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basis.

B.5.1.3. Transfer pricing issues relating to intangibles should be resolved using the fundamental transfer pricing principles contained in Chapters III to V of this Manual. However, as intangibles may be unique, may be difficult to value and may be very

issues related to intangibles can be very challenging for both tax administrations and taxpayers in developed and developing countries. This Chapter therefore supplements the general principles contained in earlier Chapters to provide special practical guidance on transfer pricing matters related to intangibles.

B.5.1.4. In carrying out a transfer pricing analysis involving intangibles it is necessary to consider: (i) the identification of the specific intangibles involved, (ii) the ownership of intangibles within the MNE group, (iii) the value of the identified intangibles, (iv) how the intangibles contribute to the creation of value by the MNE group, and (v) the identity of the members of the MNE group that contribute to intangible value and how they should be rewarded. This framework for analyzing transfer pricing issues related to intangibles is discussed in the following sections.

B.5.2. **Identifying Intangibles**

Definition of intangibles

B.5.2.1. Article 9 of the UN Model Tax Convention is concerned with the conditions of transactions between associated enterprises, not with assigning labels to such transactions. The key consideration is whether a transaction conveys economic value from one associated enterprise to another, whether that benefit derives from tangible property, intangibles, services or other activities. As is the case with other transfer pricing matters the analysis of cases involving the use or transfer of intangibles should begin with a thorough identification of the commercial and financial relations entered into by the associated enterprises and the economically relevant characteristics attached to those relations. Such an approach is pursued in order to accurately delineate the actual transaction involving the use or transfer of intangibles. However, whether a particular item falls within the definition of intangibles or not will have little consequence for the analysis, since Chapters III through V will apply in any event. The following definition is provided primarily to aid in discussion rather than to create a substantive difference between cases involving intangibles and those that do not.

B.5.2.2. Difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangibles that are either too narrow or too broad. If an overly narrow definition of the term intangible is applied either taxpayers or governments may argue, incorrectly, that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent

considered in transfer pricing analyses involving intangibles. They are illustrative and not intended to be comprehensive.

B.5.2.6. From a transfer pricing standpoint it should be emphasized that generic references to the categorization as outlined below

B.5.2.19. *Distributor Y distributes branded products for which the brand is owned by a foreign affiliated enterprise. Assume that the foreign brand owner runs a comprehensive global marketing team and that Distributor Y solely implements locally the marketing campaigns designed by the brand owner.*

Alternatively, goodwill is sometimes described as a representation of the future economic benefits associated with business assets that are not individually identified and separately recognised.

In still other contexts goodwill is referred to as the expectation of future trade from existing customers.

The term ongoing concern value is sometimes referred to as the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity.

It is also sometimes described as the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership, aside from any intangibles.

It is also sometimes referred to as the value of the assembled assets of an operating business over and above the sum of the separate values of the individual assets.

B.5.2.26. If features of a business such as a reputation for producing high quality products or providing high quality services allow that business to charge higher prices for goods or services than an entity lacking such reputation, and such features might be characterised as goodwill or ongoing concern under one or another definition of such termoh ooinim[(BDC BT1 0 0 1 70.824 599.26 Tm[(d)-3(e)6(f)-11(initio)6(n)-3( )-101

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with respect to the transaction taking place with MineCo, the taxpayer values the

of an accurate comparability (including functional) analysis at the level of each of the relevant associated enterprises.

B.5.2.40 (ii) (a) ***Simple central procurement function***: For instance, assume that the MNE Group N decides to implement a policy of cost savings. In this respect, it incorporates Company P in Country L to centralize the procurement function and take advantage of volume discounts that arise solely because of the MNE group s aggregated purchasing. Assume that Company P does not take title of the raw materials from suppliers. The concerned group members directly acquire the raw materials from the suppliers under the conditions applying to the group.

B.5.2.41. In this scenario, Company P performs a deliberate concerted action which should generally be reflected in the pricing of a procurement fee to be paid by the group members to Company P. T consideration of Company P would typically be an administrative fee and should

(ii) (c) Same fact pattern as in (ii) (b), and additionally, Company P takes title of the procured goods and through its personnel controls risks centrally regarding amongst others volume commitments, price fluctuations, exchange rate risks, quality control risks, etc. and has the financial capacity and capability to assume these risks. Company P resells the raw materials it purchases to other group members. In such cases, Company P would earn a profit margin on the products resold to the group members. Such profit margin should be appropriate in view of the value created by P, including the fact that it bears the working capital to fund inventory and reflect the range of risks associated with the procurement. Depending on the detailed facts, such profit margin may include a share of the anticipated savings derived due to actions, and may be an amount that is greater than under (ii) (b). This reflects the fact that in this scenario Company P is not only contributing value through its know-how but also through bearing inventory costs and associated risks.

Workforce in place

B.5.2.43. Another important aspect to be taken into account in a transfer pricing analysis can be the existence of a qualified and skilled workforce.

B.5.2.44. Generally, the existence of the workforce does not need to be remunerated separately for transfer pricing purposes. This is because the value provided by a workforce is typically reflected in
goods produced or the services performed by the workforce. By contrast, rights under contracts which may include the use of a workforce in place - could constitute an intangible within the meaning of paragraph 2.3 of this Chapter.

B.5.2.45 Another situation concerns the transfer of 289.61 T0 0 1 158.i5(r [(-)])1026h

employment and other associated costs, or the remuneration required for the services carried out by the seconded employees.

B.5.2.47. The use or transfer of part or all of a workforce does not, in itself, constitute the transfer of intangibles. However, it can also be the case that the transfer of certain employees is accompanied by the transfer of intangibles such as know-how from one associated enterprise to another.

Example:

B.5.2.48. Assume that several employees of Company G have developed over the years a specific algorithm to accurately price derivative instruments. The algorithm is owned by Company G as it was developed by the individuals in their capacity as employees of Company G. Assume that the employees are seconded by Company G to the associated Company M. The secondment of the personnel from Company G to Company M does not constitute a transfer of an

licensed does not affect its legal ownership, but rather creates a separate right of use for the licensee.

B.5.3.9. The legal owner(s) will be considered to be the sole owner(s) of the intangible for transfer pricing purposes. If no legal owner is identified, then the member of the group that controls decisions concerning exploitation of the intangible and that has the practical capacity to restrict others will be considered the legal owner.

B.5.3.13. *Assume RCo is a member of an MNE group engaged in R&D activities,*

intangible are those necessary to select the most appropriate intangible in the market, to analyze its anticipated benefits, take the decision to take on the risk-bearing opportunity through purchasing the intangible and manage the actual conclusion of the acquisition. A key asset would be the funding required to purchase the intangible.

B.5.3,20. For self-developed intangibles important functions in relation to the development of the intangible are those necessary to select the most appropriate research and development project, to analyze its anticipated benefits, and take the decision to take on the risk-bearing opportunity through funding the development activities and the performance of the R&D function. A key asset would be the funding required to develop the intangible.

B.5.3.21. In respect of both acquired and internally developed intangibles, the type of return warranted by the provision of funding will depend on the extent of the functions performed and risk assumed by the funding entity. See paragraphs 3.32 and 3.33 for more details.

B.5.3.22. In some cases an acquired intangible may require some further development before it becomes fully exploitable. In such cases, a combination of contributions related to the acquisition and the development of the intangible will be needed.

Example: MMD

Risks

B.5.3.25. A comparability (including functional) analysis would be incomplete unless

B.5.3.32. Funding and risk taking are integrally related in the sense that funding often coincides with the taking of certain risks. For example, a decision to fund R&D in exchange for rights in the potential benefits of that R&D involves the risk that the R&D will be unsuccessful and the funding will be lost. In addition, the larger the amount of the funds provided, the larger the potential impact of the risk on the provider of the funding.

B.5.3.33. It is important to distinguish between the financial risk that is linked to the funding provided (such as, for example, the risk associated with the commitment of

operational risks associated with the funded activity (such as, for example, the risk associated with the successful performance of the R&D function). Control over a financial risk requires the capability to make the relevant decisions related to the risk bearing opportunity. These include decisions related to taking on, laying off, or declining a risk bearing investment opportunity and the decisions on whether and how to respond to the risks associated with the investment opportunity.

Ex ante and ex post returns

B.5.3.34. It is important to distinguish between ex ante returns and ex post returns. Ex ante returns are anticipated or expected returns at the time a trans7005C1023Bi3(n)6( )-241

accurately delineated transaction (for example, the contractual terms, assuming they have substance) will determine which entity or entities assume such risks.

B.5.3.37. The notion that all contributions to value must be appropriately remunerated, as discussed above, is an ex ante concept.

Example: Contract R&D

B.5.3.38. *A multinational enterprise decides to invest in the development of a new*

Return to funding and associated financial risk:

B.5.3.44. Assume an entity provides funding and has the ability to control its financial investment risk.

On an *ex ante* basis: this entity is entitled to an appropriate risk-adjusted anticipated rate of retuID 1.etuID 1.315ation>BDC BT1 0 0 1 474.8n-3(ti21)] T-1

expected to take seven years before being eventually successful for commercial exploitation purposes.

B.5.3.47. *Under the contractual arrangement High-Yield Co will contribute all the funding associated with the development of the intangible, which is anticipated to be an amount of 100 million per year for seven years. TechCo makes all the other contributions to the remaining DAEMPE related to the intangible, whereas High-Yield Co will control the risk associated with the funding activities amounting to an overall amount of 700 million. Once the intangible is developed, High-Yield Co will legally*

Step 3: Conduct interviews with 348(inter);ETBT1 0 0 1 266.81 662.0

B.5.5. Selection of the most appropriate transfer pricing method

B.5.5.1. The principles set out in Chapter 6 of the Manual apply to select the most appropriate method in the circumstances of the case where the transaction involves

CUP method: acquisition price method in the case of transactions involving sales of intangibles

B.5.6.1.As regards the application of the CUP method, in some circumstances the intangibles transferred between associated enterprises were part of a recent acquisition by the MNE group from a third party. For instance, an MNE group acquires a company which owns intangibles. Further to the acquisition, it is decided to transfer the intangibles owned by the acquired company to another entity that is a member of the MNE group, in order to integrate them with other group intangibles. In such a situation, the consideration, i.e. the price, paid for the acquisition of the company from third parties may represent a useful starting point for determining the consisting of the transfer of intangibles from the acquired company to another group member under the CUP method. This type of CUP method is sometimes referred to as an acquisition price method. See paragraphs 2.

determine the ar
enterprises. In particular, the application of valuation techniques based on the calculation of the discounted value of projected future income streams or cash flows (DCF) derived from the exploitation of the intangible being valued, may be useful. Depending on the facts and circumstances, valuation techniques may be used by taxpayers and tax administrations as a part of one of the methods described in Chapter VI or as a tool that can be use
price.

Note

The discussion of DCF methods in this Section is necessarily rudimentary in nature, as a fuller exposition of the theory and practical application of this method requires a separate volume. Corporate finance textbooks provide a fairly solid grounding in this area

B.5.6.9. Some transfers of intangibles involve risks associated w 0 0 1 455.86 583.42 Tm[(d Tm[(d42f

analysis of the anticipated profitability of the intangible (i.e., financial projections, discussed in Section 5B below), and an analysis of the anticipated risks involved (discussed in Section 5C below). While this type of analysis is not undertaken for all intangibles, it is more likely that such an analysis may have been undertaken where the intangible is relatively important (i.e. potentially valuable) to the multinational and/or is susceptible to reasonably direct financial tracking. For example, multinationals often evaluate potential projects to develop specific intangibles, such as pharmaceut

- often for non-tax reasons - in order to gauge the anticipated profitability of a project to determine its viability. These evaluations could be undertaken at any stage, or in several stages, of development.

value of the intangible at the time of the transfer, and accordingly be useful in

ten years, then the income or cash flow projections should also be determined for a ten year period. The useful life of an intangible is the entire period during which the exploitation of the property is anticipated to occur. Exploitation of intangibles includes any direct or indirect use or transfer of the intangible property, including use without further development, use in the further development of the intangible (and any exploitation of the further-developed intangible), and use in the development of other intangibles (and any exploitation of the other intangibles when they are developed).

B.5.6.14. Example 5.1: Assume that a project is undertaken in order to develop a genetically modified grass for livestock grazing. The project will involve R&D undertaken for two years. If the R&D is successful, then the intangible will be exploited in years three through five, after which the intangible is anticipated to be worth nothing due to anticipated competitive pressures. While the future R&D expense is fairly certain, the outcome of the R&D is less certain, so the financial projections for sales are uncertain. Accordingly, the taxpayer prepares three sets of sales projections associated with an optimistic outcome, an expected outcome, and a pessimistic outcome. The taxpayer estimates that the expected outcome is most likely to occur, and that both the optimistic scenario and the pessimistic scenario are less likely. Accordingly, based on its technical and business judgment, the taxpayer assigns a 50 percent probability of sales achieving the expected outcome, a 25% probability of sales achieving the optimistic outcome, and a 25% probability of sales achieving the pessimistic outcome. Assume further that production costs are estimated to be equal to 40 percent of sales and operating expenses are estimated to be equal to 20 percent of sales. The taxpayer determines the most reliable financial projections by performing a probability-weighted calculation as follows:

Table 1: Expected Scenario, 50% probability of occurring							
Year		**1**	**2**	**3**	**4**	**5**	
Sales				250	250	250	

Operating Expenses (SGA)				0	0	0	
Operating Income		(100)	(100)	0	0	0	

Table 4 PROBABILITY-WEIGHTED FINANCIAL PROJECTIONS **([Table 1 times 50%] PLUS [Table 2 times 25%] PLUS [Table 3 times 25%])**							
Year		**1**	**2**	**3**	**4**	**5**	
Sales				312	312	312	
R&D		100	100				
COGS				125	125	125	
Operating Expenses (SGA)				62	62	62	
Operating Income		**(100)**	**(100)**	**125**	**125**	**125**	

Discount rate

B.5.6.15. A Discount rate is used to convert the projected future year results to an equivalent present value. The discount rate is supposed to compensate for the time and risk associated with the projected income or cash flows. A discount rate should be used that most reliably reflects the market-correlated risks of the projected income or cash flows, providing a measure of the appropriate anticipated return to the risk undertaken. For example, if a particular income or cash flow is projected to occur

with complete certainty, the discount rate should only take into account the time required to receive such income or cash flows. In this case, a risk-free rate might provide the most reliable discount rate e.g. long term government bond rates for the time value of money invested. On the other hand, if the projected income or cash flows are highly uncertain due to risk, those risks should be taken into account when determining the applicable discount rate. In such situations, the discounting rate might be calculated based on a higher rate than the risk-free rate, to adjust for risk premium.

Technical Note : Ex ante versus ex post financial projections;

Ex post financial projections are, of course, not really projections at all, but the *actual* financial results. Assume, for example, that the actual results of the project in example 5.1 turn out to be what was considered the optimistic scenario at the outset of the project, reflected in Table 2.

capital of unrelated companies that engage in similarly risky projects;

B.5.6.20.

Table 5						
Year	**Present Value at 11% Disc. Rt.**	**1**	**2**	**3**	**4**	**5**
Sales				312	312	312
R&D		100	100			
COGS				125	125	125
Operating Expenses (SGA)				62	62	62
Operating Income	**77**	(100)	(100)	125	125	125
return to mfg and sales	**24**	0	0	10	10	10
Operating Income attributable to intangibles	**53**	(100)	(100)	115	115	115

B.5.6.21. T

-- First, for example, discount rates are typically determined on an after-

How do the actual results compare to the anticipated results? Are the actual results within or outside the anticipated

Guidelines discusses these situations (paragraphs 6.186 6.195), and the discussion and conclusions of that Section are fully endorsed by this Manual.

Other applications of DCF – using DCF to set ex ante contingent payments

B.5.6.27.