



**Grant Thornton**

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## Intra-Group Services & Intangibles



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# What is covered under Intangible Property

## Definition:

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- 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





# What is transfer pricing? In the news

 <b>STARBUCKS®</b> ■ Domicile: UK ■ UK turnover: £398m ■ UK corporation tax paid: None ■ Year: 2011	 <b>Google</b> ■ Domicile: Ireland ■ UK turnover: £2.6bn ■ UK corporation tax paid: £6million ■ Year: 2011	 <b>amazon.com</b> ■ Domicile: Luxembourg ■ UK turnover: £3.3bn ■ UK corporation tax paid: None ■ Year: 2010
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facebook





# 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



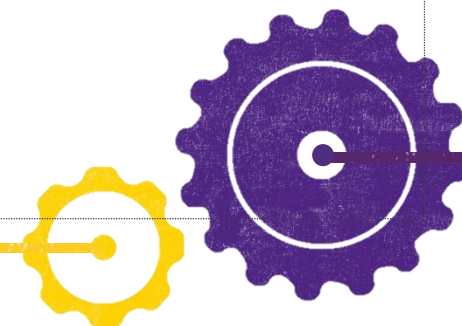
IP related financial issues exist in commercial practices



Accounting and attribution of profits



Group synergies



# Focus on Intangible Property



## Commercial Practices:



Commercial practice of selling IP or patents as a group



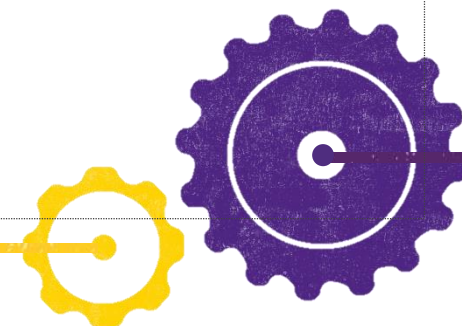
How to establish the value



Jurisdictions and protection and taxation of IP

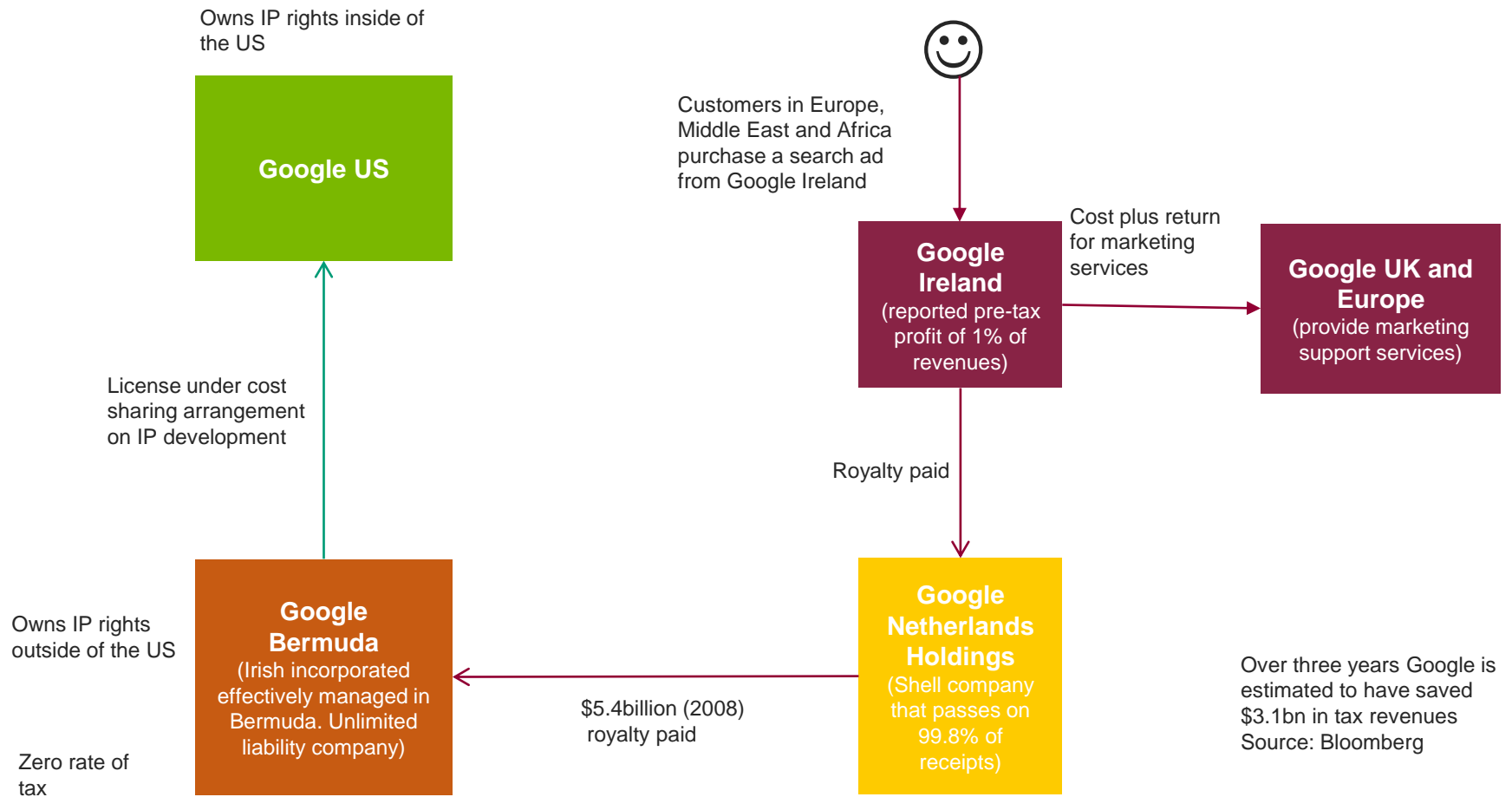


Allocation of all related development costs to the group entities



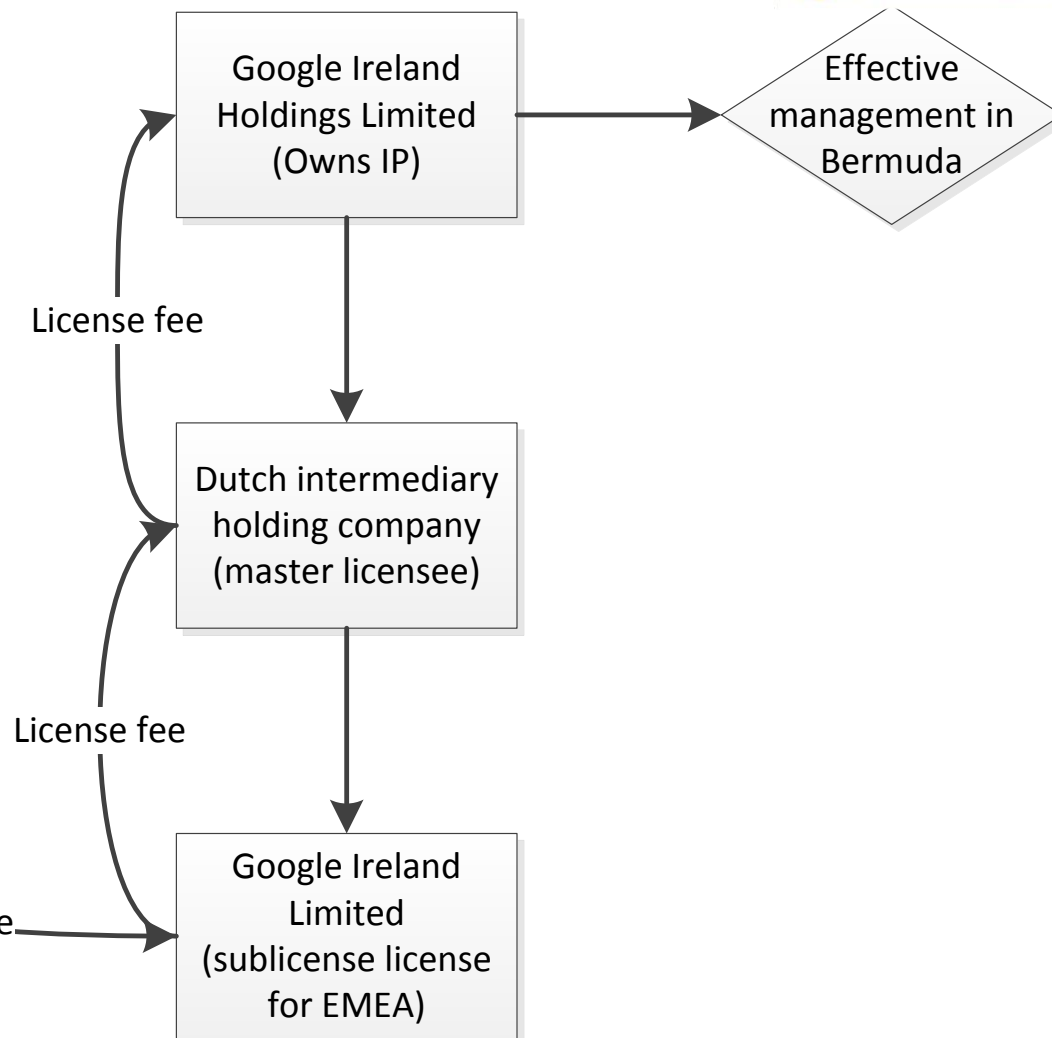


# So what is BEPS really all about?



# So what is BEPS really all about?

**“All’s well that  
ends well” for  
Google’s  
shareholders?**



# 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  $\frac{1}{4}$  of Oracles' total pretax income. The subsidiary accomplished all of this without one recorded employee



# Intra group services



## Governing legislation / guidance:

- Section 3 read with 18(3)
- OECD/G20 BEPS Action 8-10: Aligning TP Outcomes with Value Creation (BEPS Action 8-10)
- UN Practical Manual on TP for Developing Countries (UN Manual)

## Two main steps of analysing intra-group service transactions:

- Has an intra-group service been rendered? and
- If yes, what should the charge be for such service?



# Has an intra-group service been rendered?



## Benefits test

- Economic or commercial value
- Independent willingness to pay

## Facts and circumstances





# Has an intra-group service been rendered?



## Benefits test – Generally fail the test:

- Shareholder activities
- Duplication of activities
- Incidental benefits
- Centralised services



## Form of remuneration

- "On call" or "retainer"



**Is the service beneficial?**

# Low value adding services



- Motivation for introduction
- Definition of low value-adding intra-group services
  - supportive
  - not core business
  - do not require unique, valuable IP
  - do not lead to creation of unique, valuable IP



**Is this a low value add service?**

# Low value adding services



- Should be made available on request:
  - Description of services
  - Written contracts / agreements
  - Calculations – cost pool, allocation keys and mark-up

**"The simplified charge method is elective"**





# Engaging consultants on intra group services



- Supporting documentation of transaction
- Assist with identifying efficient value chain, unlock value and profit optimisation (decentralised vs centralised)
- Costs are born/charged to correct entity within group
- Treaty consideration / WHT (technical vs management services)
- Exchange control approvals
- Assist with tax authority queries

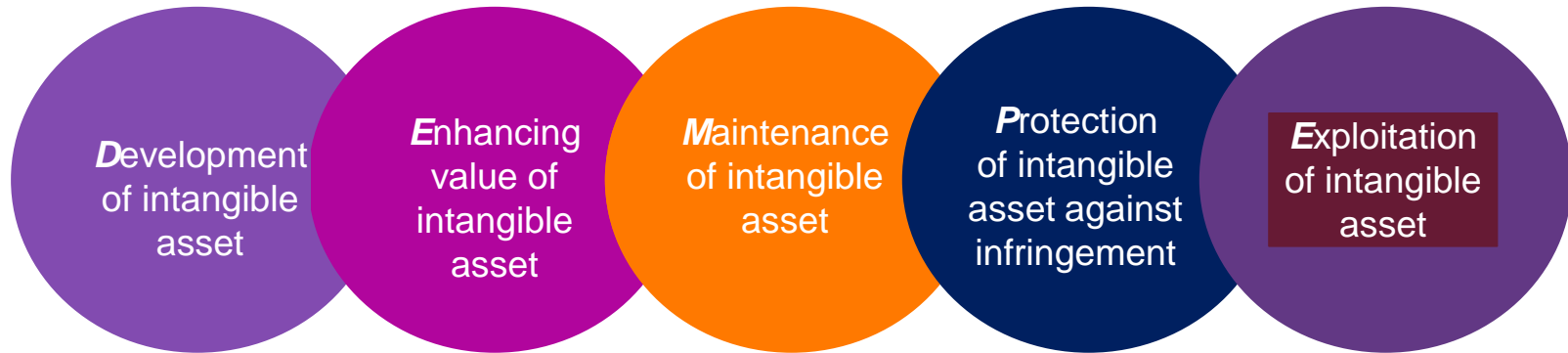




# How to deal with IP



# IP Functions



Requirement to directly perform or to control the performance of DEMPE functions and related risks

Return to be retained by an entity depends on the contributions it makes through DEMPE functions to the anticipated value of intangible relative to contributions made by other group members

**The new OECD guidance focuses on “substance” for conducting transfer pricing analysis of intangibles.**



# Identification of IP, legal ownership and contracts as basis for transfer pricing analysis

## Six-step process for TP analysis of intangibles under Action 8

1. Identify intangibles
2. Identify legal owner
3. Identify contributors
4. Consistency between contracts and conduct of the parties
5. Delineate transactions related to DEMPE in light of legal ownership, contracts and contributions of functions, risks and assets
6. Where possible, determine arm's length prices for contributions

Legal ownership based on

- Original ownership (registration, etc.)
- Contractual (license) agreements
- Other indicia of ownership

New TP guidelines

Affirmation by OECD of the important role of intercompany legal arrangements as the starting point of the transfer pricing analysis.

# Broad definition of intangibles

“Something which is capable of being owned or controlled for use in commercial activities and whose use or transfer would be compensated ... between independent parties ...”

<b>Goodwill and going concern</b>	<ul style="list-style-type: none"> <li>• Relationship capital (innovation community, ecosystem and supply chain partnerships)</li> <li>• Reputational value</li> <li>• Key human capital</li> </ul>	<p><b>However, revised OECD transfer pricing guidance on intangibles explicitly excludes:</b></p> <ul style="list-style-type: none"> <li>• Group synergies</li> <li>• Market-specific characteristics</li> </ul>
<b>Non-registered IP</b>	<ul style="list-style-type: none"> <li>• Know-how and trade secrets</li> <li>• Software (copyright)</li> <li>• Marketing intangibles</li> <li>• Distribution network and customer lists</li> <li>• Product design and technology</li> <li>• Process technology provided to buyers</li> <li>• Supplier lists and procurement processes</li> <li>• Contractual rights</li> </ul>	<p><b>Ownership in non-registered IP typically vests in the legal entity employing the individual creating such IP.</b></p> <p><b>Transfers from R&amp;D companies to IP companies/principals need contractual basis.</b></p>
<b>Registered IP</b>	<ul style="list-style-type: none"> <li>• Patents</li> <li>• Designs</li> <li>• Trademarks</li> <li>• Domain names</li> </ul>	<p><b>Are you in position to identify all the intangibles and IP owned, controlled or used in your business and to demonstrate the ownership chain?</b></p>



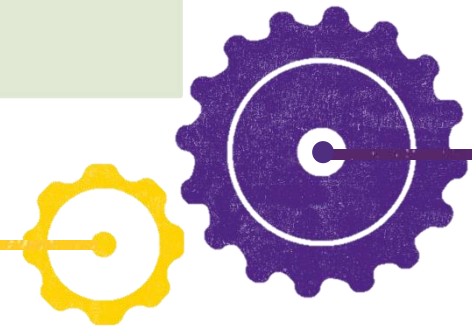
# Development of IP

## Contract R&D

- Set up separate entity
- Few locations
- Ownership
- Control

## Cost sharing

- Centralised
- Different entities share





# Structuring and Documenting

“What tax authorities will look for”





# 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



# 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"



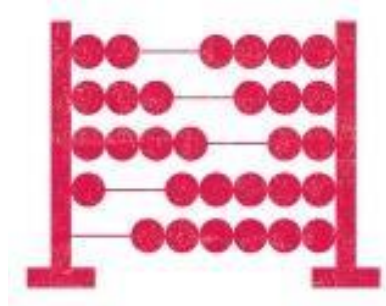
# Cost Contribution Agreement for Intangibles

## 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

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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**

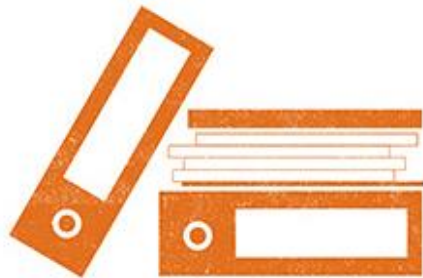
In practice an approach which is frequently used is to reflect the participant's proportionate share of expected benefits is by use of an **allocation key**

(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

## 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





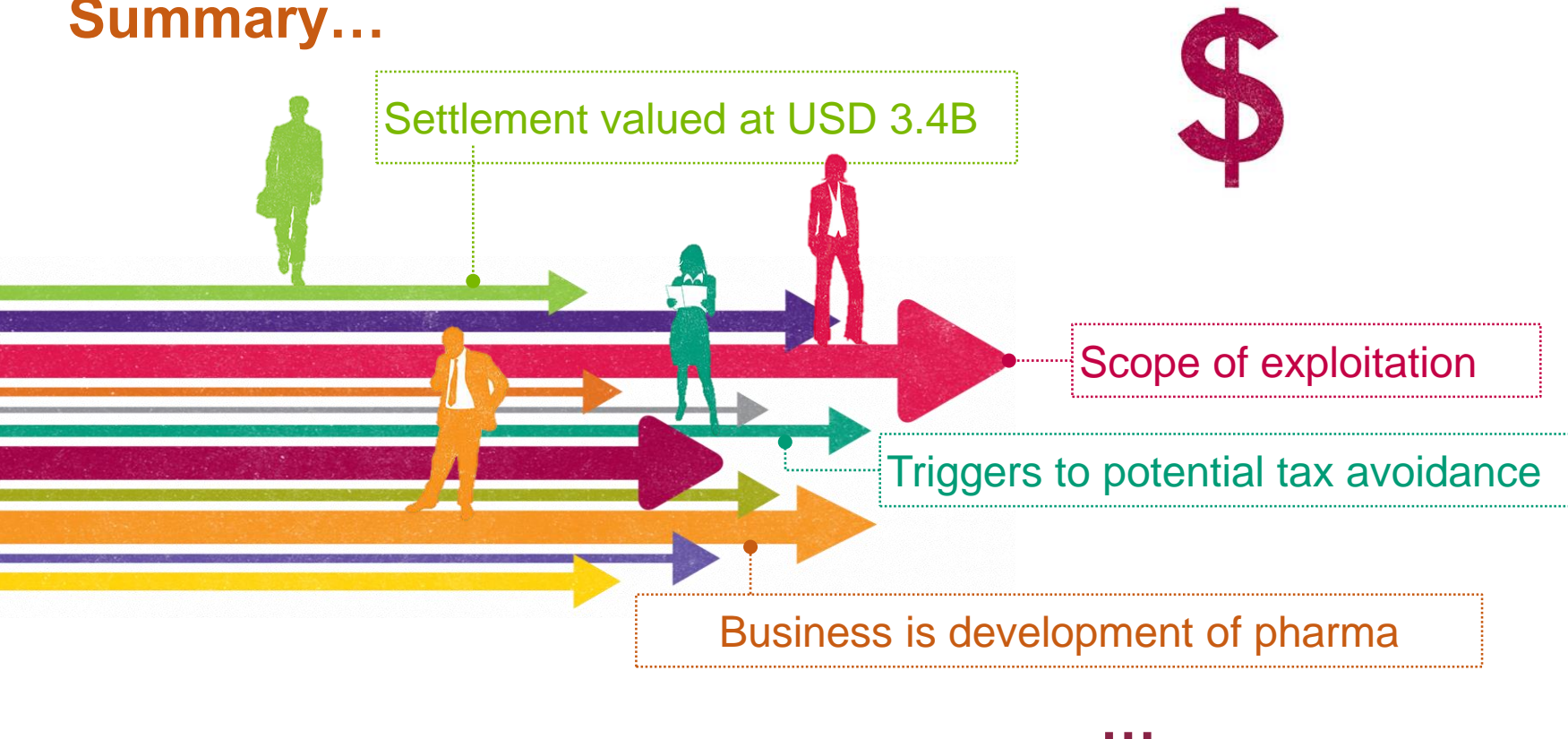
GlaxoSmithkline Holdings  
(America) Inc.  
vs.  
Commissioner of Internal  
Revenue



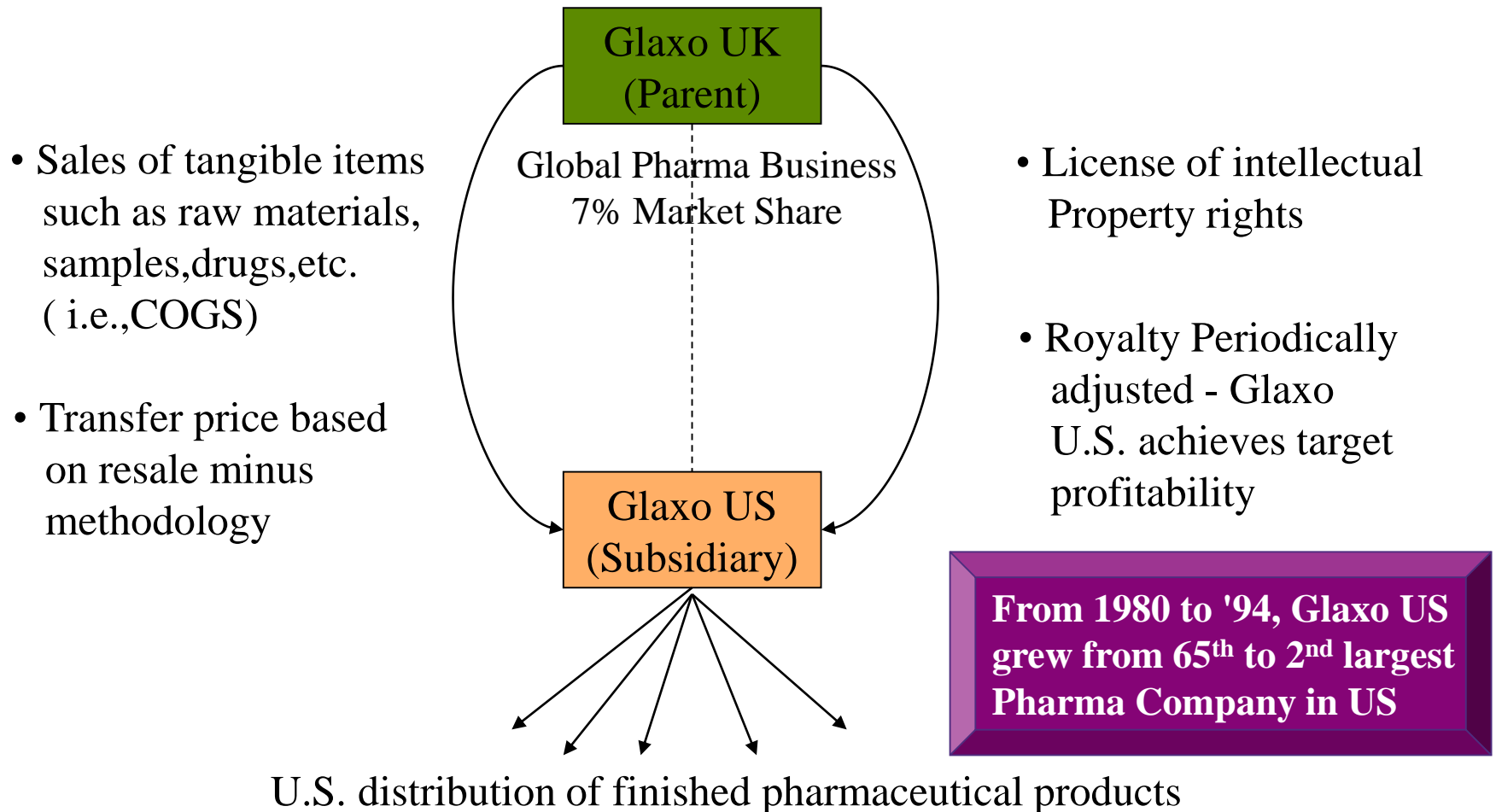


# GlaxoSmithkline (GSK) Valuation of IP

## Summary...



# GlaxoSmithkline (GSK) Case Transactional Flow / Facts



# 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

<u>Performed in U.K.</u>	<u>Performed in U.S.</u>
<ul style="list-style-type: none"> <li>Discovered, developed, patented ZANTAC. Reimbursed US for development expenses.</li> </ul>	<ul style="list-style-type: none"> <li>Some clinical trials</li> </ul>
<ul style="list-style-type: none"> <li>Manufacturing process R&amp;D</li> </ul>	
<ul style="list-style-type: none"> <li>Developed regulatory approval package</li> </ul>	<ul style="list-style-type: none"> <li>Assisted with US FDA approval process.</li> </ul>
<ul style="list-style-type: none"> <li>Primary manufacturing (chemical)</li> </ul>	<ul style="list-style-type: none"> <li>Secondary manufacturing (formulation/packaging)</li> </ul>
<ul style="list-style-type: none"> <li>Owned trademarks</li> </ul>	
<ul style="list-style-type: none"> <li>Designed marketing and co-promotion strategy</li> </ul>	<ul style="list-style-type: none"> <li>Conducted promotion and direct selling activities.</li> </ul>

# GlaxoSmithkline (GSK) Valuation of IP

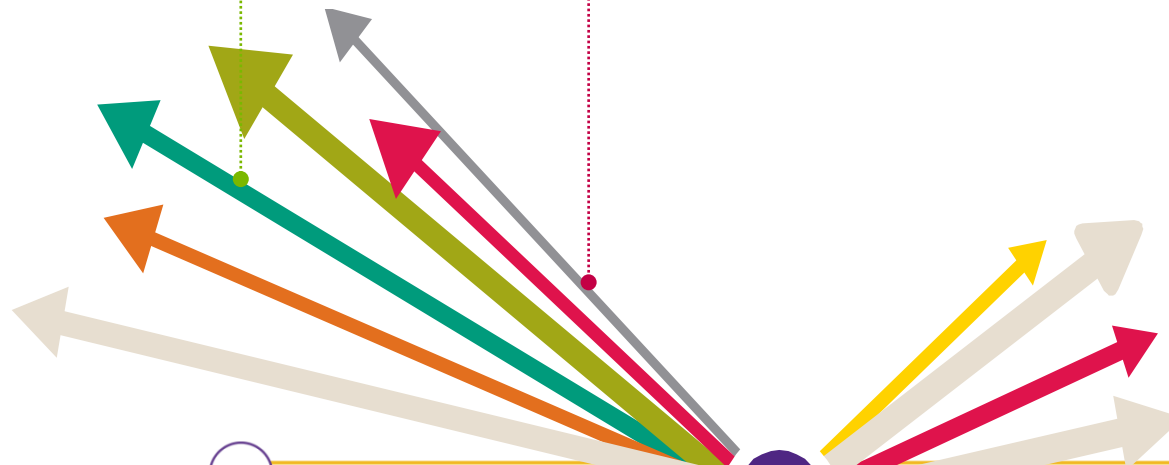
Royalties paid to the UK



Success based on  
marketing and  
sales in US market



Not able to prove clear  
ownership of patent



## IRS Deficiency notice - Royalty

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- 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



## IRS Deficiency notice - Constructive Dividend

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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).



## Lessons from GSK Case

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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



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