Annex I to Chapter VI

Examples to illustrate the guidance on intangibles

Example 1

1. Premiere is the parent company of an MNE group. Company S is a wholly owned subsidiary of Premiere and a member of the Premiere group. Premiere funds R&D and performs ongoing R&D functions in support of its business operations. When its R&D functions result in patentable inventions, it is the practice of the Premiere group that all rights in such inventions be assigned to Company S in order to centralise and simplify global patent administration. All patent registrations are held and maintained in the name of Company S.

2. Company S employs three lawyers to perform its patent administration work and has no other employees. Company S does not conduct or control any of the R&D activities of the Premiere group. Company S has no technical R&D personnel, nor does it incur any of the Premiere group's R&D expense. Key decisions related to defending the patents are made by Premiere management, after taking advice from employees of Company S. Premiere's management, and not the employees of Company S, controls all decisions regarding licensing of the group's patents to both independent and associated enterprises.

3. At the time of each assignment of rights from Premiere to Company S, Company S makes a nominal EUR 100 payment to Premiere in consideration of the assignment of rights to a patentable invention and, as a specific condition of the assignment, simultaneously grants to Premiere an exclusive, royalty free, patent licence, with full rights to sub-licence, for the full life of the patent to be registered. The nominal payments of Company S to Premiere are made purely to satisfy technical contract law requirements related to the assignments and, for purposes of this example, it is assumed that they do not reflect arm's length compensation for the assigned rights to patentable inventions. Premiere uses the patented inventions in manufacturing and selling its products throughout the world and from time to time sublicenses patent

rights to others. Company S makes no commercial use of the patents nor is it entitled to do so under the terms of the licence agreement with Premiere.

4. Under the agreement, Premiere performs all functions related to the development, enhancement, maintenance, protection and exploitation of the intangibles except for patent administration services. Premiere contributes and uses all assets associated with the development and exploitation of the intangible, and assumes all or substantially all of the risks associated with the intangibles. Premiere should be entitled to the bulk of the returns derived from exploitation of the intangibles. Tax administrations could arrive at an appropriate transfer pricing solution by delineating the actual transaction undertaken between Premiere and Company S. Depending on the facts, it might be determined that taken together the nominal assignment of rights to Company S and the simultaneous grant of full exploitation rights back to Premiere reflect in substance a patent administration service arrangement between Premiere and Company S. An arm's length price would be determined for the patent administration services and Premiere would retain or be allocated the balance of the returns derived by the MNE group from the exploitation of the patents.

Example 2

5. The facts related to the development and control of patentable inventions are the same as in Example 1. However, instead of granting a perpetual and exclusive licence of its patents back to Premiere, Company S, acting under the direction and control of Premiere, grants licences of its patents to associated and independent enterprises throughout the world in exchange for periodic royalties. For purposes of this example, it is assumed that the royalties paid to Company S by associated enterprises are all arm's length.

6. Company S is the legal owner of the patents. However, its contributions to the development, enhancement, maintenance, protection, and exploitation of the patents are limited to the activities of its three employees in registering the patents and maintaining the patent registrations. The Company S employees do not control or participate in the licensing transactions involving the patents. Under these circumstances, Company S is only entitled to compensation for the functions it performs. Based on an analysis of the respective functions performed, assets used, and risks assumed by Premiere and Company S in developing, enhancing, maintaining, protecting, and exploiting the intangibles, Company S should not be entitled ultimately to retain or be attributed income from its licensing arrangements over and above the arm's length compensation for its patent registration functions.

7. As in Example 1 the true nature of the arrangement is a patent administration service contract. The appropriate transfer pricing outcome

can be achieved by ensuring that the amount paid by Company S in exchange for the assignments of patent rights appropriately reflects the respective functions performed, assets used, and risks assumed by Premiere and by Company S. Under such an approach, the compensation due to Premiere for the patentable inventions is equal to the licensing revenue of Company S less an appropriate return to the functions Company S performs.

Example 3

8. The facts are the same as in Example 2. However, after licensing the patents to associated and independent enterprises for a few years, Company S, again acting under the direction and control of Premiere, sells the patents to an independent enterprise at a price reflecting appreciation in the value of the patents during the period that Company S was the legal owner. The functions of Company S throughout the period it was the legal owner of the patents were limited to performing the patent registration functions described in Examples 1 and 2.

9. Under these circumstances, the income of Company S should be the same as in Example 2. It should be compensated for the registration functions it performs, but should not otherwise share in the returns derived from the exploitation of the intangibles, including the returns generated from the disposition of the intangibles.

Example 4

10. The facts related to the development of the patents are the same as described in Example 3. In contrast to Example 1, Company S in this example has employees capable of making, and who actually make, the decision to take on the patent portfolio. All decisions relating to the licensing programme were taken by Company S employees, all negotiations with licensees were undertaken by Company S employees, and Company S employees monitored compliance of independent licensees with the terms of the licenses. It should be assumed for purposes of this example that the price paid by Company S in exchange for the patents was an arm's length price that reflected the parties' respective assessments of the future licensing programme and the anticipated returns to be derived from exploitation of the patents as of the time of their assignment to Company S. For the purposes of this example, it is assumed that the approach for hard-to-value intangibles in Section D.4 does not apply.

11. Following the assignments, Company S licensed the patents to independent enterprises for a few years. Thereafter the value of the patents increases significantly because of external circumstances unforeseen at the time the patents were assigned to Company S. Company S then sells the

patents to an unrelated purchaser at a price exceeding the price initially paid by Company S to Premiere for the patents. Company S employees make all decisions regarding the sale of the patents, negotiate the terms of the sale, and in all respects manage and control the disposition of the patents.

12. Under these circumstances, Company S is entitled to retain the proceeds of the sale, including amounts attributable to the appreciation in the value of the patents resulting from the unanticipated external circumstances.

Example 5

13. The facts are the same as in Example 4 except that instead of appreciating, the value of the patents decreases during the time they are owned by Company S as a result of unanticipated external circumstances. Under these circumstances, Company S is entitled to retain the proceeds of the sale, meaning that it will suffer the loss.

Example 6

14. In Year 1, a multinational group comprised of Company A (a Country A corporation) and Company B (a Country B corporation) decides to develop an intangible, which is anticipated to be highly profitable based on Company B's existing intangibles, its track record and its experienced research and development staff. The intangible is expected to take five years to develop before possible commercial exploitation. If successfully developed, the intangible is anticipated to have value for ten years after initial exploitation. Under the development agreement between Company A and Company B, Company B will perform and control all activities related to the development, enhancement, maintenance, protection and exploitation of the intangible. Company A will provide all funding associated with the development of the intangible (the development costs are anticipated to be USD 100 million per year for five years), and will become the legal owner of the intangible. Once developed, the intangible is anticipated to result in profits of USD 550 million per year (years 6 to 15). Company B will license the intangible from Company A and make contingent payments to Company A for the right to use the intangible, based on returns of purportedly comparable licensees. After the projected contingent payments, Company B will be left with an anticipated return of USD 200 million per year from selling products based on the intangible.

15. A functional analysis by the Country B tax administration of the arrangement assesses the functions performed, assets used and contributed, and risks assumed by Company A and by Company B. The analysis through which the actual transaction is delineated concludes that although Company A

is the legal owner of the intangibles, its contribution to the arrangement is solely the provision of funding for the development of an intangible. This analysis shows that Company A contractually assumes the financial risk, has the financial capacity to assume that risk, and exercises control over that risk in accordance with the principles outlined in paragraphs 6.63 and 6.64. Taking into account Company A's contributions, as well as the realistic alternatives of Company A and Company B, it is determined that Company A's anticipated remuneration should be a risk-adjusted return on its funding commitment. Assume that this is determined to be USD 110 million per year (for Years 6 to 15), which equates to an 11% risk-adjusted anticipated financial return.[1] Company B, accordingly, would be entitled to all remaining anticipated income after accounting for Company A's anticipated return, or USD 440 million per year (USD 550 million minus USD 110 million), rather than USD 200 million per year as claimed by the taxpayer. (Based on the detailed functional analysis and application of the most appropriate method, the taxpayer incorrectly chose Company B as the tested party rather than Company A).

Example 7

16. Primero is the parent company of an MNE group engaged in the pharmaceutical business and does business in Country M. Primero develops patents and other intangibles relating to Product X and registers those patents in countries around the world.

17. Primero retains its wholly owned Country N subsidiary, Company S, to distribute Product X throughout Europe and the Middle East on a limited risk basis. The distribution agreement provides that Primero, and not Company S, is to bear product recall and product liability risk, and provides further that Primero will be entitled to all profit or loss from selling Product X in the territory after providing Company S with the agreed level of compensation for its distribution functions. Operating under the contract, Company S purchases Product X from Primero and resells Product X to independent customers in countries throughout its geographical area of operation. In performing its distribution functions, Company S follows all applicable regulatory requirements.

18. In the first three years of operations, Company S earns returns from its distribution functions that are consistent with its limited risk

1. For purposes of this example, it is not necessary to derive these results. The example assumes that making a funding "investment" of USD 100 million per year for five years in a project with this level of risk should earn at arm's length anticipated profits of USD 110 million per year for the following ten years. This corresponds to an 11% return on funding.

characterisation and the terms of the distribution contract. Its returns reflect the fact that Primero, and not Company S, is entitled to retain income derived from exploitation of the intangibles with respect to Product X. After three years of operation, it becomes apparent that Product X causes serious side effects in a significant percentage of those patients that use the product and it becomes necessary to recall the product and remove it from the market. Company S incurs substantial costs in connection with the recall. Primero does not reimburse Company S for these recall related costs or for the resulting product liability claims.

19. Under these circumstances, there is an inconsistency between Primero's asserted entitlement to returns derived from exploiting the Product X intangibles and its failure to bear the costs associated with the risks supporting that assertion. A transfer pricing adjustment would be appropriate to remedy the inconsistency. In determining the appropriate adjustment, it would be necessary to determine the true transaction between the parties by applying the provisions of Section D.1 of Chapter I. In doing so, it would be appropriate to consider the risks assumed by each of the parties on the basis of the course of conduct followed by the parties over the term of the agreement, the control over risk exercised by Primero and Company S, and other relevant facts. If it is determined that the true nature of the relationship between the parties is that of a limited risk distribution arrangement, then the most appropriate adjustment would likely take the form of an allocation of the recall and product liability related costs from Company S to Primero. Alternatively, although unlikely, if it is determined on the basis of all the relevant facts that the true nature of the relationship between the parties includes the exercising control over product liability and recall risk by Company S, and if an arm's length price can be identified on the basis of the comparability analysis, an increase in the distribution margins of Company S for all years might be made to reflect the true risk allocation between the parties.

Example 8

20. Primair, a resident of Country X, manufactures watches which are marketed in many countries around the world under the R trademark and trade name. Primair is the registered owner of the R trademark and trade name. The R name is widely known in countries where the watches are sold and has obtained considerable economic value in those markets through the efforts of Primair. R watches have never been marketed in Country Y, however, and the R name is not known in the Country Y market.

21. In Year 1, Primair decides to enter the Country Y market and incorporates a wholly owned subsidiary in Country Y, Company S, to act

as its distributor in Country Y. At the same time, Primair enters into a long-term royalty-free marketing and distribution agreement with Company S. Under the agreement, Company S is granted the exclusive right to market and distribute watches bearing the R trademark and using the R trade name in Country Y for a period of five years, with an option for a further five years. Company S obtains no other rights relating to the R trademark and trade name from Primair, and in particular is prohibited from re-exporting watches bearing the R trademark and trade name. The sole activity of Company S is marketing and distributing watches bearing the R trademark and trade name. It is assumed that the R watches are not part of a portfolio of products distributed by Company S in Country Y. Company S undertakes no secondary processing, as it imports packaged watches into Country Y ready for sale to the final customer.

22. Under the contract between Primair and Company S, Company S purchases the watches from Primair in Country Y currency, takes title to the branded watches and performs the distribution function in Country Y, incurs the associated carrying costs (e.g. inventory and receivables financing), and assumes the corresponding risks (e.g. inventory, credit and financing risks). Under the contract between Primair and Company S, Company S is required to act as a marketing agent to assist in developing the market for R watches in Country Y. Company S consults with Primair in developing the Country Y marketing strategy for R watches. Primair develops the overall marketing plan based largely on its experience in other countries, it develops and approves the marketing budgets, and it makes final decisions regarding advertising designs, product positioning and core advertising messages. Company S consults on local market issues related to advertising, assists in executing the marketing strategy under Primair's direction, and provides evaluations of the effectiveness of various elements of the marketing strategy. As compensation for providing these marketing support activities, Company S receives from Primair a service fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

23. Assume for the purpose of this example that, based upon a thorough comparability analysis, including a detailed functional analysis, it is possible to conclude that the price Company S pays Primair for the R watches should be analysed separately from the compensation Company S receives for the marketing it undertakes on behalf of Primair. Assume further that based upon identified comparable transactions, the price paid for the watches is arm's length and that this price enables Company S to earn an arm's length level of compensation from selling the watches for the distribution function it performs, the assets it uses and the risks it assumes.

24. In Years 1 to 3, Company S embarks on a strategy that is consistent with its agreement with Primair to develop the Country Y market for

R watches. In the process, Company S incurs marketing expenses. Consistent with the contract, Company S is reimbursed by Primair for the marketing expenses it incurs, and is paid a mark-up on those expenses. By the end of Year 2, the R trademark and trade name have become well established in Country Y. The compensation derived by Company S for the marketing activities it performed on behalf of Primair is determined to be arm's length, based upon comparison to that paid to independent advertising and marketing agents identified and determined to be comparable as part of the comparability analysis.

25. Under these circumstances, Primair is entitled to retain any income derived from exploiting the R trademark and trade name in the Country Y market that exceeds the arm's length compensation to Company S for its functions and no transfer pricing adjustment is warranted under the circumstances.

Example 9

26. The facts in this example are the same as in Example 8, except as follows:

- Under the contract between Primair and Company S, Company S is now obligated to develop and execute the marketing plan for Country Y without detailed control of specific elements of the plan by Primair. Company S bears the costs and assumes certain of the risks associated with the marketing activities. The agreement between Primair and Company S does not specify the amount of marketing expenditure Company S is expected to incur, only that Company S is required to use its best efforts to market the watches. Company S receives no direct reimbursement from Primair in respect of any expenditure it incurs, nor does it receive any other indirect or implied compensation from Primair, and Company S expects to earn its reward solely from its profit from the sale of R brand watches to third party customers in the Country Y market. A thorough functional analysis reveals that Primair exercises a lower level of control over the marketing activities of Company S than in Example 8 in that it does not review and approve the marketing budget or design details of the marketing plan. Company S bears different risks and is compensated differently than was the case in Example 8. The contractual arrangements between Primair and Company S are different and the risks assumed by Company S are greater in Example 9 than in Example 8. Company S does not receive direct cost reimbursements or a separate fee for marketing activities. The only controlled transaction between Primair and Company S in Example 9 is the transfer of the branded watches. As a result, Company S can obtain its reward for its marketing activities only through selling R brand watches to third party customers.

- As a result of these differences, Primair and Company S adopt a lower price for watches in Example 9 than the price for watches determined for purposes of Example 8. As a result of the differences identified in the functional analysis, different criteria are used for identifying comparables and for making comparability adjustments than was the case in Example 8. This results in Company S having a greater anticipated total profit in Example 9 than in Example 8 because of its higher level of risk and its more extensive functions.

27. Assume that in Years 1 through 3, Company S embarks on a strategy that is consistent with its agreement with Primair and, in the process, performs marketing functions and incurs marketing expenses. As a result, Company S has high operating expenditures and slim margins in Years 1 through 3. By the end of Year 2, the R trademark and trade name have become established in Country Y because of Company S's efforts. Where the marketer/distributor actually bears the costs and associated risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. Assume that the enquiries of the Country Y tax administrations conclude, based on a review of comparable distributors, that Company S would have been expected to have performed the functions it performed and incurred its actual level of marketing expense if it were independent from Primair.

28. Given that Company S performs the functions and bears the costs and associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the R watches, there is an opportunity for Company S to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. Based on an analysis of reasonably reliable comparable data, it is concluded that, for purposes of this example, the benefits obtained by Company S result in profits similar to those made by independent marketers and distributors bearing the same types of risks and costs as Company S in the first few years of comparable long-term marketing and distribution agreements for similarly unknown products.

29. Based on the foregoing assumptions, Company S's return is arm's length and its marketing activities, including its marketing expenses, are not significantly different than those performed by independent marketers and distributors in comparable uncontrolled transactions. The information on comparable uncontrolled arrangements provides the best measure of the arm's length return earned by Company S for the contribution to intangible value provided by its functions, risks, and costs. That return therefore reflects arm's length compensation for Company S's contributions and accurately measures its share of the income derived from exploitation of the trademark

and trade name in Country Y. No separate or additional compensation is required to be provided to Company S.

Example 10

30. The facts in this example are the same as in Example 9, except that the market development functions undertaken by Company S in this Example 10 are far more extensive than those undertaken by Company S in Example 9.

31. Where the marketer/distributor actually bears the costs and assumes the risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. A thorough comparability analysis identifies several uncontrolled companies engaged in marketing and distribution functions under similar long-term marketing and distribution arrangements. Assume, however, that the level of marketing expense Company S incurred in Years 1 through 5 far exceeds that incurred by the identified comparable independent marketers and distributors. Assume further that the high level of expense incurred by Company S reflects its performance of additional or more intensive functions than those performed by the potential comparables and that Primair and Company S expect those additional functions to generate higher margins or increased sales volume for the products. Given the extent of the market development activities undertaken by Company S, it is evident that Company S has made a larger functional contribution to development of the market and the marketing intangibles and has assumed significantly greater costs and assumed greater risks than the identified potentially comparable independent enterprises (and substantially higher costs and risks than in Example 9). There is also evidence to support the conclusion that the profits realised by Company S are significantly lower than the profit margins of the identified potentially comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

32. As in Example 9, Company S bears the costs and associated risks of its marketing activities under a long-term contract of exclusive marketing and distribution rights for the R watches, and therefore expects to have an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case Company S has performed functions and borne marketing expenditures beyond what independent enterprises in potentially comparable transactions with similar rights incur for their own benefit, resulting in significantly lower profit margins for Company S than are made by such enterprises.

33. Based on these facts, it is evident that by performing functions and incurring marketing expenditure substantially in excess of the levels of

function and expenditure of independent marketer/distributors in comparable transactions, Company S has not been adequately compensated by the margins it earns on the resale of R watches. Under such circumstances it would be appropriate for the Country Y tax administration to propose a transfer pricing adjustment based on compensating Company S for the marketing activities performed (taking account of the risks assumed and the expenditure incurred) on a basis that is consistent with what independent enterprises would have earned in comparable transactions. Depending on the facts and circumstances reflected in a detailed comparability analysis, such an adjustment could be based on:

- Reducing the price paid by Company S for the R brand watches purchased from Primair. Such an adjustment could be based on applying a resale price method or transactional net margin method using available data about profits made by comparable marketers and distributors with a comparable level of marketing and distribution expenditure if such comparables can be identified.
- An alternative approach might apply a residual profit split method that would split the relevant profits from sales of R branded watches in Country Y by first giving Company S and Primair a basic return for the functions they perform and then splitting the residual profit on a basis that takes into account the relative contributions of both Company S and Primair to the generation of income and the value of the R trademark and trade name.
- Directly compensating Company S for the excess marketing expenditure it has incurred over and above that incurred by comparable independent enterprises including an appropriate profit element for the functions and risks reflected by those expenditures.

34. In this example, the proposed adjustment is based on Company S's having performed functions, assumed risks, and incurred costs that contributed to the development of the marketing intangibles for which it was not adequately compensated under its arrangement with Primair. If the arrangements between Company S and Primair were such that Company S could expect to obtain an arm's length return on its additional investment during the remaining term of the distribution agreement, a different outcome could be appropriate.

Example 11

35. The facts in this example are the same as in Example 9, except that Company S now enters into a three-year royalty-free agreement to market and distribute the watches in the Country Y market, with no option to renew.

At the end of the three-year period, Company S does not enter into a new contract with Primair.

36. Assume that it is demonstrated that independent enterprises do enter into short-term distribution agreements where they incur marketing and distribution expenses, but only where they stand to earn a reward commensurate with the functions performed, the assets used, and the risks assumed within the time period of the contract. Evidence derived from comparable independent enterprises shows that they do not invest large sums of money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation. The potential short-term nature of the marketing and distribution agreement is such that Company S could not, or may not be able to, benefit from the marketing and distribution expenditure it incurs at its own risk. The same factors mean that Company S's efforts may well benefit Primair in the future.

37. The risks assumed by Company S are substantially higher than in Example 9 and Company S has not been compensated on an arm's length basis for bearing these additional risks. In this case, Company S has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profit margins for Company S than are made by comparable enterprises. The short term nature of the contract makes it unreasonable to expect that Company S has the opportunity of obtaining appropriate benefits under the contract within the limited term of the agreement with Primair. Under these circumstances, Company S is entitled to compensation for its at risk contribution to the value of the R trademark and trade name during the term of its arrangement with Primair.

38. Such compensation could take the form of direct compensation from Primair to Company S for the anticipated value created through the marketing expenditures and market development functions it has undertaken. Alternatively, such an adjustment could take the form of a reduction in the price paid by Company S to Primair for R watches during Years 1 through 3.

Example 12

39. The facts in this example are the same as in Example 9 with the following additions:

- By the end of Year 3, the R brand is successfully established in the Country Y market and Primair and Company S renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, which is to commence at the beginning of Year 4, is for five years with Company S having an option for a further five years. Under this agreement, Company S agrees to pay a royalty to Primair based on the gross sales of all watches bearing the R trademark. In all other respects, the new agreement has the same terms and conditions as in the previous arrangement between the parties. There is no adjustment made to the price payable by Company S for the branded watches as a result of the introduction of the royalty.

- Company S's sales of R brand watches in Years 4 and 5 are consistent with earlier budget forecasts. However, the introduction of the royalty from the beginning of year 4 results in Company S's profit margins declining substantially.

40. Assume that there is no evidence that independent marketers/ distributors of similar branded products have agreed to pay royalties under similar arrangements. Company S's level of marketing expenditure and activity, from Year 4 on, is consistent with that of independent enterprises.

41. For transfer pricing purposes, it would not generally be expected that a royalty would be paid in arm's length transactions where a marketing and distribution entity obtains no rights for transfer pricing purposes in trademarks and similar intangibles other than the right to use such intangibles in distributing a branded product supplied by the entity entitled to the income derived from exploiting such intangibles. Furthermore, the royalty causes Company S's profit margins to be consistently lower than those of independent enterprises with comparable functions performed, assets used and risks assumed during the corresponding years of similar long-term marketing and distribution arrangements. Accordingly, a transfer pricing adjustment disallowing the royalties paid would be appropriate based on the facts of this example.

Example 13

42. The facts in this example are the same as those set out in Example 10 with the following additions:

- At the end of Year 3, Primair stops manufacturing watches and contracts with a third party to manufacture them on its behalf. As a result, Company S will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the R name and logo and package the watches before sale to the final customer. It will then sell and distribute the watches in the manner described in Example 10.

- As a consequence, at the beginning of Year 4, Primair and Company S renegotiate their earlier agreement and enter into a new long term licensing agreement. The new agreement, to start at the beginning of Year 4, is for five years, with Company S having an option for a further five years.
- Under the new agreement, Company S is granted the exclusive right within Country Y to process, market and distribute watches bearing the R trademark in consideration for its agreement to pay a royalty to Primair based on the gross sales of all such watches. Company S receives no compensation from Primair in respect of the renegotiation of the original marketing and distribution agreement. It is assumed for purposes of this example that the purchase price Company S pays for the watches from the beginning of Year 4 is arm's length and that no consideration with respect to the R name is embedded in that price.

43. In connection with a tax audit conducted by Country Y tax administrations in Year 6, it is determined, based on a proper functional analysis, that the level of marketing expenses Company S incurred during Years 1 through 3 far exceeded those incurred by independent marketers and distributors with similar long term marketing and distribution agreements. It is also determined that the level and intensity of marketing activity undertaken by Company S exceeded that of independent marketers and distributors, and that the relatively greater activity has been successful in expanding volumes and/or increasing the Primair group's overall margins from sales in Country Y. Given the extent of the market development activities undertaken by Company S, including its strategic control over such activities, it is evident from the comparability and functional analysis that Company S has assumed significantly greater costs and assumed greater risks than comparable independent enterprises. There is also evidence that the individual entity profit margins realised by Company S are significantly lower than the profit margins of comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution arrangements.

44. The Country Y audit also identifies that in Years 4 and 5, Company S bears the costs and associated risks of its marketing activities under the new long-term licensing arrangement with Primair, and because of the long-term nature of the agreement, Company S may have an opportunity to benefit (or suffer a loss) from its activities. However, Company S has undertaken market development activities and incurred marketing expenditure far beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit, resulting in significantly lower anticipated profit margins for Company S than those of comparable enterprises.

45. Based on these facts, Company S should be compensated with an additional return for the market development functions it performs, the assets it uses and the risks it assumes. For Years 1 through 3, the possible bases for such an adjustment would be as described in Example 10. For Years 4 and 5 the bases for an adjustment would be similar, except that the adjustment could reduce the royalty payments from Company S to Primair, rather than the purchase price of the watches. Depending on the facts and circumstances, consideration could also be given to whether Company S should have received compensation in connection with the renegotiation of the arrangement at the end of Year 3 in accordance with the guidance in Part II of Chapter IX.

Example 14

46. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in Country X and the other operated by Company S, a subsidiary of Shuyona operating in Country Y. The Shuyona R&D centre is responsible for the overall research programme of Shuyona group. The Shuyona R&D centre designs research programmes, develops and controls budgets, makes decisions as to where R&D activities will be conducted, monitors the progress on all R&D projects and, in general, controls the R&D function for the MNE group, operating under strategic direction of Shuyona group senior management.

47. The Company S R&D centre operates on a separate project by project basis to carry out specific projects assigned by the Shuyona R&D centre. Suggestions of Company S R&D personnel for modifications to the research programme are required to be formally approved by the Shuyona R&D centre. The Company S R&D centre reports on its progress on at least a monthly basis to supervisory personnel at the Shuyona R&D centre. If Company S exceeds budgets established by Shuyona for its work, approval of Shuyona R&D management must be sought for further expenditures. Contracts between the Shuyona R&D centre and the Company S R&D centre specify that Shuyona will bear all risks and costs related to R&D undertaken by Company S. All patents, designs and other intangibles developed by Company S research personnel are registered by Shuyona, pursuant to contracts between the two companies. Shuyona pays Company S a service fee for its research and development activities.

48. The transfer pricing analysis of these facts would begin by recognising that Shuyona is the legal owner of the intangibles. Shuyona

controls and manages both its own R&D work and that of Company S. It performs the important functions related to that work such as budgeting, establishing research programmes, designing projects and funding and controlling expenditures. Under these circumstances, Shuyona is entitled to returns derived from the exploitation of the intangibles developed through the R&D efforts of Company S. Company S is entitled to compensation for its functions performed, assets used, and risks assumed. In determining the amount of compensation due Company S, the relative skill and efficiency of the Company S R&D personnel, the nature of the research being undertaken, and other factors contributing to value should be considered as comparability factors. To the extent transfer pricing adjustments are required to reflect the amount a comparable R&D service provider would be paid for its services, such adjustments would generally relate to the year the service is provided and would not affect the entitlement of Shuyona to future returns derived from exploiting intangibles derived from the Company S R&D activities.

Example 15

49. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in Country X, and the other operated by Company S, a subsidiary of Shuyona, operating in Country Y.

50. The Shuyona group sells two lines of products. All R&D with respect to product line A is conducted by Shuyona. All R&D with respect to product line B is conducted by the R&D centre operated by Company S. Company S also functions as the regional headquarters of the Shuyona group in North America and has global responsibility for the operation of the business relating to product line B. However, all patents developed through Company S research efforts are registered by Shuyona. Shuyona makes no or only a nominal payment to Company S in relation to the patentable inventions developed by the Company S R&D centre.

51. The Shuyona and Company S R&D centres operate autonomously. Each bears its own operating costs. Under the general policy direction of Shuyona senior management, the Company S R&D centre develops its own research programmes, establishes its own budgets, makes determinations as to when R&D projects should be terminated or modified, and hires its own R&D staff. The Company S R&D centre reports to the product line B management team in Company S, and does not report to the Shuyona R&D

centre. Joint meetings between the Shuyona and Company S R&D teams are sometimes held to discuss research methods and common issues.

52. The transfer pricing analysis of this fact pattern would begin by recognising that Shuyona is the legal owner/registrant of intangibles developed by Company S. Unlike the situation in Example 14, however, Shuyona neither performs nor exercises control over the research functions carried out by Company S, including the important functions related to management, design, budgeting and funding that research. Accordingly, Shuyona's legal ownership of the intangibles does not entitle it to retain or be attributed any income related to the product line B intangibles. Tax administrations could arrive at an appropriate transfer pricing outcome by recognising Shuyona's legal ownership of the intangibles but by noting that, because of the contributions of Company S in the form of functions, assets, and risks, appropriate compensation to Company S for its contributions could be ensured by confirming that Company S should make no royalty or other payment to Shuyona for the right to use any successfully developed Company S intangibles, so that the future income derived from the exploitation of those intangibles by Company S would be allocated to Company S and not to Shuyona.

53. If Shuyona exploits the product line B intangibles by itself, Shuyona should provide appropriate compensation to Company S for its functions performed, assets used and risks assumed related to intangible development. In determining the appropriate level of compensation for Company S, the fact that Company S performs all of the important functions related to intangible development would likely make it inappropriate to treat Company S as the tested party in an R&D service arrangement.

Example 16

54. Shuyona is the parent company of an MNE group. Shuyona is organised in and operates exclusively in Country X. The Shuyona group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, ongoing research is carried out by the Shuyona group to improve existing products and develop new products. The Shuyona group maintains two R&D centres, one operated by Shuyona in Country X, and the other operated by Company S, a subsidiary of Shuyona, operating in Country Y. The relationships between the Shuyona R&D centre and the Company S R&D centre are as described in Example 14.

55. In Year 1, Shuyona sells all rights to patents and other technology related intangibles, including rights to use those intangibles in ongoing research, to a new subsidiary, Company T, organised in Country Z. Company T establishes a manufacturing facility in Country Z and begins to supply products to members of the Shuyona group around the world. For purposes of this

example, it is assumed that the compensation paid by Company T in exchange for the transferred patents and related intangibles is based on a valuation of anticipated future cash flows generated by the transferred intangibles at the time of the transfer.

56. At the same time as the transfer of patents and other technology related intangibles, Company T enters into a contract research agreement with Shuyona and a separate contract research agreement with Company S. Pursuant to these agreements, Company T contractually agrees to bear the financial risk associated with possible failure of future R&D projects, agrees to assume the cost of all future R&D activity, and agrees to pay Shuyona and Company S a service fee based on the cost of the R&D activities undertaken plus a mark-up equivalent to the profit mark-up over cost earned by certain identified independent companies engaged in providing research services.

57. Company T has no technical personnel capable of conducting or supervising the research activities. Shuyona continues to develop and design the R&D programme related to further development of the transferred intangibles, to establish its own R&D budgets, to determine its own levels of R&D staffing, and to make decisions regarding whether to pursue or terminate particular R&D projects. Moreover, Shuyona continues to supervise and control the R&D activities in Company S in the manner described in Example 14.

58. The transfer pricing analysis begins by identifying the commercial or financial relations between the parties and the conditions and economically relevant circumstances attaching to those relations in order that the controlled transaction is accurately delineated under the principles of Chapter I, Section D.1. Key assumptions in this example are that Company T functions as a manufacturer and performs no activities in relation to the acquisition, development or exploitation of the intangibles and does not control risks in relation to the acquisition of the intangibles or to their further development. Instead, all development activities and risk management functions relating to the intangibles are performed by Shuyona and Company S, with Shuyona controlling the risk. A thorough examination of the transaction indicates that it should accurately be delineated as the provision of financing by Company T equating to the costs of the acquired intangibles and the ongoing development. A key assumption in this example is that, although Company T contractually assumes the financial risk and has the financial capacity to assume that risk, it does not exercise control over that risk in accordance with the principles outlined in paragraphs 6.63 and 6.64. As a result, in addition to its manufacturing reward, Company T is entitled to no more than a risk-free return for its funding activities. (For further guidance see Section D.1 of Chapter I, and in particular paragraph 1.103.)

Example 17

59. Company A is a fully integrated pharmaceutical company engaged in the discovery, development, production and sale of pharmaceutical preparations. Company A conducts its operations in Country X. In conducting its research activities, Company A regularly retains independent Contract Research Organisations (CROs) to perform various R&D activities, including designing and conducting clinical trials with regard to products under development by Company A. However, such CROs do not engage in the blue sky research required to identify new pharmaceutical compounds. Where Company A does retain a CRO to engage in clinical research activities, research personnel at Company A actively participate in designing the CRO's research studies, provide to the CRO results and information derived from earlier research, establish budgets and timelines for CRO projects, and conduct ongoing quality control with respect to the CRO's activities. In such arrangements, CROs are paid a negotiated fee for services and do not have an ongoing interest in the profits derived from sales of products developed through their research.

60. Company A transfers patents and related intangibles related to Product M, an early stage pharmaceutical preparation believed to have potential as a treatment for Alzheimer's disease to Company S, a subsidiary of Company A operating in Country Y (the transaction relates strictly to the existing intangibles and does not include compensation for future R&D services of Company A). It is assumed for purposes of this example that the payment of Company S for the transfer of intangibles related to Product M is based on a valuation of anticipated future cash flows. Company S has no technical personnel capable of designing, conducting or supervising required ongoing research activities related to Product M. Company S therefore contracts with Company A to carry on the research programme related to Product M in the same manner as before the transfer of intangibles to Company S. Company S agrees to fund all of the ongoing Product M research, assume the financial risk of potential failure of such research, and to pay for Company A's services based on the cost plus margins earned by CROs like those with which Company A regularly transacts.

61. The transfer pricing analysis of these facts begins by recognising that, following the transfer, Company S is the legal owner of the Product M intangibles under relevant contracts and registrations. However, Company A continues to perform and control functions and to manage risks related to the intangibles owned by Company S, including the important functions described in paragraph 6.56, and is entitled to compensation for those contributions. Under these circumstances, Company A's transactions with CRO's are not comparable to the arrangements between Company S and Company A related to Product M and may not be used as a benchmark for the arm's length compensation required to be provided to Company A for its

ongoing R&D activity with respect to the Product M intangibles. Company S does not perform or control the same functions or control the same risks in its transactions with Company A, as does Company A in its transactions with the CROs.

62. While Company S is the legal owner of the intangibles, it should not be entitled to all of the returns derived from the exploitation of the intangibles. Because Company S lacks the capability to control research related risks, Company A should be treated as bearing a substantial portion of the relevant risk and Company A should also be compensated for its functions, including the important functions described in paragraph 6.56. Company A should be entitled to larger returns than the CROs under these circumstances.

63. A thorough examination of the transaction in this example may show that it should accurately be delineated as the provision of financing by Company S equating to the costs of the acquired intangibles and the ongoing development. As a result, Company S is entitled to only a financing return. The level of the financing return depends on the exercising of control over the financing risk in accordance with the guidance in Section D.1 of Chapter I and the principles outlined in paragraphs 6.63 and 6.64. Company A would be entitled to retain the remaining income or losses.

Example 18

64. Primarni is organised in and conducts business in Country A. Company S is an associated enterprise of Primarni. Company S is organised in and does business in Country B. Primarni develops a patented invention and manufacturing know-how related to Product X. It obtains valid patents in all countries relevant to this example. Primarni and Company S enter into a written licence agreement pursuant to which Primarni grants Company S the right to use the Product X patents and know-how to manufacture and sell Product X in Country B, while Primarni retains the patent and know-how rights to Product X throughout Asia, Africa, and in Country A.

65. Assume Company S uses the patents and know-how to manufacture Product X in Country B. It sells Product X to both independent and associated customers in Country B. Additionally, it sells Product X to associated distribution entities based throughout Asia and Africa. The distribution entities resell the units of Product X to customers throughout Asia and Africa. Primarni does not exercise its retained patent rights for Asia and Africa to prevent the sale of Product X by Company S to the distribution entities operating in Asia and Africa.

66. Under these circumstances, the conduct of the parties suggests that the transaction between Primarni and Company S is actually a licence of

the Product X patents and know-how for Country B, plus Asia and Africa. In a transfer pricing analysis of the transactions between Company S and Primarni, Company S's licence should be treated as extending to Asia and Africa, and should not be limited to Country B, based on the conduct of the parties. The royalty rate should be recalculated to take into account the total projected sales by Company S in all territories including those to the Asian and African entities.

Example 19

67. Company P, a resident of Country A conducts a retailing business, operating several department stores in Country A. Over the years, Company P has developed special know-how and a unique marketing concept for the operation of its department stores. It is assumed that the know-how and unique marketing concept constitute intangibles within the meaning of Section A of Chapter VI. After years of successfully conducting business in Country A, Company P establishes a new subsidiary, Company S, in Country B. Company S opens and operates new department stores in Country B, obtaining profit margins substantially higher than those of otherwise comparable retailers in Country B.

68. A detailed functional analysis reveals that Company S uses in its operations in Country B, the same know-how and unique marketing concept as the ones used by Company P in its operations in Country A. Under these circumstances, the conduct of the parties reveals that a transaction has taken place consisting in the transfer from Company P to Company S of the right to use the know-how and unique marketing concept. Under comparable circumstances, independent parties would have concluded a license agreement granting Company S the right to use in Country B, the know-how and unique marketing concept developed by Company P. Accordingly, one possible remedy available to the tax administration is a transfer pricing adjustment imputing a royalty payment from Company S to Company P for the use of these intangibles.

Example 20

69. Ilcha is organised in Country A. The Ilcha group of companies has for many years manufactured and sold Product Q in countries B and C through a wholly owned subsidiary, Company S1, which is organised in Country B. Ilcha owns patents related to the design of Product Q and has developed a unique trademark and other marketing intangibles. The patents and trademarks are registered by Ilcha in Countries B and C.

70. For sound business reasons, Ilcha determines that the group's business in Countries B and C would be enhanced if those businesses were operated through separate subsidiaries in each country. Ilcha therefore organises in Country C a wholly owned subsidiary, Company S2. With regard to the business in Country C:

- Company S1 transfers to Company S2 the tangible manufacturing and marketing assets previously used by Company S1 in Country C.
- Ilcha and Company S1 agree to terminate the agreement granting Company S1 the following rights with relation to Product Q: the right to manufacture and distribute Product Q in Country C; the right to use the patents and trademark in carrying out its manufacturing and distribution activities in Country C; and, the right to use customer relationships, customer lists, goodwill and other items in Country C (hereinafter, "the Rights").
- Ilcha enters into new, long-term licence agreements with Company S2 granting it the Rights in Country C.

The newly formed subsidiary thereafter conducts the Product Q business in Country C, while Company S1 continues to conduct the Product Q business in Country B.

71. Assume that over the years of its operation, Company S1 developed substantial business value in Country C and an independent enterprise would be willing to pay for that business value in an acquisition. Further assume that, for accounting and business valuation purposes, a portion of such business value would be treated as goodwill in a purchase price allocation conducted with regard to a sale of Company S1's Country C business to an independent party.

72. Under the facts and circumstances of the case, there is value being transferred to Company S2 through the combination of (i) the transfer of part of Company S1's tangible business assets to Company S2 in Country C, and (ii) the surrendering by Company S1 of the Rights and the subsequent granting of the Rights by Ilcha to Company S2. There are three separate transactions:

- the transfer of part of Company S1's tangible business assets to Company S2 in Country C;
- the surrendering by Company S1 of its rights under the licence back to Ilcha; and
- the subsequent granting of a licence by Ilcha to Company S2.

For transfer pricing purposes, the prices paid by Ilcha and by Company S2 in connection with these transactions should reflect the value of the business which would include amounts that may be treated as the value of goodwill for accounting purposes.

Example 21

73. Första is a consumer goods company organised and operating in Country A. Prior to Year 1, Första produces Product Y in Country A and sells it through affiliated distribution companies in many countries around the world. Product Y is well recognised and attracts a premium compared to its competitors, to which Första is entitled as the legal owner and developer of the trademark and related goodwill giving rise to that premium.

74. In Year 2, Första organises Company S, a wholly owned subsidiary, in Country B. Company S acts as a super distributor and invoicing centre. Första continues to ship Product Y directly to its distribution affiliates, but title to the products passes to Company S, which reinvoices the distribution affiliates for the products.

75. Beginning in Year 2, Company S undertakes to reimburse the distribution affiliates for a portion of their advertising costs. Prices for Product Y from Company S to the distribution affiliates are adjusted upward so that the distribution affiliate operating profit margins remain constant notwithstanding the shift of advertising cost to Company S. Assume that the operating profit margins earned by the distribution affiliates are arm's length both before and after Year 2 given the concurrent changes in product pricing and the reimbursement of advertising costs. Company S performs no functions with regard to advertising nor does it control any risk related to marketing the products.

76. In Year 3, the prices charged by Första to Company S are reduced. Första and Company S claim such a reduction in price is justified because Company S is now entitled to income related to intangibles. It asserts that such income is attributable to intangibles in respect of Product Y created through the advertising costs it has borne.

77. In substance, Company S has no claim to income derived from the exploitation of intangibles with respect to Product Y. It performs no functions, assumes no risk, and in substance bears no costs related to the development, enhancement, maintenance or protection of intangibles. Transfer pricing adjustments to increase the income of Första in Year 3 and thereafter would be appropriate.

Example 22

78. Company A owns a government licence for a mining activity and a government licence for the exploitation of a railway. The mining licence has a standalone market value of 20. The railway licence has a standalone market value of 10. Company A has no other net assets.

79. Birincil, an entity which is independent of Company A, acquires 100% of the equity interests in Company A for 100. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to the mining licence; 10 to the railway licence; and 70 to goodwill based on the synergies created between the mining and railway licences.

80. Immediately following the acquisition, Birincil causes Company A to transfer its mining and railway licences to Company S, a subsidiary of Birincil.

81. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for the transaction with Company A, it is important to identify with specificity the intangibles transferred. As was the case with Birincil's arm's length acquisition of Company A, the goodwill associated with the licences transferred to Company S would need to be considered, as it should generally be assumed that value does not disappear, nor is it destroyed as part of an internal business restructuring.

82. As such, the arm's length price for the transaction between Companies A and S should take account of the mining licence, the railway licence, and the value ascribed to goodwill for accounting purposes. The 100 paid by Birincil for the shares of Company A represents an arm's length price for those shares and provides useful information regarding the combined value of the intangibles.

Example 23

83. Birincil acquires 100% of the equity interests in an independent enterprise, Company T for 100. Company T is a company that engages in research and development and has partially developed several promising technologies but has only minimal sales. The purchase price is justified primarily by the value of the promising, but only partly developed, technologies and by the potential of Company T personnel to develop further new technologies in the future. Birincil's purchase price allocation performed for accounting purposes with respect to the acquisition attributes 20 of the purchase price to tangible property and identified intangibles, including patents, and 80 to goodwill.

84. Immediately following the acquisition, Birincil causes Company T to transfer all of its rights in developed and partially developed technologies, including patents, trade secrets and technical know-how to Company S, a subsidiary of Birincil. Company S simultaneously enters into a contract research agreement with Company T, pursuant to which the Company T workforce will continue to work exclusively on the development of the transferred technologies and on the development of new technologies on behalf of Company S. The agreement provides that Company T will be compensated for its research services by payments equal to its cost plus a mark-up, and that all rights to intangibles developed or enhanced under the research agreement will belong to Company S. As a result, Company S will fund all future research and will assume the financial risk that some or all of the future research will not lead to the development of commercially viable products. Company S has a large research staff, including management personnel responsible for technologies of the type acquired from Company T. Following the transactions in question, the Company S research and management personnel assume full management responsibility for the direction and control of the work of the Company T research staff. Company S approves new projects, develops and plans budgets and in other respects controls the ongoing research work carried on at Company T. All company T research personnel will continue to be employees of Company T and will be devoted exclusively to providing services under the research agreement with Company S.

85. In conducting a transfer pricing analysis of the arm's length price to be paid by Company S for intangibles transferred by Company T, and of the price to be paid for ongoing R&D services to be provided by Company T, it is important to identify the specific intangibles transferred to Company S and those retained by Company T. The definitions and valuations of intangibles contained in the purchase price allocation are not determinative for transfer pricing purposes. The 100 paid by Birincil for the shares of Company T represents an arm's length price for shares of the company and provides useful information regarding the value of the business of Company T. The full value of that business should be reflected either in the value of the tangible and intangible assets transferred to Company S or in the value of the tangible and intangible assets and workforce retained by Company T. Depending on the facts, a substantial portion of the value described in the purchase price allocation as goodwill of Company T may have been transferred to Company S together with the other Company T intangibles. Depending on the facts, some portion of the value described in the purchase price allocation as goodwill may also have been retained by Company T. Under arm's length transfer pricing principles, Company T should be entitled to compensation for such value, either as part of the price paid by Company S for the transferred rights to technology intangibles, or through the compensation Company T is paid in years following the transaction for the R&D services of its

workforce. It should generally be assumed that value does not disappear, nor is it destroyed, as part of an internal business restructuring. If the transfer of intangibles to Company S had been separated in time from the acquisition, a separate inquiry would be required regarding any intervening appreciation or depreciation in the value of the transferred intangibles.

Example 24

86. Zhu is a company engaged in software development consulting. In the past Zhu has developed software supporting ATM transactions for client Bank A. In the process of doing so, Zhu created and retained an interest in proprietary copyrighted software code that is potentially suitable for use by other similarly situated banking clients, albeit with some revision and customisation.

87. Assume that Company S, an associated enterprise of Zhu, enters into a separate agreement to develop software supporting ATM operations for another bank, Bank B. Zhu agrees to support its associated enterprise by providing employees who worked on the Bank A engagement to work on Company S's Bank B engagement. Those employees have access to software designs and know-how developed in the Bank A engagement, including proprietary software code. That code and the services of the Zhu employees are utilised by Company S in executing its Bank B engagement. Ultimately, Bank B is provided by Company S with a software system for managing its ATM network, including the necessary licence to utilise the software developed in the project. Portions of the proprietary code developed by Zhu in its Bank A engagement are embedded in the software provided by Company S to Bank B. The code developed in the Bank A engagement and embedded in the Bank B software would be sufficiently extensive to justify a claim of copyright infringement if copied on an unauthorised basis by a third party.

88. A transfer pricing analysis of these transactions should recognise that Company S received two benefits from Zhu which require compensation. First, it received services from the Zhu employees that were made available to work on the Bank B engagement. Second, it received rights in Zhu's proprietary software which was utilised as the foundation for the software system delivered to Bank B. The compensation to be paid by Company S to Zhu should include compensation for both the services and the rights in the software.

Example 25

89. Prathamika is the parent company of an MNE group. Prathamika has been engaged in several large litigation matters and its internal legal department has become adept at managing large scale litigation on behalf of Prathamika. In the course of working on such litigation, Prathamika has developed proprietary document management software tools unique to its industry.

90. Company S is an associated enterprise of Prathamika. Company S becomes involved in a complex litigation similar to those with which the legal department of Prathamika has experience. Prathamika agrees to make two individuals from its legal team available to Company S to work on the Company S litigation. The individuals from Prathamika assume responsibility for managing documents related to the litigation. In undertaking this responsibility they make use of the document management software of Prathamika. They do not, however, provide Company S the right to use the document management software in other litigation matters or to make it available to Company S customers.

91. Under these circumstances, it would not be appropriate to treat Prathamika as having transferred rights in intangibles to Company S as part of the service arrangement. However, the fact that the Prathamika employees had experience and available software tools that allowed them to more effectively and efficiently perform their services should be considered in a comparability analysis related to the amount of any service fee to be charged for the services of the Prathamika employees.

Example 26

92. Osnovni is the parent company of an MNE Group engaged in the development and sale of software products. Osnovni acquires 100% of the equity interests in Company S, a publicly traded company organised in the same country as Osnovni, for a price equal to 160. At the time of the acquisition, Company S shares had an aggregate trading value of 100. Competitive bidders for the Company S business offered amounts ranging from 120 to 130 for Company S.

93. Company S had only a nominal amount of fixed assets at the time of the acquisition. Its value consisted primarily of rights in developed and partially developed intangibles related to software products and its skilled workforce. The purchase price allocation performed for accounting purposes by Osnovni allocated 10 to tangible assets, 60 to intangibles, and 90 to goodwill. Osnovni justified the 160 purchase price in presentations to its Board of Directors by reference to the complementary nature of the existing products of the Osnovni group and the products and potential products of Company S.

94. Company T is a wholly owned subsidiary of Osnovni. Osnovni has traditionally licensed exclusive rights in all of its intangibles related to the European and Asian markets to Company T. For purposes of this example it is assumed that all arrangements related to the historic licences of European and Asian rights to Company T prior to the acquisition of Company S are arm's length.

95. Immediately following the acquisition of Company S, Osnovni liquidates Company S, and thereafter grants an exclusive and perpetual licence to Company T for intangible rights related to the Company S products in European and Asian markets.

96. In determining an arm's length price for the Company S intangibles licensed to Company T under the foregoing arrangements, the premium over the original trading value of the Company S shares included in the acquisition price should be considered. To the extent that premium reflects the complementary nature of Osnovni group products with the acquired products in the European and Asian markets licensed to Company T, Company T should pay an amount for the transferred Company S intangibles and rights in intangibles that reflects an appropriate share of the purchase price premium. To the extent the purchase price premium is attributable exclusively to product complementarities outside of Company T's markets, the purchase price premium should not be taken into account in determining the arm's length price paid by Company T for Company S intangibles related to Company T's geographic market. The value attributed to intangibles in the purchase price allocation performed for accounting purposes is not determinative for transfer pricing purposes.

Example 27

97. Company A is the Parent of an MNE group with operations in Country X. Company A owns patents, trademarks and know-how with regard to several products produced and sold by the MNE group. Company B is a wholly owned subsidiary of Company A. All of Company B's operations are conducted in Country Y. Company B also owns patents, trademarks and know-how related to Product M.

98. For sound business reasons related to the co-ordination of the group's patent protection and anti-counterfeiting activities, the MNE group decides to centralise ownership of its patents in Company A. Accordingly, Company B sells the Product M patents to Company A for a lump-sum price. Company A assumes responsibility to perform all ongoing functions and it assumes all risks related to the Product M patents following the sale. Based on a detailed comparability and functional analysis, the MNE group concludes that it is not able to identify any comparable uncontrolled transactions that can be used to

determine the arm's length price. Company A and Company B reasonably conclude that the application of valuation techniques represents the most appropriate transfer pricing method to use in determining whether the agreed price is consistent with arm's length dealings.

99. Valuation personnel apply a valuation method that directly values property and patents to arrive at an after-tax net present value for the Product M patent of 80. The analysis is based on royalty rates, discount rates and useful lives typical in the industry in which Product M competes. However, there are material differences between Product M and the relevant patent rights related to Product M, and those typical in the industry. The royalty arrangements used in the analysis would therefore not satisfy the comparability standards required for a CUP method analysis. The valuation seeks to make adjustments for these differences.

100. In conducting its analysis, Company A also conducts a discounted cash flow based analysis of the Product M business in its entirety. That analysis, based on valuation parameters typically used by Company A in evaluating potential acquisitions, suggests that the entire Product M business has a net present value of 100. The 20 difference between the 100 valuation of the entire Product M business and the 80 valuation of the patent on its own appears to be inadequate to reflect the net present value of routine functional returns for functions performed by Company B and to recognise any value for the trademarks and know-how retained by Company B. Under these circumstances further review of the reliability of the 80 value ascribed to the patent would be called for.

Example 28

101. Company A is the Parent company of an MNE group with operations in Country S. Company B is a member of the MNE group with operations in Country T, and Company C is also a member of the MNE group with operations in Country U. For valid business reasons the MNE group decides to centralise all of its intangibles related to business conducted outside of Country S in a single location. Accordingly, intangibles owned by Company B are sold to Company C for a lump sum, including patents, trademarks, know-how, and customer relationships. At the same time, Company C retains Company B to act as a contract manufacturer of products previously produced and sold by Company B on a full-risk basis. Company C has the personnel and resources required to manage the acquired lines of business, including the further development of intangibles necessary to the Company B business.

102. The MNE group is unable to identify comparable uncontrolled transactions that can be used in a transfer pricing analysis of the arm's

length price to be paid by Company C to Company B. Based on a detailed comparability and functional analysis, the MNE group concludes that the most appropriate transfer pricing method involves the application of valuation techniques to determine the value of the transferred intangibles. In conducting its valuation, the MNE group is unable to reliably segregate particular cash flows associated with all of the specific intangibles.

103. Under these circumstances, in determining the arm's length compensation to be paid by Company C for the intangibles sold by Company B, it may be appropriate to value the transferred intangibles in the aggregate rather than to attempt a valuation on an asset by asset basis. This would particularly be the case if there is a significant difference between the sum of the best available estimates of the value of individually identified intangibles and other assets when valued separately and the value of the business as a whole.

Example 29

104. Pervichnyi is the parent of an MNE group organised and doing business in Country X. Prior to Year 1, Pervichnyi developed patents and trademarks related to Product F. It manufactured Product F in Country X and supplied the product to distribution affiliates throughout the world. For purposes of this example assume the prices charged to distribution affiliates were consistently arm's length.

105. At the beginning of Year 1, Pervichnyi organises a wholly owned subsidiary, Company S, in Country Y. In order to save costs, Pervichnyi transfers all of its production of Product F to Company S. At the time of the organisation of Company S, Pervichnyi sells the patents and trademarks related to Product F to Company S for a lump sum. Under these circumstances, Pervichnyi and Company S seek to identify an arm's length price for the transferred intangibles by utilising a discounted cash flow valuation technique.

106. According to this valuation analysis, Pervichnyi could have generated after tax residual cash flows (after rewarding all functional activities of other members of the MNE group on an arm's length basis) having a present value of 600 by continuing to manufacture Product F in Country X. The valuation from the buyer's perspective shows that Company S could generate after tax residual cash flows having a present value of 1 100 if it owned the intangibles and manufactured the product in Country Y. The difference in the present value of Pervichnyi's after tax residual cash flow and the present value of Company S's after tax residual cash flow is attributable to several factors.

107. Another option open to Pervichnyi would be for Pervichnyi to retain ownership of the intangible, and to retain Company S or an alternative supplier to manufacture products on its behalf in Country Y. In this scenario,

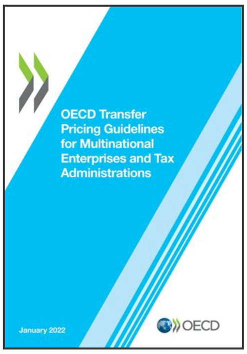
Pervichnyi calculates it would be able to generate after tax cash flow with a present value of 875.

108. In defining arm's length compensation for the intangibles transferred by Pervichnyi to Company S, it is important to take into account the perspectives of both parties, the options realistically available to each of them, and the particular facts and circumstances of the case. Pervichnyi would certainly not sell the intangibles at a price that would yield an after tax residual cash flow with a present value lower than 600, the residual cash flow it could generate by retaining the intangible and continuing to operate in the manner it had done historically. Moreover there is no reason to believe Pervichnyi would sell the intangible for a price that would yield an after tax residual cash flow with a present value lower than 875. If Pervichnyi could capture the production cost savings by retaining another entity to manufacture on its behalf in a low cost environment, one realistically available option open to it would be to establish such a contract manufacturing operation. That realistically available option should be taken into account in determining the selling price of the intangible.

109. Company S would not be expected to pay a price that would, after taking into account all relevant facts and circumstances, leave it with an after tax return lower than it could achieve by not engaging in the transaction. According to the discounted cash flow valuation, the net present value of the after tax residual cash flow it could generate using the intangible in its business would be 1 100. A price might be negotiated that would give Pervichnyi a return equal to or greater than its other available options, and give Company S a positive return on its investment considering all of the relevant facts, including the manner in which the transaction itself would be taxed.

110. A transfer pricing analysis utilising a discounted cash flow approach would have to consider how independent enterprises dealing at arm's length would take into account the cost savings and projected tax effects in setting a price for the intangibles. That price should, however, fall in the range between a price that would yield Pervichnyi after tax residual cash flow equivalent to that of its other options realistically available, and a price that would yield Company S a positive return to its investments and risks, considering the manner in which the transaction itself would be taxed.

111. The facts of this example and the foregoing analysis are obviously greatly oversimplified by comparison to the analysis that would be required in an actual transaction. The analysis nevertheless reflects the importance of considering all of the relevant facts and circumstances in performing a discounted cash flow analysis, evaluating the perspectives of each of the parties in such an analysis, and taking into consideration the options realistically available to each of the parties in performing the transfer pricing analysis.



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