largest portion of the development costs may have been borne by a foreign subsidiary. Proprietary rights strategies vary among different countries and different corporations, and thus the legal ownership test leads to a haphazard treatment of intangibles.

⁵² OECD Guidelines at para 6.26. For a consideration of the profit split method see 4.3.3 below.

⁵³ Regs § 1.482(f)(3)(i), (f)(3)(ii)(B), and (f)(3)(iii).

⁵⁴ Regs § 1.482(f)(3)(ii)(A).

⁵⁵ Regs § 1.482(f)(2)(ii)(B).

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This focus on “legal” ownership is not reflected in the OECD Guidelines, where economic ownership is given precedence.⁵⁶ As mentioned above, the Guidelines also recognise that associated enterprises may, for wholly legitimate business reasons, structure an intercompany transfer of intangibles in a manner that independent enterprises would not contemplate. This would appear to be a more flexible and realistic approach than basing ownership on legal title. It should be noted that Division 13 makes no mention of ownership, legal or economic.

The conflict between US and OECD rules in determining ownership of a legally protected intangible may expose taxpayers to the risk of double taxation, and is a problem that needs to be addressed by the revenue authorities both in the US and in OECD countries such as Australia.

3.2.2 *Ownership by agreement*

The ownership of rights to exploit an intangible can be established by agreement, usually in the form of an exclusive or non-exclusive licence. The rights given to a licensee may vary. Although, or perhaps because, the US final regulations may imply such an agreement by the conduct of the parties,⁵⁷ it is recommended that licence agreements be committed to writing.

3.2.3 *Ownership via cost contribution arrangements*⁵⁸

Both the OECD Guidelines⁵⁹ and the US Final Regulations⁶⁰ make provision for cost contribution arrangements (“CCAs”) between two or more associated enterprises. They are not mentioned in the Australian transfer pricing provisions.

A cost contribution arrangement is an agreement under which affiliates share the costs and risks of developing one or more intangibles, based on the proportionate benefit they may reasonably derive from their individual exploitation of the interests in the intangibles assigned to them under the agreement. The obvious benefit of such an arrangement is that,

each participant in a CCA would be entitled to exploit its interest in the CCA separately as an effective owner thereof and not as a

⁵⁶ See OECD Guidelines, para 6.36 to 6.39.

⁵⁷ Regs § 1.482-4(f)(3)(ii)(A).

⁵⁸ The scope of this paper does not permit a full discussion of cost contribution arrangements - this would merit a paper in itself.

⁵⁹ See Chapter VIII of the OECD Guidelines, published in August 1997.

⁶⁰ Regs § 1.482-7(a)(1).

licensee, and so without paying a royalty or other consideration to any party for that interest.⁶¹

Likewise, s 482 provides that each participant under such an arrangement is deemed the “owner” and is not required to pay an arm’s length consideration to the participant holding legal title to the intangible.⁶²

The essential questions raised in evaluating the arm’s length nature of a CCA are:

- 1 Is there a clear benefit for the recipient? and
- 2 Does the method used to fix the contribution fairly reflect the anticipated benefit?

The OECD Guidelines deal with these questions by requiring a determination that all the participants have the expectation of benefits. Following this, a calculation of each participant’s relative contribution to the joint activity (whether in cash or in kind) must be made, and finally a determination of whether the allocations of CCA contributions (as adjusted for any balancing payments made among participants) is proper must be carried out.⁶³ The OECD is very aware of the potential to shift profits among CCA participants, and lists various recommendations for structuring and documenting CCAs.⁶⁴ The complexities of determining whether a CCA complies with the arm’s length principle means that the above questions must be resolved on a case-by-case basis. The Guidelines recognise that determining the relative value of each participant’s contribution is unlikely to be a straightforward matter, unless all contributions are made wholly in cash, for example, where the activity is undertaken by an external service provider and the costs are jointly funded by all participants.⁶⁵

The US final regulations impose far more complex and restrictive rules on taxpayers seeking to participate in a CCA. A taxpayer may only rely on the US cost sharing rules if the arrangement meets the definition of a “qualified cost sharing arrangement” and the taxpayer is a “controlled participant” in that qualified cost sharing arrangement. Specific requirements are provided for the cost sharing arrangement, which must be recorded in a document, including the provision of a methodology to calculate each controlled participant’s share of intangible development costs, based on factors that can reasonably be expected to reflect the participant’s share of anticipated benefits.⁶⁶ It has been noted that:

⁶¹ OECD Guidelines at para 8.3.

⁶² Mogle, above n 4 at 10.

⁶³ OECD Guidelines at para 8.9.

⁶⁴ Ibid at paras 8.40 - 8.43.

⁶⁵ Ibid at para 8.15.

⁶⁶ Regs § 1.482-7(b).

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The cost-sharing regulations do not rely on the arm's-length standard to determine the appropriate allocation of costs among participants, and there is no reference to comparable uncontrolled transactions in the cost-sharing regulations.⁶⁷

Taxpayers must fulfil accounting and administrative requirements and submit to various tests.

Tax practitioners have generally welcomed the final cost sharing regulations, concluding that although they are "less definitive" than the proposed regulations, they provide greater flexibility.⁶⁸

3.3 Modes of transfer of an intangible

In a transfer of rights to intangibles, the transferor generally receives a payment for their value, while the transferee acquires an asset that can generate an income stream. Such transfers are thus sensitive transactions, as they can have a major effect on the distribution of the profits of an MNE.

Transfers of intangible property usually take place by way of sale or licence.⁶⁹ Where intangibles are sold outright, the owner/developer must receive an arm's length consideration on transfer. An exception to this rule is the United States, which does not accept outright sale for a fixed price.

Determining an arm's length royalty rate can be a difficult task. The Guidelines provide that a royalty would normally be a recurrent payment based on the user's output, sales, or in some rare circumstances, profit.⁷⁰ Where output or sales are used, the rate may vary according to the turnover of the licensee. The conditions of remuneration may also need to be revised where facts and circumstances have changed, for example, new designs or increased advertising of the trademark by the owner.

Some of the problems that the OECD and the IRS have discovered in applying the arm's length principle to transfers of intangibles have already

⁶⁷ Coopers & Lybrand, *International Transfer Pricing 1997-98* (1997 CCH) at para 822.

⁶⁸ See for eg, Carlson G et al, "Analysis of the Cost-Sharing Regulations" (8 February 1996) *Tax Notes International* for a favourable analysis, but see Coopers & Lybrand, *ibid* at para 822:

Rather than using a cost-to-operating income ratio to check the reasonableness of the allocation of research and development costs, the final regulations rely on an application of the "Best Method Rule" to determine the appropriate method for testing the arm's-length character of intercompany transfers of tangible and intangible property. Accordingly, the final regulations are substantially more flexible but less definitive regarding the allocation of costs under a cost-sharing arrangement.

⁶⁹ OECD Guidelines at para 6.16.

⁷⁰ *Ibid*.

been outlined above, especially in relation to the search for comparables. The IRS has not been able to establish a consistent and reliable standard of comparability:

As a result, disputes between taxpayers and the IRS over what constitutes an arm's-length royalty have typically been resolved in ad hoc fashion without any coherent or consistent rationale.⁷¹

The "arm's length range" concept adopted in *Seagate*⁷² may form a standard to be applied in such cases.

A problem that arises in relation to the transfer of intangibles relates to so-called "package deals", where a single charge is made for a variety of things. A company might sell goods, licence intellectual property and provide technical services, all for an undifferentiated payment. Tax authorities may want to deal with the various parts of the transaction separately, as the tax treatment of the various ingredients may differ either under domestic law or under the relevant DTA.

The OECD states that there is no general principle that can be applied, except that there should be no double deduction for the provision of technology.⁷³ As the situation is a complex one, the facts and circumstances must determine the appropriate method of handling any specific situation.

Where the tax laws of a particular country require a disaggregation of a package, for example, for the sale of equipment (tangible property) along with some intangible property incorporated into the equipment (for example, software) this can have a dramatic effect on the supplier, since in most cases sales of equipment by a nonresident supplier will be exempt from local tax, while payments for the supply of intangible property may be subject to a withholding tax. However, a recent International Fiscal Association report has found that:

It appears that, absent unusual circumstances, most jurisdictions are content, for income tax purposes, to focus on the tangible property element of such contracts, and to view the accompanying technology transfer as incidental or ancillary. In many cases, this is the only practical result, since virtually any transfer of tangible property can be viewed as encompassing some form of a technology transfer. However...a technology supplier must take into account, in dealing with mixed contracts, a wide variety of local rules that are often inconsistent.⁷⁴

⁷¹ Mogle, above n 4 at 22.

⁷² See above n 30.

⁷³ OECD Guidelines at para 6.17.

⁷⁴ "The taxation of income derived from the supply of technology" LXXXIIa (1997) *Cahiers de Droit Fiscal International* at 37-38.

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Even the US final regulations provide that “embedded intangibles” will not be considered a transfer of intangible property where the purchaser of the tangible property does not acquire any rights to exploit the intangible, other than the right to resell the tangible property under normal commercial circumstances.⁷⁵ Presumably, the US regulations would treat the package mentioned above as a transfer of tangible property.⁷⁶

4 METHODS FOR DETERMINING ARM'S LENGTH CONSIDERATION FOR TRANSFERS OF INTANGIBLE PROPERTY

4.1 Choosing a transfer pricing methodology for intangible property transfers

There are marked similarities in the US, OECD and Australian approaches to choosing a transfer pricing methodology for intangible property transfers.

The US final regulations adopt the “Best Method Rule”, which was introduced with the intention of avoiding the rigid hierarchical system that had previously applied. The final regulations require a taxpayer to select the pricing method that, under the facts and circumstances under review, provides the most reliable measure of an arm's length result, relative to the reliability of other applicable methods. The greater flexibility of the final regulations is also indicated by the fact that the taxpayer is allowed to establish an arm's length amount through the use of a method (properly documented) other than those specified in the regulations.

Factors influencing the selection of a particular method include:

- 1 The use of comparable uncontrolled transactions, and their degree of comparability with the taxpayer's transactions under review;
- 2 The quality, ie, the completeness and accuracy of the underlying data; and
- 3 The reliability of the assumptions used in the analysis.⁷⁷

Three methods can be used to determine whether an intangible property transaction has taken place at arm's length: the comparable uncontrolled transaction (“CUT”) method,⁷⁸ the comparable profit method (“CPM”), and

⁷⁵ Regs § 1.482-3(f).

⁷⁶ See Mogle, above n 4 at n 86.

⁷⁷ Regs § 1.482-1(c).

⁷⁸ The US counterpart to the OECD comparable uncontrolled price (CUP) method. In the US, the CUP method is only utilised for tangible goods.

certain specified “other” methods.⁷⁹ These methods are to apply to transfers of intangible property, as well as transfers of tangible property which involve significant, non-routine intangibles.⁸⁰

The OECD Guidelines do not explicitly refer to the Best Method Rule, but adopt essentially the same principle. They recommend that taxpayers select a method that is able to provide the best estimation of an arm’s length price, taking into account the facts and circumstances of the case, the mix of evidence available and the relative reliability of the various methods under consideration.⁸¹

Comparisons with uncontrolled transactions can only be relevant where the economically relevant characteristics of the situations undergoing comparison are sufficiently comparable.⁸² Factors determining comparability are:

- 1 The specific characteristics of the property - in the case of intangible property, the form of transaction (for example, licensing or sale), the type of property (for example, patent, trademark or know how), the duration and degree of protection, and the anticipated benefits from the use of the property;⁸³
- 2 The functions performed by the parties;
- 3 Any contractual terms;
- 4 The economic circumstances of the parties; and
- 5 The business strategies of the parties.⁸⁴

The Guidelines are flexible in the use of transfer pricing methods, in that MNE groups are given the freedom to apply methods other than those described in the Report to establish prices, provided those prices satisfy the arm’s length principle.⁸⁵ (Tax administrators are requested to “hesitate” from making minor or marginal adjustments!)⁸⁶ However, relevant documentation should be maintained in this regard. It is not necessary to apply more than one method.⁸⁷

The Guidelines accept five transfer pricing principles as potentially consistent with the arm’s length principle: the comparable uncontrolled price (“CUP”) method, the resale price method (“RPM”), the cost plus method (“CP”), the profit split method (“PSM”), and the transactional net margin

⁷⁹ Regs § 1.482-4(a).

⁸⁰ Regs § 1.482-4(b).

⁸¹ OECD Guidelines at para 1.69.

⁸² Ibid at para 1.15.

⁸³ Ibid at para 1.19.

⁸⁴ Ibid at para 1.17.

⁸⁵ Ibid at para 1.68.

⁸⁶ Ibid.

⁸⁷ Ibid at para 1.69.

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method ("TNMM"). It is generally accepted that these are applied in much the same way as their namesakes in the US regulations.⁸⁸

These five arm's length methodologies are also accepted by the Australian revenue authorities,⁸⁹ which utilise similar attributes of comparability to the US final regulations and the OECD Guidelines.⁹⁰ However, unlike the Guidelines, the Australian authorities are of the opinion that sometimes a hybrid or more than one method is needed.⁹¹ In addition, where a traditional transaction method (ie, CUP, RPM or CP) has been employed and there is some uncertainty as to the reliability of the outcome, perhaps due to comparability factors and the quality of the data used, they state that another basis should be used as a check.⁹²

4.2 Traditional transaction methods

4.2.1 Comparable uncontrolled price method ("CUP")

The CUP method is closest to market conditions as it compares the price charged for controlled transfers to the price charged for comparable uncontrolled transfers.⁹³ When comparable uncontrolled transactions can be identified it gives the most reliable results, which is why the Guidelines regard it as "preferable over all other methods"⁹⁴ in such circumstances. However, as the Guidelines observe, the unique qualities of many intangibles makes it difficult to establish transfer prices based on comparable uncontrolled transactions.⁹⁵ Tax authorities are advised to consider whether intangible property has the same value and usefulness to the controlled licensee as it would have to an independent licensee.⁹⁶

The key factor in evaluating comparables under the CUP method is product similarity. In practice, this method is often very difficult to apply to intangible transactions, as it is unlikely that MNEs will be able to access details of appropriately comparable transactions. This is a particularly the case in Australia, where:

⁸⁸ Chip WW, "OECD Guidelines" in Feinschreiber, above n 29 at 20-9. Practitioners would appear to agree that the US and OECD methods are applied in either identical or similar fashion.

⁸⁹ See TR 97/20 para 3.1.

⁹⁰ Ibid at paras 3.6 - 3.9.

⁹¹ Ibid at para 3.4.

⁹² Ibid at para 3.8.

⁹³ OECD Guidelines at para 2.6.

⁹⁴ Ibid at para 2.7.

⁹⁵ Ibid at para 6.13.

⁹⁶ Ibid at para 6.14.

Reliable information regarding comparable uncontrolled prices and products is difficult to locate in the Australian market. Whilst a database is available, ("Profound") which identifies organisations on an industry and activity basis, the particularly small Australian market makes identification of reliable comparables difficult. Further, the Australian market is somewhat "incestuous" in that many Australian companies are members of multinational groups and thus themselves are engaged in controlled transactions such that reliable comparisons cannot be made.⁹⁷

The US CUT method has particularly stringent comparability requirements, which limit its applicability. It can only be applied if transactions can be identified which pertain to: the same class of intangible property, the same type of products, the same general industry, the same "profit potential" and comparable circumstances.⁹⁸

4.2.2 Resale price method ("RPM")

With this method, one starts with the price at which goods are sold to arm's length purchasers and deducts an appropriate mark-up (the "resale price margin"). It is most useful where a person buys from a related seller and then sells on to an independent purchaser, and most accurate where the margin is realised soon after the reseller's purchase of the goods. A time lapse will mean that it is likely that other factors, such as exchange rate fluctuations, will need to be taken into account in a comparison.⁹⁹

As a method, it is not ordinarily used where a controlled taxpayer uses its intangible property to add substantial value to the sale of tangible goods. For intangible property transactions, the Guidelines specifically state that this method may be used to analyse the terms of the controlled transaction where the associated enterprise sub-licenses the property to third parties.¹⁰⁰ This is in marked contrast to the US final regulations, which only utilises RPM for transactions involving tangible property.

Where the CUP method focuses on product similarity, the RPM is concerned with similarity of functions, risks and contractual terms. Factors such as management efficiency and differences in business experience, which would have little effect on comparability under the CUP method, may need to be taken into account. However, once again, in practice, RPM may be difficult to apply. There is a need for relatively complete accounting information in order to identify and adjust for differences in accounting classifications of expenses between cost of goods sold and operating expenses.

⁹⁷ Coopers & Lybrand, above n 67 at para 1111.

⁹⁸ Regs § 1.482-4(c)(2)(ii).

⁹⁹ OECD Guidelines at para 2.23.

¹⁰⁰ Ibid at para 6.23.

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Both the Guidelines and the latest Australian taxation ruling on arm's length transfer pricing methodologies for international dealings¹⁰¹ acknowledge that it is difficult to obtain information about arm's length margins. The ruling notes that there is no current requirement in Australia for companies to publicly disclose their gross margins.¹⁰²

4.2.3 Cost plus method ("CP")

This method determines an arm's length price by taking the supplier's cost and adding an appropriate profit mark-up. It may be useful where comparable actual selling prices to external customers are not available. However, problems can arise in determining an arm's length profit mark-up, as many factors can influence profits, for example, competitive conditions in the marketplace. Like the RPM, it is dependent on similarity of functions performed, risks borne and contractual terms. Another major problem is that there is no universal cost accounting concept. The difficulty in obtaining the relevant information about arm's length margins in uncontrolled transactions is applicable here, too. Unlike the OECD and the Australian tax authorities, the US final regulations only contemplate the use of CP for sales of tangible property.

4.3 Profit methods

Traditionally, transactional methods have been preferred over profit methods, as they are seen to be more in line with the arm's length principle. However, in recent years, more and more attention has been focused on profit-based methods. This is due mainly to the growing realisation that transaction-based methods are very difficult to apply to MNEs with a vast array of interrelated transactions. Technology based industries dealing in intangibles struggle to find reliable data to analyse comparability, especially where non-routine intangibles are involved. The US and Australian tax authorities and the OECD now all accept the need for profit-based methods, to varying degrees.

In addition to the comparable profits method, the US final regulations also prescribe two profit split methods: the comparable profit split and the residual profit split.¹⁰³ The inclusion of these two profit split methods has been attributed to "the strong urging of high-technology industries".¹⁰⁴ In the

¹⁰¹ TR 97/20.

¹⁰² Ibid at para 3.19.

¹⁰³ Regs § 1.482-6(c) (1).

¹⁰⁴ Nolan J, "US Final Transfer Pricing Regulations" (April 1996) 50 *University of Miami Law Review* at 566.

US, several investigations have demonstrated that methods other than transactional methods are more frequently used in practice.¹⁰⁵

In Australia, in situations where there may be no comparables for a combination of transactions (such as transfers of tangible and intangible goods and services):

profit methods may be a more reliable way to set or review the transfer pricing used in the dealings between the associated enterprises, or to check findings made using traditional methods if there is doubt about the reliability of the data used or the outcome produced.¹⁰⁶

Here the profit method used will depend on the facts and circumstances of the case. The profit-based methods include the profit split method and the transactional net margin method ("TNMM"). The Australian revenue authorities have generally adopted a more flexible approach than the OECD.¹⁰⁷

The OECD has long been resistant to the idea of profit-based methods, but now allows them as a method of last resort, where "traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all".¹⁰⁸ The only profit methods the OECD regards as complying with the arm's length principle are those that are consistent with the profit split method or the transactional net margin method as described in the Guidelines. The OECD singles out "so-called 'comparable profits methods' or 'modified cost plus/resale price methods'"¹⁰⁹ as being acceptable only to the extent that they are consistent with the Guidelines.

4.3.1 *The comparable profit method ("CPM")*

The comparable profit method compares the profit margins on related party transactions with profit margins of similar, independent enterprises. Objective measures of comparability referred to as profit level indicators ("PLIs") are used to determine an arm's length consideration for a controlled transaction. Such PLIs are ratios that measure relationships between profits with costs incurred or resources employed.¹¹⁰ The CPM places considerable emphasis on comparability regarding cost structure, ie, resources employed, costs assumed and functional comparability. Because of this:

¹⁰⁵ Becker H, "The New OECD Report on Transfer Pricing – A First Overview and Comment" (1994) 8 *Intertax* at 361.

¹⁰⁶ TR 97/20 para 3.52.

¹⁰⁷ See for example, *ibid* at para 3.98.

¹⁰⁸ OECD Guidelines at para 3.1.

¹⁰⁹ *Ibid*.

¹¹⁰ Regs § 1.482-5(b)(4).

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The comparable profit method does not provide an accurate measure of an arm's length result when the tested party uses valuable, nonroutine intangibles that it developed itself or acquired from a third party. This method will then be limited to use when the intangible is routine and not unique. Because no clear definition of valuable, nonroutine intangibles has been given in the regulations, it is unclear when this limitation will apply.¹¹¹

It is interesting to note the alternative viewpoints presented regarding CPM. Coopers & Lybrand have stated that "[m]any taxpayers have found that CPM provides the most practical method to test the arm's length character of their transfer prices."¹¹² On the other hand, a survey of over a hundred of the one thousand largest US industrial corporations for 1993, as reported in Fortune Magazine, achieved a different result:

The comparable profit method seems to be least preferred for several reasons. This approach could be applied in a manner that would be inconsistent with the arm's-length standards. This concern might be attributable to the fact that operating profit is normally affected by more factors than gross profit or price, which are the measure employed under other methods. In addition, the comparable profit method would be applied without taking these additional differences into account, and as a result, the comparability achieved under this method would be weaker than the comparability required under other methods. Finally, it is possible to apply the comparable profit method without making adjustments for observed material differences, which might lead the respondents to believe that the IRS would routinely apply the method in a manner that did not provide a reasonable and reliable measure of an arm's-length result.¹¹³

As mentioned above, the OECD has expressed serious reservations about the CPM. Perhaps the most important criticism is that operating profit can be influenced by factors totally unrelated to prices or margins involved in intercompany transactions. The OECD has evaluated the CPM and come up with its own alternative: the TNMM.

4.3.2 Comparable profit split method

This method depends on discovering the profit on comparable transactions between two unrelated enterprises. The difficulties involved in obtaining such data prevent most taxpayers from using this method.

¹¹¹ Bee CW, "The Best Method Rule" in Feinschreiber, above n 29 at 7-13.

¹¹² Coopers & Lybrand, above n 67 at para 811.

¹¹³ Kim SH, Swinnerton E & Ulferts G, "1994 final transfer pricing regulations of the United States" (Spring 1997) 5 *Multinational Business Review* Detroit Issue 1 at 8.

4.3.3 *Residual profit split method (US)*

This profit split method attempts to estimate an arm's length return for each party in a controlled group by a comparison of the relative economic contribution of each party to the success of the business as a whole, and dividing the worldwide profit between them on the basis of the relative value of each contribution.

Here, the combined operating profit or loss from the relevant business activity is allocated between controlled taxpayers in a two-step process:¹¹⁴

- 1 Operating income is allocated to each party in a manner that will yield a market return to them for routine contributions to the business activity.
- 2 Residual profit that is attributable to the controlled group's valuable intangibles is apportioned.

Comparables still need to be found, which may prove difficult. A functional analysis will determine the "routine contributions", and the rate of return is based on market returns of controlled taxpayers by reference to another specified method, for example, CPM.

The second step refers to the apportionment of the residual profit that remains after the income allocation, where valuable non-routine intangibles are owned by the controlled group but similar items are not owned by the uncontrolled taxpayers that are used to determine market returns in the first step. Three methods of apportionment are provided:¹¹⁵

- 1 The relative values of the item or items of intangible property may be measured by external "market benchmarks". The regulations do not define this term. The IRS informally indicated that market benchmarks refer to external data involving uncontrolled taxpayers or uncontrolled transactions.
- 2 The relative values of the item or items of intangible property may be estimated by the capitalized cost of originally developing the property, plus the cost of developing all related improvements and updates, less amortization, based on the useful life of each intangible. The regulations reserve on the reliability of this capital cost method, although it is used in the only example given on computation of a profit split.
- 3 Finally, if research and development expenditures of the parties are relatively constant and the useful life is approximately the same, actual expenses may be used to determine the relative value of each item of intangible property.¹¹⁶

¹¹⁴ Regs § 1.482-6(c)(3)(I).

¹¹⁵ Regs § 1.482-6(c)(3)(I)(b).

¹¹⁶ Hammer RM & Feinschreiber R "Profit Split Methodologies" in Feinschreiber, above n 29 at 27-21.

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4.3.4 Profit-split method (OECD)

The OECD Guidelines outline a profit-split method similar to that adopted in the US. The OECD method determines the division of profits from controlled transactions in accordance with how profits would have been divided between independent enterprises.¹¹⁷ Like the US version, it utilises a contribution and a residual analysis, referring to the profits arising from “high-value, sometimes unique, intangibles”.¹¹⁸ In fact, although the OECD has shown great reluctance to accept the profit-split method, the Guidelines now explicitly state that the profit-split method may be acceptable in the case of highly valuable intangibles for which no comparable uncontrolled transactions can be found.¹¹⁹ The difference lies in the fact that while the division of profits between comparable independent parties is only one factor to be evaluated under the Guidelines’ contribution analysis, it is the essential factor under the US regulations.

4.3.5 Transactional net margin method (“TNMM”)

Introduced by the OECD Guidelines, TNMM is substantially similar to the Comparable Profits Methods (“CPM”) under the s 482 regulations. It compares the net profit margins from controlled and uncontrolled transactions relative to an appropriate base, such as sales, costs or assets.¹²⁰ The primary distinction between the two methods is their approach to aggregation of financial data about controlled and uncontrolled transactions:

The comparable profits method requires that the analysis be based on the “most narrowly identifiable business activity” for which financial data is available. By contrast, the Guidelines start from the presumption that transactions are ideally analyzed individually and that each level of aggregation must be justified. Critics of the comparable profits method in some OECD countries are concerned that “the most narrowly identifiable business activity” may exceed the degree of aggregation that would be acceptable under the Guidelines.¹²¹

¹¹⁷ OECD Guidelines at para 3.5.

¹¹⁸ Ibid.

¹¹⁹ Ibid at para 6.26.

¹²⁰ Ibid at para 3.26.

¹²¹ Chip WW, “OECD Guidelines” in Feinschreiber, above n 29 at 20-13.

5 OTHER ISSUES

5.1 Global formulary apportionment

Global formulary apportionment, a non-arm's length approach to transfer pricing, is sometimes advocated as an alternative to the arm's length methodologies, particularly in the United States. Under this method, the aggregate income of related companies in an international group is divided among taxing jurisdictions according to a formula.

Proponents of this method argue that it reflects economic reality by treating MNE groups on a consolidated basis. It eliminates many of the problems associated with the arm's length principle, for example, comparable uncontrolled transactions become unnecessary, and it reduces the administrative burden on taxpayers because only one set of accounts is needed for tax purposes. It decreases the uncertainty of an audit and improves tax compliance.¹²²

The OECD has steadfastly rejected global formulary apportionment as a "predetermined and mechanistic formula".¹²³ It is the use of a predetermined fraction, not the use of ratios per se, to which the OECD objects. It states that formulary apportionment should not be confused with the TNMM and profit split allocations of profits in proportion to sales or assets, or with the situation where an MNE group and a national tax administration agree on a proportional apportionment formula, such as might be used in a mutual agreement procedure, advance transfer pricing agreement or other bilateral or multilateral determination.¹²⁴ These formulas are derived from the "particular facts and circumstances" of a taxpayer and thus avoid being pre-determined or mechanistic.

The Guidelines reject global formulary apportionment on the basis that it would be difficult to implement the system in a manner that both protects against double taxation and ensures single taxation.¹²⁵ This would require extensive international cooperation, and countries may not be willing to agree to a universal formula. If all the major countries failed to agree to move to global formulary apportionment, MNEs would be compelled to comply with two totally different systems.¹²⁶

¹²² See Lester, above n 1 at 300.

¹²³ OECD Guidelines at para 3.59.

¹²⁴ Ibid at para 3.60.

¹²⁵ Ibid at para 3.64.

¹²⁶ Ibid at para 3.66.

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Predetermined formulas are regarded as arbitrary, and as disregarding market conditions.¹²⁷ The arm's length principle is also better equipped to deal with the economic consequences of exchange rate fluctuations, because it analyses the specific facts and circumstances of the taxpayer.¹²⁸ Australia, as an OECD member country, does not consider global formulary apportionment to be an acceptable alternative to the arm's length principle for the same reasons.¹²⁹

It is fair to say that:

Neither the arm's length/separate accounting methodology nor formula apportionment works very satisfactorily to divide the income of MNEs among the countries in which they conduct business. This is especially true in the case of income from intangible assets, which are often unique. Separate accounting fails because there are commonly no comparable arm's length transactions. While the failure of separate accounting to deal with this problem might seem to suggest that formula apportionment is appropriate, this method also fails in these cases, and for similar reasons. It is not possible to know either the value or the location of intangible assets, which cannot simply be ignored, since they are "the franchise" in many industries dominated by MNEs.¹³⁰

A compromise that has been suggested is to have separate accounting and formula apportionment as points on a continuum,¹³¹ presumably with profit-split methods somewhere in the middle. There may be room to combine these opposite approaches by devising formulas that are appropriate for certain classes of taxpayers – perhaps high-technology MNEs would choose to adopt global formulary apportionment. This issue needs to be explored further.

5.2 Advance pricing agreements ("APAs")¹³²

An APA is a prospective agreement entered into between taxpayer/s and revenue authority/s as to the transfer pricing methodology to be used to determine arm's length prices in respect of one or more cross-border transactions. It is a relatively recent innovation in the international transfer pricing arena.

Tax authorities are subjecting transfer pricing transactions, especially transfer pricing transactions relating to intangible property, to increased scrutiny. An

¹²⁷ Ibid at para 3.67.

¹²⁸ Ibid at para 3.68.

¹²⁹ TR 97/20 paras 3.100 - 3.106.

¹³⁰ McLure CE, "US Federal Use of Formula Apportionment to Tax Income From Intangibles" (1997) 14 *Tax Notes International* at 870.

¹³¹ Ibid and Lester, above n 1 at 304.

¹³² The scope of this paper does not permit an in-depth analysis of this topic.

APA can “provide a high degree of certainty where there is a transfer pricing risk, whilst maintaining flexibility in the strategic decision making process”.¹³³

Utilising an APA is a particularly attractive option in Australia, as the dearth of comparable transactions makes an arm’s length analysis very difficult. It has found favour with the Australian Taxation Office (“ATO”), which is understood to be considering formalising its APA structure, as recommended in paragraph 22.16 of the Ralph Report.¹³⁴

A number of concerns have been expressed about the confidentiality of very sensitive taxpayer information. This is particularly since the US Bureau of National Affairs Inc has brought an action against the IRS seeking public disclosure of all APAs, and the IRS has responded by asserting that APAs are not subject to the privacy and non-disclosure protection of s 6103 of the Internal Revenue Code.¹³⁵ The Tax Executives Institute has filed a brief amicus curiae with the US District Court for the District of Columbia, and the outcome remains to be seen. The ATO will need to formally respond to the fear of a similar Freedom of Information request being sought here. The APA procedure has been found to be a good way to resolve issues, and it would be unfortunate if it was sabotaged by confidentiality concerns.

6 CONCLUSION: AN APPROPRIATE TYPOLOGY OF INTERNATIONAL DEALINGS INVOLVING INTANGIBLES

The question of the tax treatment of intangibles in the context of transfer pricing in the global economy has led to a re-evaluation of the arm’s length principle, and has seen a move towards greater flexibility and cooperation with MNEs by revenue authorities in many developed countries. The many valid criticisms that have been levelled against the arm’s length principle need to be resolved. In the United States, definitional problems in relation to non-routine intangibles, problems engendered by the new legal ownership test and the need for the introduction of a consistent and reliable standard of comparability for arm’s length royalty rates require urgent attention. Many transfer pricing problems arise out of a lack of uniformity of treatment of intangible asset transactions - greater coordination and standardisation here will encourage a truly global economy to flourish.

¹³³ Donaldson J, “Australia aims to allay APA fears” (March 1999) 10 *International Tax Review* 1.

¹³⁴ *A Tax System Redesigned* (1999 AGPS) (“Ralph Report”) available at <<http://www.rbt.treasury.gov.au>> (at 3 March 2000).

¹³⁵ “APAs should remain confidential, TEI says in brief” (March/April 1999) *Tax Executive* 1.

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Problems with traditional transaction methods, particularly for unique non-routine intangibles, both in the US and in OECD member countries such as Australia, have compelled revenue authorities to explore profit-based methods more comprehensively. Once again, these methods are reliant on finding comparables, and the lack of external data remains a hurdle in all developed countries, but particularly in Australia. Perhaps the establishment of a global database could be explored. The way ahead certainly lies in increased cooperation between the various national tax authorities, and between these authorities and MNEs.

APAs have a role to play in resolving uncertainties, but there is a need to look beyond these to a more efficient procedure for dispute resolution. A move away from an adversarial attitude would facilitate solutions. Flexibility and the willingness to explore new avenues for acceptable methodologies are key concepts in realising an improved transfer pricing policy for intangible transactions in the new millennium.

The primary goal of the transfer pricing continuum is to interject rational tax principles into the international transfer pricing debate. Rational tax principles suggest a more pragmatic approach to resolving transfer pricing issues. Debate on these issues should be guided by our shared understanding for good tax principles, rather than the present conventional wisdom of the tax community.

Athens, the largest and most powerful city in ancient Greece, was the chief administrator of the Delian League. The league was a defense alliance to which weak cities paid a compulsory tribute tax in exchange for protection. Aristides the Just was the first tax assessor. The biographer Plutarch, described Aristides taxes:

[H]e drew up the list of assessments not only with scrupulous integrity and justice but also in such a way that all states felt they had been justly and fairly taxed. ... [The cities] desired Aristides of the Athenians and gave him command, surveying the country and revenue, to assess everyone according to ability and worth.

The time of Aristides was a "golden age" for Athens and its allies. If we too are to experience a golden age, then our tax systems must be just for both tax administrators and taxpayers.¹³⁶

¹³⁶ Lester, above n 1 at 284.