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# Transfer Pricing & Intangible Property

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# What is covered under Intangible Property

## Definition:

- Property with no physical existence but whose value depends on the legal rights of the owner

- Patents, trademarks, trade names, designs or models, artistic property rights and intellectual property such as trade secrets (OECD 2010 TPG Chapter VI 6.2)

# Examples

# Focus on Intangible Property

## Why are IP prices susceptible to TP manipulation

1

### High value

2

### Easy mobility

3

### Complexity

# Focus on Intangible Property

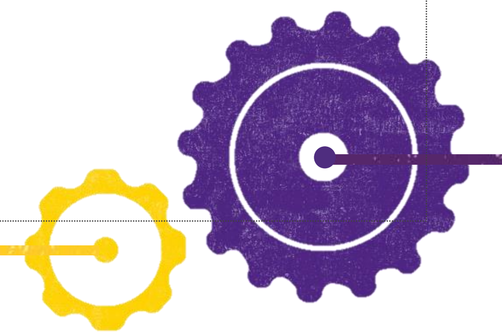
**Why the complexity:**

Intangible asset without physical presence

IP related financial issues exist in commercial practices

Accounting and attribution of profits

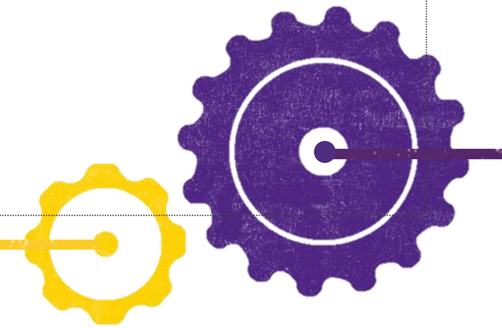
Group synergies



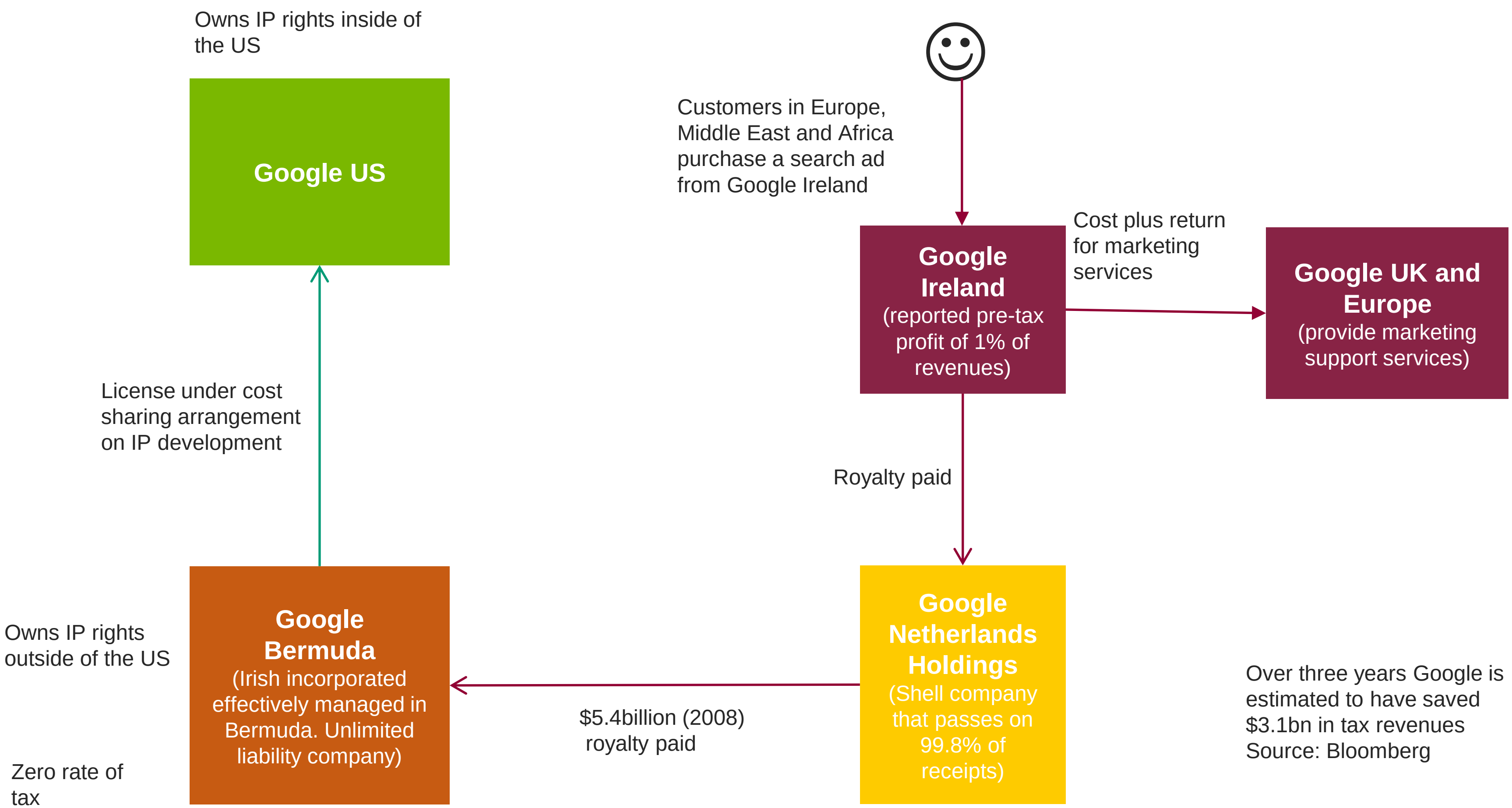
# Focus on Intangible Property

## Commercial Practices:

- Commercial practice of selling IP or patents as a group
- How to establish the value
- Jurisdictions and protection and taxation of IP
- Allocation of all related development costs to the group entities



# So what is BEPS really all about?



# Case law

## Some examples…

**Pfizer** 2007-2009 reported a net loss of $5.2 billion in the US, (corporate headquarters) In those same years, its foreign subsidiary located in Ireland, reported a pretax profit of $20.4 billion

**Oracle Corporation's** Irish subsidiary paid no income taxes 2006 - 2007 while it managed to produce ¼ of Oracles' total pretax income. The subsidiary accomplished all of this without one recorded employee

# History of BEPS

### JUNE 2012
**Initial Discussion Draft issued**

- Result of the project commenced by OECD WP 6 in 2010
- 1.5 years ahead of original schedule

### NOV 2012
**Public Consultation**

- Not all intangibles give rise to premium returns
- Dilution of return following risk
- Intangible related return = residual profit

### JUNE 2013
**BEPS kick off**

- Public pressure resulting in political consensus on tax planning
- G20 requests OECD to develop Action Plan

### JULY 2013
**BEPS Action plan addressing IP**

- IP is part of Action Plan 8, ensuring that transfer pricing outcomes are in line with value creation
- IP is seen as a key value driver

### JULY 2013
**Revise d Discussion Draft**

- Some softening on:
  - Legal ownership
  - Funding
- New guidance on local market features, location savings, group synergies, assembled workforce

### SEPT 2013
**Reque st for comments**

- Importance of value creating functions
- Special measures… new term for profit share

### SEPT 2014
**Revise d Chapter VI guidance**

- Finalised guidance on definition of intangibles and certain valuation issues
- Guidance on IP ownership and DEMPE functions remains interim

### DEC 2014
**Discus sion Draft on Profit Splits**

- Poses questions on the practical application of profit splits

### DEC 2014
**Discus sion Draft on Chapter I**

- Reviews the location of risk, and its impact upon the question of when tax authorities should have the right to re-characterise transactions as established by taxpayers

### APRIL 2015
**Discus sion Draft on CCAs**

- Objective in revising the guidance is to align the transfer pricing of intangibles under CCAs with the general guidance in revised Chapter VI
- Focus is on the requirement to measure contributions at value rather than at cost

# Focus areas

- What is an intangible

- "… intangible is … something that is not a physical asset or a financial asset, and which is capable of being owned or controlled (or transferred) for use in commercial activities"

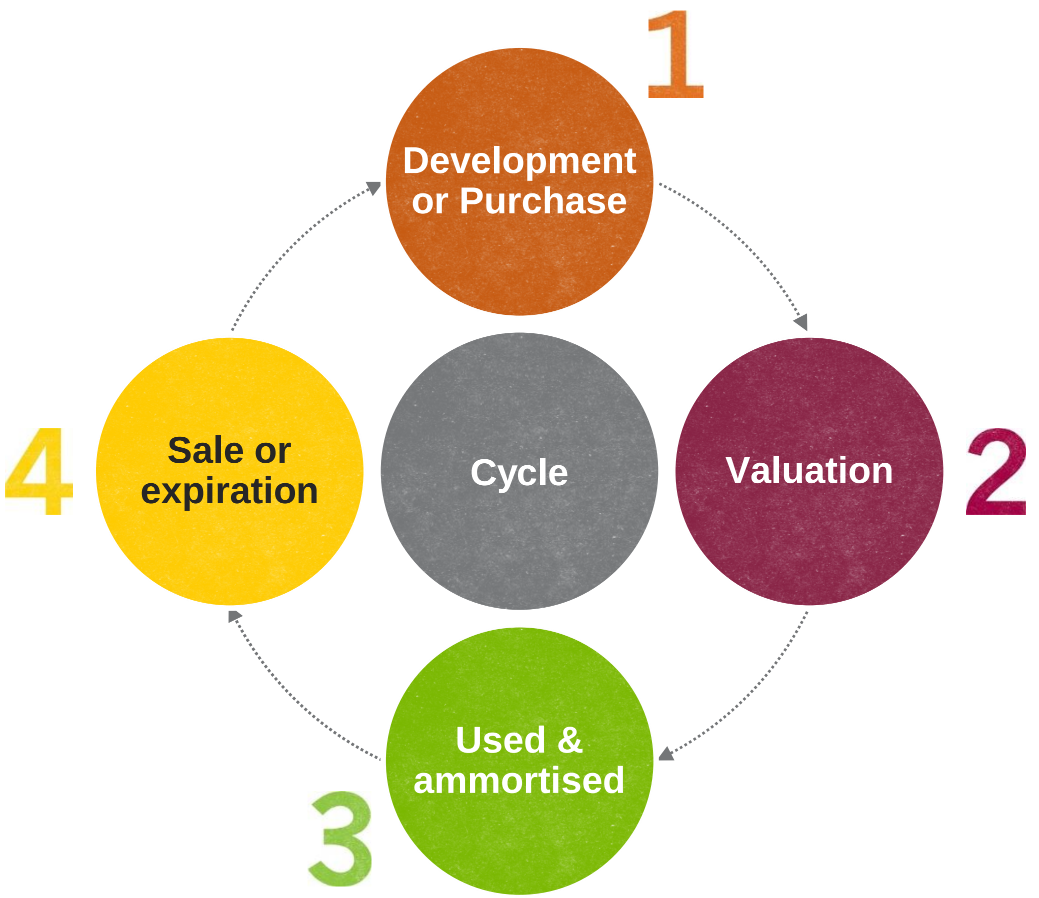
What is an appropriate return for an intangible

- "Legal rights and contractual arrangements form the starting point for any transfer pricing analysis of transactions involving intangibles"
- "The transfer pricing method selected should take into account all of the relevant factors materially contributing to the creation of value, not only intangibles and routine functions"

Where should returns for intangibles be taxed

- "If the legal owner of intangibles is to be entitled ultimately to retain all of the returns derived from exploitation of the intangibles it must perform all of the functions, contribute all assets used and assume all risks related to the:
  - **D**evelopment
  - **E**nhancement
  - **M**aintenance
  - **E**xploitation of the intangible"

# Life Cycle of IP



# Development of IP

| Contract R&D | Cost sharing |
|---|---|
| • Set up separate entity<br>• Few locations<br>• Ownership<br>• Control | • Centralised<br>• Different entities share |

# Structuring and Documenting

## “What tax authorities will look for”



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# Structuring and documenting a CCA

Should reflect **arm's length price**

Use of **allocation keys**

**Full access** to information

Properly **documented**

# Cost Contribution Agreement for Intangibles

**OECD Guidelines, Chapter VIII, Paragraph 3**

share of the overall contributions to the arrangement will be consistent with the participant's proportionate share of expected benefits

'Each participant entitled to exploit its interest in the CCA separately as an **effective owner** thereof and not as a licensee, and so **without royalty** or other consideration to any party for that interest

# Cost Contribution Agreement for Intangibles

- Each participant is accorded separate rights to exploit the intangible property, for example in specific geographic areas or applications
  - in other words a participant uses the intangible property for its own purposes rather than in a joint activity with other participants
- Note: CCAs can exist for any joint funding or sharing of costs and risks, for developing or acquiring or for obtaining services

# Steps in a CCA

- Arm’s length principle
- Determining participants
- Contribution
- Withdrawal or termination

# Cost Contribution Agreement for Intangibles

## Applying the arm's length principle

- "For the conditions of a CCA to satisfy the arm's length principle, a participant's contributions must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances, given the benefits it reasonably expects to derive from the arrangement"
- "What distinguishes contributions to a CCA from an ordinary intra-group transfer of property or services is that part or all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills"

# Cost Contribution Agreement for Intangibles

## Applying the arm's length principle (cont..)

- Considering how independent enterprises would carry out a CCA is key..
- "Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement"
- Clearly the potential exists to allocate contributions amongst CCA participants to manipulate taxable profits in different jurisdictions: taxpayers should be prepared to substantiate the basis of their claim

# Cost Contribution Agreement for Intangibles

## Contribution

The concept of mutual benefit is key to a CCA: a party may only be considered if there is reasonable benefit from the CCA activity

Note that the requirement of an expected benefit does **NOT** impose a condition that the subject activity in fact be successful

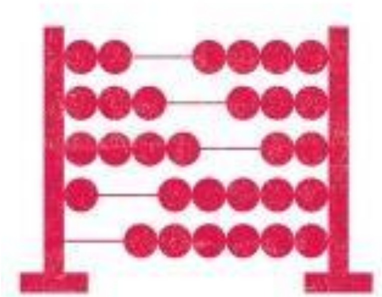
Participants may decide that a separate company that is not a participant carry out the subject activity in which case an arm's length charge would be appropriate to compensate the company

# Cost Contribution Agreement for Intangibles

## Contribution


Should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances (OECD guidelines Chapters I-VII)

Evaluation process should recognise all contributions by participants to the arrangement, including property or services that are used in both CCA activity and the participant's own business activity



# Cost Contribution Agreement for Intangibles

## Contribution

Not an exact science, the goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate the contributions in the same proportions

In practice an approach which is frequently used is to reflect the participant's proportionate share of expected benefits is by use of an allocation key

(possibilities for allocation keys include sales, units used produced or sold, gross or operating profit, the number of employees, capital invested etc)

# Cost Contribution Agreement for Intangibles

## CCA Entry, withdrawal or termination

Not an exact science, the goal is to estimate the shares of benefits expected to be obtained by each participant and to allocate the contributions in the same proportions

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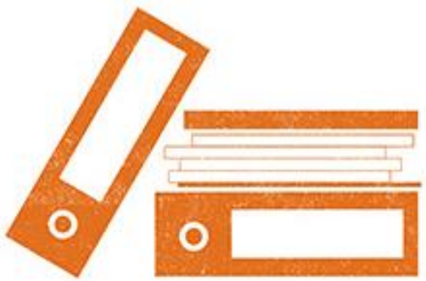
# Cost Contribution Agreement for Intangibles

Entry, Withdrawal or termination:



**OECD Guidelines Chapter 8 Paragraph 31**

Entry
An entity that becomes a participant in an already active CCA may obtain an interest in results of prior CCA activity

Buy-in payment:

"arm's length principle, value for the transferred interest."

If the results of the of prior CCA activity have no value then there will be no buy-in payment

**Buy out** when participant leaves





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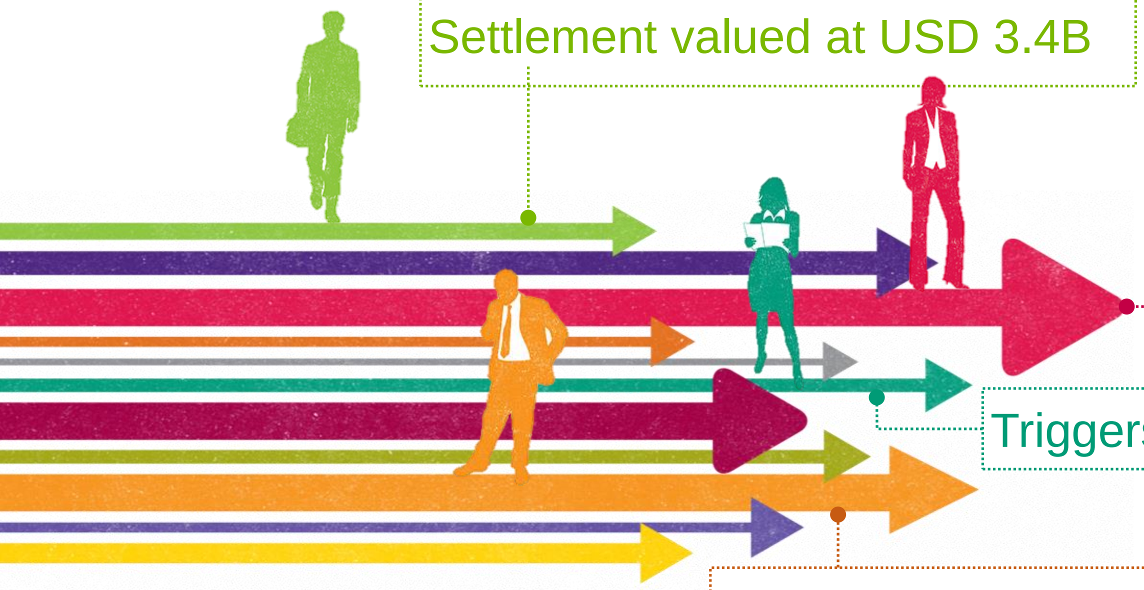
# GlaxoSmithkline Holdings (America) Inc. vs. Commissioner of Internal Revenue

# GlaxoSmithkline (GSK) Valuation of IP

## Summary…

Settlement valued at USD 3.4B



Scope of exploitation

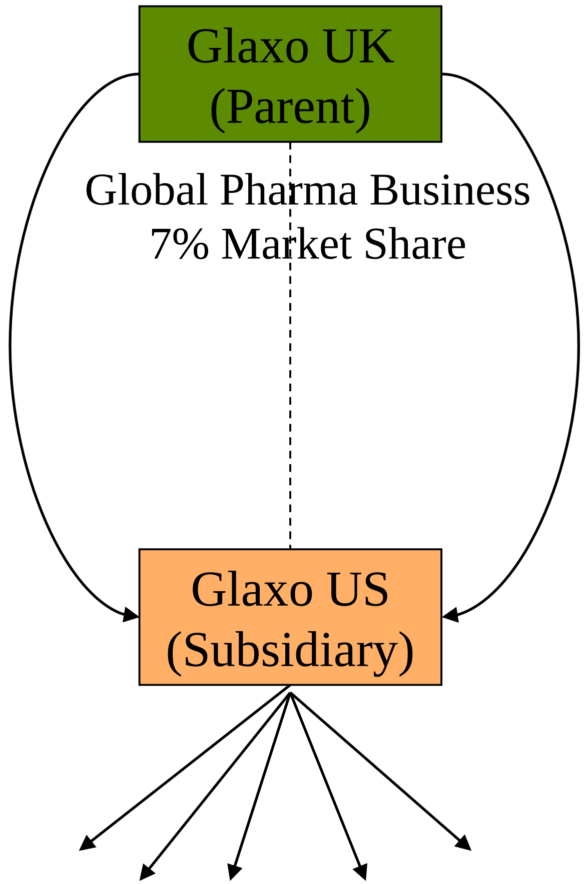
Triggers to potential tax avoidance

Business is development of pharma

…

# GlaxoSmithkline (GSK) Case Transactional Flow / Facts

- Sales of tangible items such as raw materials, samples,drugs,etc. ( i.e.,COGS)
- Transfer price based on resale minus methodology




- License of intellectual Property rights
- Royalty Periodically adjusted - Glaxo U.S. achieves target profitability

**From 1980 to '94, Glaxo US grew from 65th to 2nd largest Pharma Company in US**

U.S. distribution of finished pharmaceutical products

# GlaxoSmithkline (GSK) Valuation of IP

## Largest Transfer Pricing settlement ever

- Long dispute dating back to early 1990s covering six products licensed by Glaxo (UK parent) to its US subsidiary.
  - **ZANTAC**, anti-ulcer compound
    - Largest product represented ~77% of dispute
- Glaxo attempted APA process
  - Glaxo acquired SmithKline Beecham and desired to use similar terms to SKB's APA for TAGAMET (an earlier anti-ulcer product) but IRS refused
- US and UK Competent Authorities could not resolve. UK Inland Revenue supported Glaxo
- Subsequent to Tax Court filings, case settled
- Facts were not fully disclosed figure given as USD 3.4B

# GlaxoSmithkline (GSK) Valuation of IP

## Glaxo Functions/Risks/Activities

| Performed in U.K. | Performed in U.S. |
|---|---|
| • Discovered, developed, patented ZANTAC. Reimbursed US for development expenses. | • Some clinical trials |
| • Manufacturing process R&D | |
| • Developed regulatory approval package | • Assisted with US FDA approval process. |
| • Primary manufacturing (chemical) | • Secondary manufacturing (formulation/packaging) |
| • Owned trademarks | |
| • Designed marketing and co-promotion strategy | • Conducted promotion and direct selling activities. |

# GlaxoSmithkline (GSK) Valuation of IP

**Royalties paid to the UK**

**Success based on marketing and sales in US market**

**Not able to prove clear ownership of patent**

# GlaxoSmithkline (GSK)

## IRS Deficiency notice - Royalty

- Deduction for royalty on know-how limited to what was decided in the agreement
- Increase in Royalty rate not warranted - no increase in value of intangibles
- Royalty on Trademark / Marketing intangibles – disallowed
- Glaxo US – developer of Trademark / Marketing intangibles
- Proposed adjustments confirmed with Residual Profit Split Method

# GlaxoSmithkline (GSK)

## IRS Deficiency notice - Constructive Dividend

Transfer prices in excess of arm's length amount constitute interest free loans on which interest should be accrued and taxed

Alternatively, excess payments to related parties constitute constructive dividends subject to 5% withholding tax (separate Notices of Deficiency).

# GlaxoSmithkline (GSK)

## Lessons from GSK Case

What gross margins are appropriate for pharmaceutical distributor?

Application of developer – assister rules

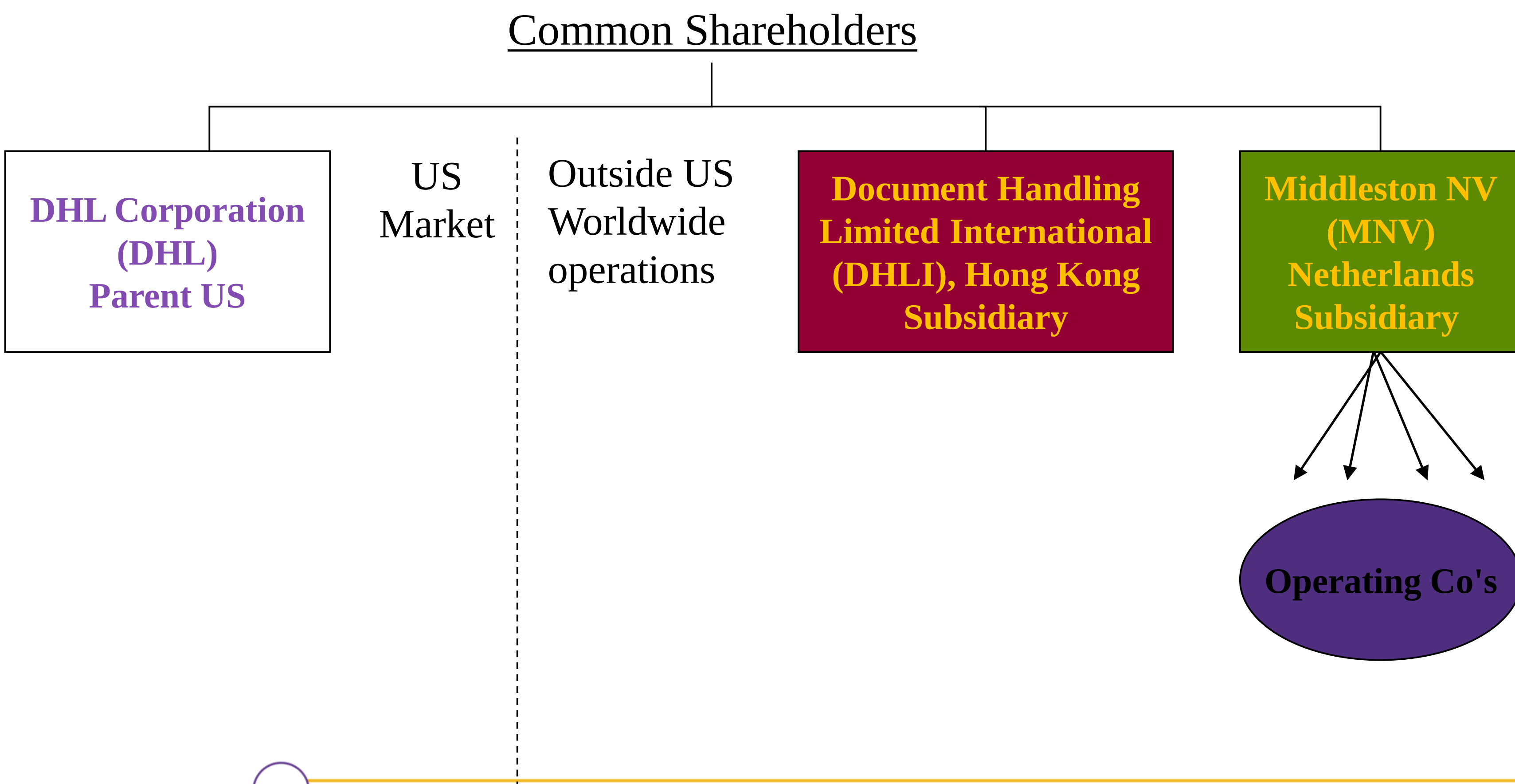
Who owns trademarks, trade names and other marketing intangibles for tax purposes?

Secrecy in patents for comparability analysis

# DHL Corporation and Subsidiaries vs. Commissioner of Internal Revenue

# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case)



# Cost Contribution Agreement for Intangibles

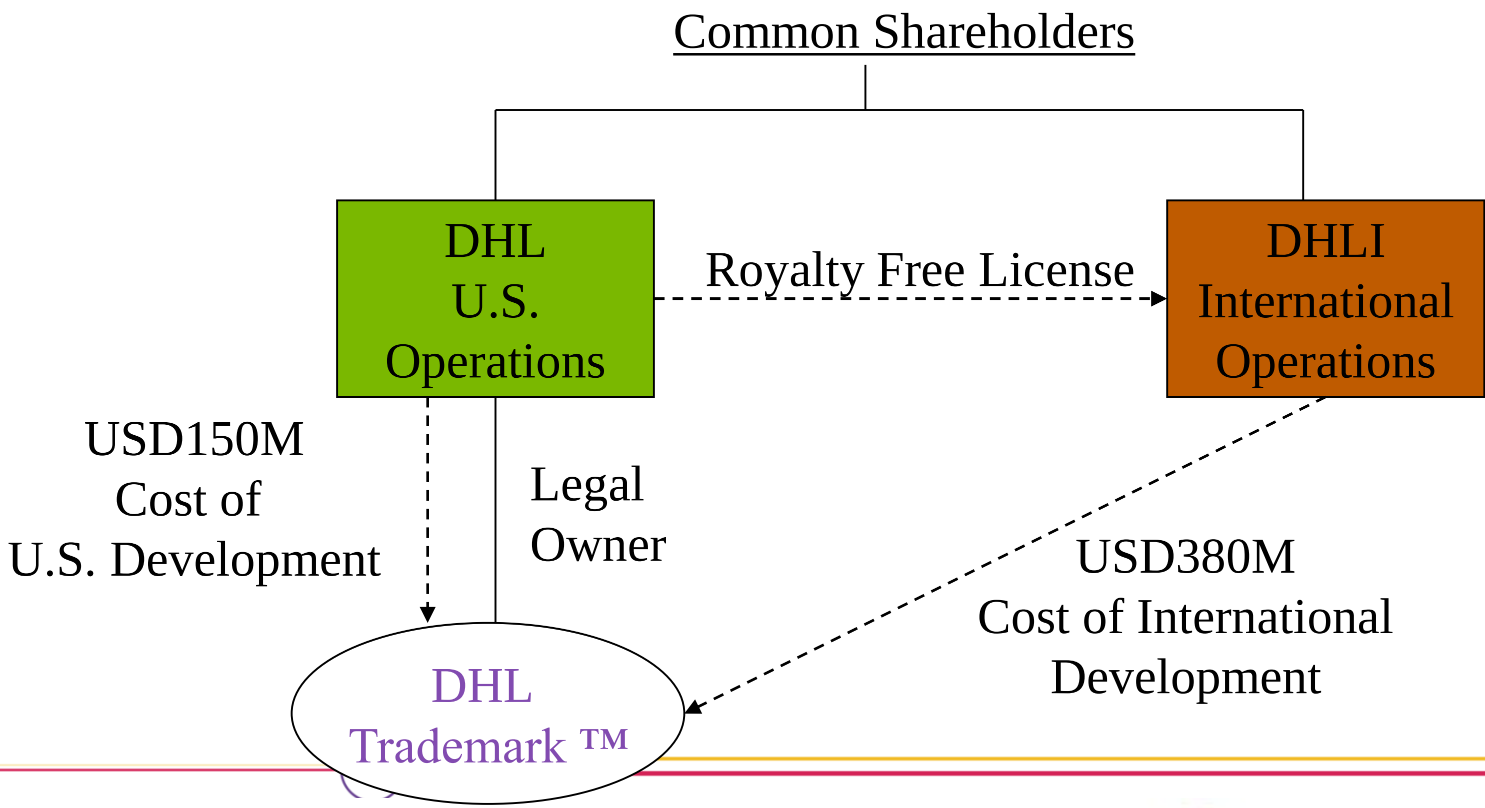
## International Case Laws – (DHL Case) (cont..)

- 1977 – DHLI commissioned the **first 'DHL logo'**
- 1988 – DHL Become the **3$^{rd}$ largest** Courier Co.
- 1992 – DHL operated in **152 countries**
- DHL handled US operations & delivered DHLI's US - bound shipment
- DHLI handled outside US operations & delivered DHL's foreign-bound shipment
- Each Co. kept for itself full amount paid by local customers
- Each Co. paid for its own advertisement expenses

# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

DHL – Pre- 1990 Structure { DHL Trademark }



# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

DHL – Pre-1990 Structure {DHL Trademark}

- Prior to 1990, DHL and DHLI were owned by the same common shareholders
- DHL owned legal title to the "DHL" worldwide trademark
- DHL licensed the trademark to DHLI without charging a royalty
- From 1972 on, DHLI incurred all costs of developing the DHL trademark outside the U.S., including registration of the name in foreign jurisdictions (in its own name), advertising and promotional costs

DHL
- Losses

DHLI
- Profits

# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

Restructuring during 1990 to 1992

- Hired Bain & Co. to resolve cash flow issues in DHL
- Bain suggested merging partner
- Identified foreign investors
- Due Diligence exercise carried out – concerns raised:
  - IRS may impute a royalty for DHLI's use of DHL TM
  - DHL's continuing cash flow problems
  - Suggestion – DHLI to purchase the TM and capitalize DHL
- TM valuations – ranged from 20M USD to 600M USD

## Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

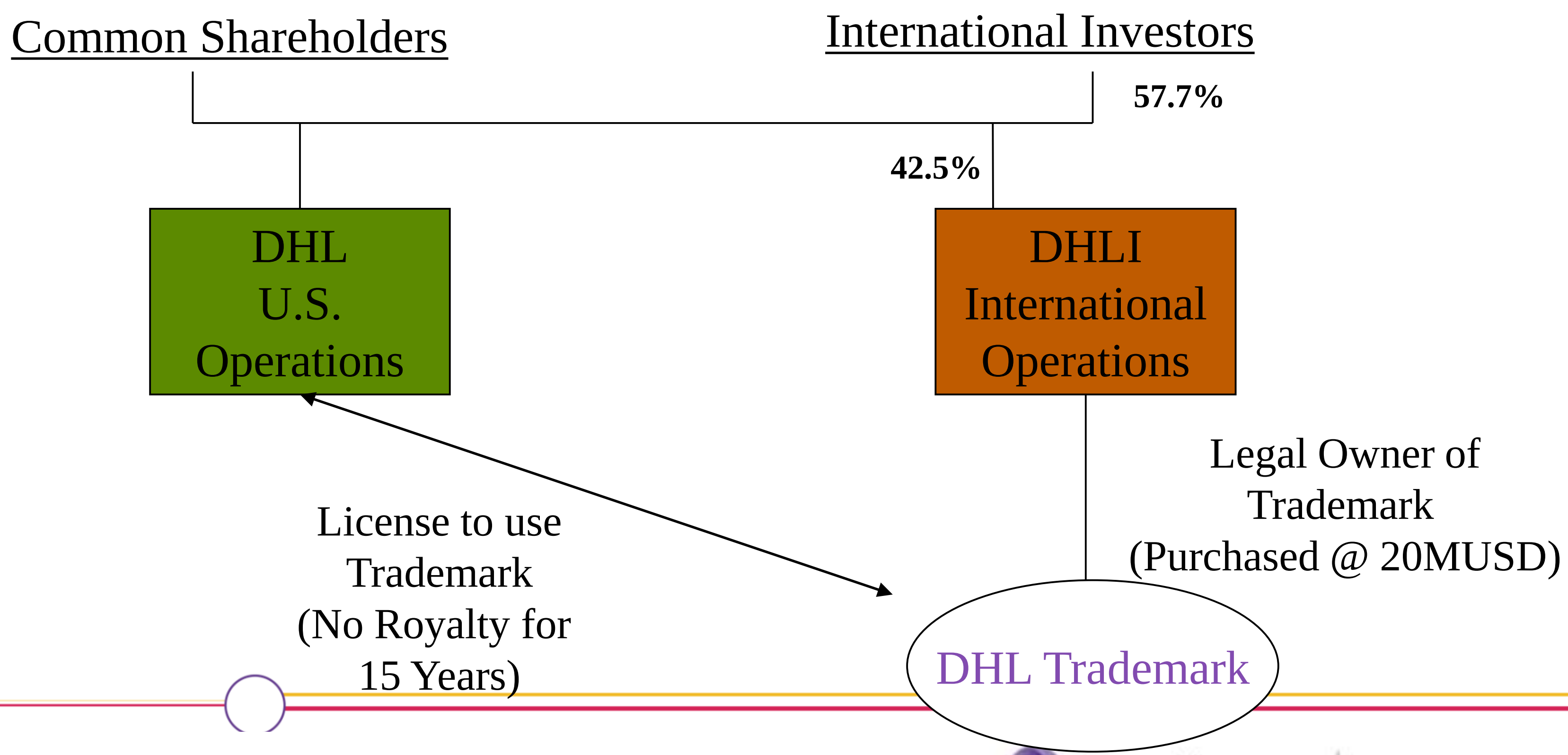
1990 Negotiations and Sale

- International Investors had option to purchase another 45%.
- DHLI also acquired option to buy worldwide rights to DHL trademark for $20 Million.
- DHL continued the royalty free license to DHLI
- **After agreement**, DHL retained Bain & Co. to appraise the trademark's value
- Bain provided a comfort letter stating that it could support the $20 million valuation

## Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

### DHL – Post 1992



# Cost Contribution Agreement for Intangibles

## Issues involved

Royalty Free License provided by DHL to DHLI

Determination of the ALP - Purchase of DHL Trademark by DHLI

# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

IRS challenged …….

DHL's Royalty Free License

20M USD Trademark purchase price

**Demanded 4195M USD Tax & 75M USD Penalties**

## Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

### Tax Court analysis

- Prior to 1992, DHL & DHLI were related parties – Section 482 applied
- Focused on who 'owned' the non-U.S. rights to the DHL trademark
- Tax Court considered a plethora of expert testimony and evidence before concluding that the DHL trademark was worth $ 150 million, including $50 million for the U.S. rights and $100 million for the non U.S. rights, reduced to $50 million due to the unclear ownership.
  - This aggregate $100 million value was only 1/6 of the IRS deficiency-notice value, but five times the taxpayer's asserted transactional value

## Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

### Tax Court's Decision

- Upheld the accuracy-related penalty of Section 6662(e)
- Taxpayer fixed the purchase price and informed Bain of that price prior to obtaining an opinion
- Questioned Bain’s independence

# Cost Contribution Agreement for Intangibles

## International Case Laws – (DHL Case) (cont..)

### Ninth Circuit's Decision

- Reversed the Tax Court on the royalty, trademark purchase price, and penalty issues
- Focused on the 1968 Regulations - developer of an intangible is the economic owner for tax purposes
- Found that DHLI developed the non-U.S. trademarks - spent in excess of $340 million promoting the mark outside the US
- DHLI was the economic owner of non-US rights
- DHLI owed no royalty for the use, exploitation, or purchase of the trademark
- Correspondingly eliminated the accuracy-related penalty - finding that the Bain "comfort" letter established that DHL had acted reasonably

## International Case Laws – (DHL Case) (cont..)

### Conclusion

- **U.S. legally owns the intangible**
  - Cheese examples may allow compensation to licensor
  - U.S. earns the revenue from the intangible function
- **Solution: move the intangible ( as early as possible)**
  - Sale
  - **Cost Sharing Agreement**

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