

The definition, ownership and transfer issues around intangible property under the OECD Transfer Pricing guidelines



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Table of Contents

TABLE OF CONTENTS	2
1 INTRODUCTION.....	5
1.1 Introduction.....	5
1.2 Problem identification.....	5
1.3 Problem Statement	6
1.4 Research questions	6
1.5 The purpose of the thesis.....	7
1.6 Structure.....	7
2 THE CHARACTERISTICS OF IP	8
2.1 Introduction.....	8
2.2 The current OECD TP guidelines regarding IP	8
2.3 Notifications from the fifty mentioned organizations	10
2.4 The accounting standard.....	11
2.4.1 IAS 38.....	11
2.4.2 Other relevant national accounting characteristics of IP.....	11
2.5 Intellectual Property Law.....	12
2.6 The definition of IP for treaty purposes	12
2.7 The definition of IP in several countries	12
2.7.1 Australia	13
2.7.2 Finland.....	13
2.7.3 Germany.....	13
2.7.4 Japan.....	15
2.7.5 New Zealand	15
2.7.6 The United Kingdom	16
2.7.7 The United States	17
2.7.8 Other countries.....	18
2.8 The definition of IP concerning domestic court decisions.....	18
2.8.1 The Glaxo case	18
2.8.2 The Merck-Case.....	19
2.8.3 The Hospital Corp. of America - case	19
2.8.4 VERITAS - case	20
2.8.5 Other American court decisions.....	21
2.8.6 DSG Retail limited - case	21
2.8.7 Other UK court cases	22
2.8.8 German court cases.....	22
2.8.9 The Sife – case	22
2.8.10 Other French court cases.....	22
2.9 Literature	22
2.10 The OECD Meeting regarding the definitional issues of IP	26
2.11 A comparison	26
2.12 Conclusion.....	29
3 THE EXISTENCE OF IP	33
3.1 Introduction.....	33
3.2 Self developed and acquired IP	33

3.3	The moment of existence of IP according to the OECD TP guidelines	34
3.4	Notifications from the written letters to the OECD	34
3.5	The process of the creation of IP for TP purposes	34
3.6	Business opportunities	36
3.6.1	Court Cases:	36
3.6.2	Literature:	37
3.7	Some examples of intangibles which may or may not be defined as IP.....	38
4	THE OWNERSHIP OF IP	40
4.1	Introduction.....	40
4.2	The different concepts of ownership	41
4.2.1	Legal ownership	41
4.2.2	Contract – based ownership	41
4.2.3	Control ownership	41
4.2.4	Functional ownership	42
4.2.5	Beneficial ownership	42
4.2.6	Economic ownership	42
4.3	Substance over form	42
4.4	Article 9 of the OECD Model Treaty and the OECD TP Guidelines	42
4.5	The OECD Report on the Attribution of profits to PE’s (“the Report”)	44
4.6	Domestic legislation/guidelines	46
4.6.1	Australia	46
4.6.2	Germany.....	46
4.6.3	Japan.....	47
4.6.4	The Netherlands.....	47
4.6.5	New Zealand	48
4.6.6	The United Kingdom	49
4.6.7	The United States	49
4.6.8	Other countries.....	51
4.7	Domestic Court decisions	52
4.7.1	The absolute Vodka & Adidas – case	52
4.7.2	The Eli Lilly - case	52
4.7.3	The DHL - Case	52
4.7.4	The Glaxo – case	53
4.7.5	The G D Searle - case	54
4.7.6	The H Group Holding – case.....	54
4.7.7	The Supreme Court of Denmark.....	54
4.7.8	The lower court of Finland.....	54
4.7.9	The lower court of the Netherlands.....	54
4.7.10	The Appellate court of the Netherlands	55
4.7.11	The Maruti-Suzuki India Ltd v. ACIT - case	55
4.8	Literature	56
4.9	The OECD meeting on the ownership issues of IP	57
4.10	A comparison	58
4.11	Conclusion.....	60
5	THE RECOGNITION AND CHARACTERIZATION OF TRANSFERS OF IP.....	63
5.1	Introduction.....	63
5.2	The definition of different ways to transfer IP	64
5.2.1	The definition of an outright sale of IP	64

5.2.2	The definition of the license of IP	64
5.3	The OECD approach.....	65
5.3.1	Article 12 of the OECD Model tax treaty	65
5.3.2	The OECD TP guidelines.....	65
5.3.3	Article 7 of the Report on the attribution of profits to PE's	66
5.4	Domestic anti-abuse provisions	66
5.5	Domestic court decisions	66
5.5.1	Bell intercontinental corporation - case.....	66
5.5.2	The Bausch & Lomb - case.....	67
5.5.3	Other US court decisions	67
5.5.4	The Supreme court of the Netherlands.....	68
5.5.5	The lower court of Breda 2007.....	68
5.5.6	The lower court of Breda 2010.....	68
5.5.7	The Belgian court of appeal	69
5.5.8	Danish court decisions	69
5.5.9	Norwegian court decisions	69
5.5.10	The Israeli court decision	69
5.6	The IAS and literature	69
5.7	A comparison	71
5.8	The conclusion	72
6	CCA'S, MARKETING IP AND THE ROUNDTRIP PROBLEM	75
6.1	Introduction.....	75
6.2	CCA'S.....	75
6.3	Marketing activities undertaken by enterprises not owning trademarks or trade names.....	77
6.3.1	Question one: the compensation for providing excessive marketing activities.....	77
6.3.2	Question two: the identification of the way to determine the return attributable to the performed marketing activities by the licensee	78
6.4	Marketing activities undertaken by enterprises not owning trade IP	79
6.5	The roundtrip problem.....	80
7	CONCLUSION	82
7.1	Initial remarks.....	82
7.2	What should be the definition of IP under the OECD TP guidelines?	82
7.3	Who should own the IP under the OECD TP guidelines?"	83
7.4	When should we recognize or re-characterize the transfer of IP under the OECD TP guidelines?	84
7.5	Examples related to the ownership and transfer issues around IP	85
8	REFERENCES.....	86
8.1	OECD Letters.....	86
8.2	Articles.....	86
8.3	Books	88
8.4	OECD Material	88
8.5	OECD's sixth party of the Committee on Fiscal Affairs documentation.....	89
8.6	Domestic legislation and court decisions	89
8.7	Other material	92

1 Introduction

1.1 Introduction

The recent globalization gives rise to the expansion of many companies in several countries through subsidiaries. As a result, these multinational enterprises produce, transfer and sell their (right to use) tangible and intangible property all over the world. Sixty percent¹ of these transfers take place between the parent company and one of its foreign subsidiaries or between different subsidiaries of the multinational enterprise. This would not be a problem, if there were not many differences between the countries with regard to the tax treatment of these transfers. These differences concern the questions which country may tax the revenues on these transfers and what should be the correct valuation of these transfers.

To harmonize many differences between the countries, for instance the differences with respect to tax revenues, many countries, including the Netherlands, are a member of the Organization for Economic Co-Operation and Development ("OECD"). This organization aims a uniform and correct implementation of global rules and guidelines with respect to international tax revenues.

One of the main publications of the OECD in relation to tax are the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the OECD TP guidelines"). The OECD TP guidelines are the clarification of article 9 of the OECD model treaty, concerning transfer pricing ("TP") issues. The OECD TP guidelines deal with the correct determination of an arm's length remuneration for intercompany transactions concerning tax revenues. According to the OECD TP guidelines the correct valuation of intercompany transactions depends on the price an unrelated party would pay for the tangible or intangible property. In other words, the price of the transaction with regard to tangible and intangible property has to be at arm's length.

The use of and investment in intangible property ("IP") are crucial for multinational enterprises to compete, grow and even survive in our international environment. More and more multinational enterprises participate for example in research and development, invest in the creation of know-how or trade secrets or make substantial interests for the right to use IP, such as patents or designs. The OECD TP guidelines deal with the intercompany transactions of IP in chapter six, for Cost Contribution Arrangements ("CCA's") in chapter eight and for business restructurings in chapter nine. In chapter six and nine the OECD mentions examples of IP and applies the arm's length principle to IP. Furthermore, chapter nine gives some starting points concerning IP for TP purposes.

1.2 Problem identification

Because of the development of IP on the global market and the insufficient explanation in chapter six, eight and nine of the OECD TP guidelines on IP, IP's are a key area of concern to governments and taxpayers for TP purposes. In particular questions arose towards the correct definition, the correct identification and the correct valuation of IP for TP purposes. The resident country of the parent company ("home state") for example defined 'something of value' as IP where the resident country of the subsidiary ("source state") did not or the home state recognized economic ownership as vital for the identification of the IP, where the source state only recognized the legal owner of the IP. Further, it was possible that the valuation of the IP differed in the home and source states. These different treatments of IP in the home and source states led to many TP disputes, uncertainties and to risks of

¹ Wills 1999.

double or less-than-single taxation in cases of IP transfers between subsidiaries of multinational enterprises in two or more countries.

Because of these issues the OECD, in particular the sixth party of the Committee on Fiscal Affairs (“the committee”), started a new project as from 2010 to develop a clear and harmonized international guidance on the TP aspects of IP². The project will update chapter six of the OECD TP guidelines and as a consequence possibly items of chapter eight. This update will be finalized at the end of 2013.

In 2010, the committee asked about 50 organizations all over the world to describe the main issues in their opinion concerning IP. This question resulted in 50 recommendations towards issues on IP (“the OECD letters”). The whole project will consequently contain a framework for the analysis of intangible-related TP issues, a clear definition of IP, the transfer of IP, economic and legal ownership of IP, cost contribution arrangements (“CCA’s”) and the valuation of IP.

With regard to the definition, transfer and ownership of IP most of the OECD letters asked a couple of more specific questions to be answered during the intangible project³:

- What is IP and what is not IP? And more in particular: When does IP exist and what are the characteristics of IP?
- Who owns the IP? This question deals with the difficulty of legal and economic ownership and the reward in return for these different kinds of ownerships;
- What rights does the IP give the owner?
- When is IP being transferred?

These questions have arisen because the questions are not solved or harmonized in the OECD TP guidelines nowadays. Since the different OECD countries answer these questions differently from each other, double taxation or non-taxation could arise when dealing with IP.

1.3 Problem Statement

Following the last mentioned questions in the problem identification, this thesis will focus on the definition and clarification of IP under the OECD TP guidelines. The main question of the thesis will be:

- *What should be the identification of IP under the OECD TP guidelines, with regard to the definition, ownership and transfer of IP?*

The purpose of this problem statement is to clarify IP under chapter six of the OECD TP guidelines by defining a clear and practical definition of IP, looking at the legal and economic ownership concepts of IP and the reward for these different types of ownership and consequently focusing on the factors to be considered before the IP or the right to use IP has been transferred.

1.4 Research questions

To answer the problem statement properly a couple of research questions must be answered. The outcomes of these questions will give a complete answer to the problem statement. These research questions are:

- *What should be the definition of IP under the OECD TP guidelines?*

The purpose of this first question is to determine a clear and practical definition of IP.

² OECD, transfer pricing and intangibles: scope of the OECD project, TPA 25 January 2011.

³ See for example the letters from: AstraZeneca 2010, Ernst & Young 2010 and Mayer Brown 2010. These letters involve the relevant questions with regard to the definition, ownership and transfer of IP.

- *Who owns the IP under the OECD TP guidelines?*

This question deals with the economic and legal ownership of IP. The purpose is to determine the correct ownership concept for TP purposes. Consequently, the question which party is entitled to the income arising from the IP and therefore subject to tax will be answered in this part of the thesis.

- *When should we recognize or re-characterize the transfer of IP under the OECD TP guidelines?*

This question includes the determination of different key lines that must be considered before the IP or the right to use the IP has been transferred. Further, this question investigates the exceptional possibility to re-characterize a transfer in case the substance of a transfer differs significantly from its form.

1.5 The purpose of the thesis

The purpose of this thesis is to give a clear definition and clarification of IP to reach for a practical and harmonized definition and clarification of IP under the OECD TP guidelines.

Using this thesis, the committee and the multinational enterprises dealing with the international transfer of potential IP between associated companies may have an important framework to change chapter six of the OECD TP guidelines within the scope of the IP project to avoid uncertainties, disputes and double or less-than-single taxation concerning IP.

1.6 Structure

In the second chapter the characteristics of IP will be discussed to define IP, because the characteristics of IP are very important to determine what IP should be according to the OECD TP guidelines. Without this first question I cannot determine the definition of IP. In the third chapter the characteristics given in chapter two will be applied in a particular situation, namely the 'moment of existence' of IP for TP purposes. Business opportunities are given as example in this chapter. Thereafter reviews the fourth chapter the different legal and economic ownership concepts from an international perspective. This chapter concerns a main issue for the identification of IP, because we have to know who owns the IP for TP purposes. The fifth chapter analyzes the key lines to recognize a transfer or the exceptional possibility to re-characterize a transfer of IP by license or outright sale. This chapter will broadly be in line with the characteristics of the correct ownership concept handled in chapter four. The recognition of the correct transfer is of main importance to identify the revenues from the IP correctly. Additionally, I will focus on the application of the correct ownership concept in case of CCA's and marketing IP and analyze transfer issues like the roundtrip problem in chapter six. I will end up the thesis with a conclusion in which I will give an answer to the problem statement and a recommendation with regard to the IP project from the committee.

2 The characteristics of IP

2.1 Introduction

Nowadays, the OECD only gives some examples of IP in chapter six of the OECD TP guidelines⁴. Furthermore, the OECD report concerning article 7 of the OECD Model tax treaty defines IP as non-physical capital⁵. However, to define IP for TP purposes it is necessary to describe certain characteristics of IP, because a list of IP can never be exhaustive, since IP's are continuously being created⁶. Nevertheless, it is very difficult to determine general characteristics of IP for TP purposes. Namely, every country uses different characteristics to define IP for TP purposes, relying on national legislation, accounting or legal standards, the OECD TP Guidelines or court decisions. Further, there are only a few countries that provide a definition of IP in their national legislation.

The main question when charactering IP under the OECD TP guidelines is: "Would an unrelated party pay a certain price for the IP?" In other words: "Is there a value attributable to the IP from the perspective of an unrelated party?"

First, I will review the current chapter six and chapter nine of the OECD TP guidelines in paragraph 2.2. The starting points mentioned in chapter nine and in domestic legislation and court decisions regarding business restructurings may also be important when determining a general definition of IP. Thereafter will the characteristics of IP be investigated in paragraph 2.3 that need to be considered in the view of the OECD letters. In paragraph 2.4 the characteristics of IP for treaty purposes will be discussed. In paragraph 2.5 the definition of IP in the International Accounting Standards ("IAS") will be handled and in paragraph 2.6 the characteristics of IP under intellectual property law will be reviewed. These accounting and legal approaches only serve as a point of origin, since IP *"is not always legally protected and registered and not all valuable intangible assets are recorded in the accounts."*⁷ In other words, IP for TP purposes provide a broader definition of IP than IP for accounting- and legal purposes. Thereafter, several countries providing characteristics of IP for TP purposes in their national legislations or national guidelines will be investigated in paragraph 2.7. In paragraph 2.8 several court decisions concerning the characteristics of IP for TP purposes will be described and in paragraph 2.8 the different views on IP for TP purposes in the literature will be discussed. Furthermore, a comparison of the different characteristics mentioned in the earlier paragraphs will be given in paragraph 2.8 using a comparative chart and I will end up with a conclusion concerning the determination of the characteristics that must be taken into account under the OECD TP guidelines in paragraph 2.9.

In addition, it should be noted that this thesis does not discuss the different disputable examples of IP, but focuses only on the general characteristics of IP for TP purposes. Furthermore, this thesis does not distinguish marketing IP from trade IP when determining the characteristics of IP.

2.2 The current OECD TP guidelines regarding IP

Chapter six of the OECD TP guidelines:

The OECD defines IP in chapter six of the OECD TP guidelines by mentioning some examples of IP:

⁴ See § 6.2 of the OECD TP guidelines: *"The term IP includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets."*

⁵ Report on the attribution of profits to permanent establishments, OECD 2010.

⁶ www.apps.americanbar.org/buslaw/newsletter/0058/materials/book.pdf.

⁷ § 9.80 of the OECD TP guidelines and the OECD, proposed revision of chapters I-III of the TP guidelines § 2.90, 2009.

⁸ § 6.2 of the OECD TP guidelines: *"These intangibles are assets that may have considerable value even though they may have no book value in the company's balance sheet."*

“The rights to use industrial assets such as patents, trademarks, trade names, designs or models, and literary and artistic property rights, as well as know-how and trade secrets.”⁹

Furthermore, the OECD categorizes IP as commercial (trade) IP and marketing IP. Commercial IP’s are:

“patents, know-how, designs, and models that are used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business (e.g. computer software).”¹⁰

Central for the recognition of commercial IP for TP purposes is the market power attributable to the owner of the IP¹¹. Marketing IP’s are:

“Trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned. Some marketing intangibles may be protected by law and used only with the owner’s permission for the relevant product or services. The value of marketing intangibles depends upon many factors, including the reputation and credibility of the trade name fostered by the quality of the goods and services provided under the name, the degree of quality control and ongoing R&D....the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services... and the nature of any right created in the intangible under the law.”¹²

With respect to marketing IP the promotional value, the quality of the IP and the potential benefits are of main importance when characterizing the IP for TP purposes. Moreover, the OECD mentions that a bundled IP transfer needs to be considered separately to verify the arm’s length character of the transfer¹³. Above, the OECD mentions that the IP must cause reasonably foreseeable benefits¹⁴. Further, the OECD indicates the calculation of the arm’s length price, the exclusive character of the IP, the start-up expenses, the development work, the distribution network and the rights to participate in further developments of the IP as important factors¹⁵.

From chapter six, it can be concluded that the following aspects are important for determining whether an IP exists:

- The trade IP can be transferred, used or made by the owner. The generation of profits by the owner is of main importance;
- Trade IP’s are created through expensive R&D activities¹⁶. There are costs made in connection to the created IP;
- The marketing IP is unique;
- The protection of an IP is not a condition, but looking at the examples, most of the IP’s are protected;
- The marketing IP adds value to the enterprise;

⁹ § 6.2 of the OECD TP guidelines.

¹⁰ § 6.3 of the OECD TP guidelines.

¹¹ G. Cottani 2007.

¹² § 6.4 of the OECD TP guidelines.

¹³ § 6.18 of the OECD TP guidelines.

¹⁴ § 6.32 of the OECD TP guidelines.

¹⁵ § 6.20 of the OECD TP guidelines.

¹⁶ § 6.3 of the OECD TP guidelines.

- The IP can be valued separately;
- The IP has an exclusive character;
- The IP causes foreseeable future economic benefits.

Chapter one of the OECD TP guidelines:

Chapter one notes characteristics that may be important to consider when valuing the transfer of an IP¹⁷:

- The form of the transaction;
- The type of property;
- The duration and degree of protection;
- The anticipated benefits from the use of the IP.

Additionally, in case of tangible property, the quality and reliability play an important role when valuing the transfer of this property. The question is if we can apply these criteria also in cases of IP. Also, compensation usually reflects the functions performed, assets used and risks assumed. To make this analysis it is essential to identify the functions performed by the relevant enterprises¹⁸. Furthermore, the OECD distinguishes property from services¹⁹.

Chapter nine of the OECD TP guidelines:

In chapter nine, the OECD TP guidelines indicate:

“An independent enterprise does not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits....When applying the arm’s length principle to business restructurings, the question is whether there is a transfer of something of value (rights or other assets)”²⁰

Furthermore, the OECD mentions that IP’s have to be identified²¹. The above mentioned characteristics will consequently result in the following criteria:

- The IP has the ability to be protected;
- The IP has the opportunity to earn future benefits;
- The IP possesses a high quality and reliability;
- The IP can be identified;
- The IP is ‘something of value’.

2.3 Notifications from the fifty mentioned organizations

With regard to the definition of IP the OECD letters discussed several optional characteristics that may be of main importance to consider when determining a clear and practical definition of IP:

- Can the IP be identified?
- Can the IP be transferred?
- Can the IP be identified and transferred separately?
- Is it possible to get a protection over the IP?
- Can the IP be privately owned?
- Does the IP know a finite or an indefinite life?
- Is the IP unique or are we dealing with a routine IP?
- Does the IP reliably have potential to earn future benefits?

¹⁷ § 1.39 of the OECD TP guidelines.

¹⁸ § 1.42 of the OECD TP guidelines and further.

¹⁹ § 1.39 of the OECD TP guidelines.

²⁰ § 9.65 of the OECD TP guidelines.

²¹ § 9.80 of the OECD TP guidelines.

- Is there a distinction between a service and an IP for TP purposes?
- Does an IP only include assets or also functions or risks?
- Is there any tangible evidence from the existence of the IP?
- Which functions or activities can lead to an IP and which functions and activities can not?
- Is there a difference between base and incremental IP's?
- Are costs connected to the IP relevant for recognizing the IP for TP purposes?
- Is there a difference between bought-in IP and internally developed IP?²²

I will take the relevant questions into consideration during this chapter to determine a clear definition of IP for TP purposes.

2.4 The accounting standard²³

2.4.1 IAS 38

The International accounting Standards ("IAS") indicate IP as "*an identifiable asset, non-monetary and without physical*"²⁴. In accordance with the IAS, IP includes the following criteria:

- The IP has to be individually identifiable²⁵;

This means that the IP can be recognized separately and can be divided from the whole entity. In other words, it has to be possible for the owner of the IP to sell, transfer or lease the IP individually or together with the contract or asset. Another option for meeting the identification criterion is that the IP arises from contractual or legal rights²⁶. Examples of IP's that do not meet the condition of identification are goodwill and going concern value because these IP's are linked to an entity in general and cannot be separately recognized.

- The owner of the IP has to control the IP²⁷;

This condition attends to the power of the owner to obtain the future economic benefits earned by the IP and the possibility to restrict the access of others regarding these benefits. Legal enforceability is not a necessary condition for the determination of control. Nevertheless, without any legal right with respect to the IP it is very difficult for the owner to prove control over the IP. Examples of IP's that do not meet this condition are specialized employees or technical skills.

- The IP causes future economic benefits²⁸.

These benefits include for example revenues from the sale or license of the IP and cost savings.

2.4.2 Other relevant national accounting characteristics of IP

This thesis will only focus on the definition of IP for TP purposes. Nevertheless, there are some relevant additional characteristics given in the national accounting standards of several countries that can be relevant when determining the definition of IP for TP purposes, namely:

- The IP can be measured with sufficient reliability²⁹.
- "*An identifiable asset is an asset that can be disposed of separately without disposing of a business of the entity*"³⁰.

²² See the letters from: Altus Alliance, Japan foreign Trade council Inc., KPMG, Mayer Brown, NERA economic consulting, PWC, Mc Dermot Will & Emery, VNONCW, WTS. In these letters the authors mention questions related to the definition of IP.

²³ The IAS embodies the international accounting principles. Nevertheless, many countries have national accounting standards, for instance the US GAAP and the French PCG. I will not focus on these national standards, since the factors are almost the same as mentioned in the IAS.

²⁴ IAS 38, § 8.

²⁵ IAS 38, § 11 and 12.

²⁶ IAS 38, § 12 under b: "*regardless of whether those rights are transferable or separable from the entity or other rights or obligations.*"

²⁷ IAS 38, § 13 till 16.

²⁸ IAS 38, § 17.

²⁹ Article 211-1 of the French PCG.

³⁰ FRS 10 (UK).

2.5 Intellectual Property Law³¹

According to IP law, IP refers to a several creations of the mind, like inventions, names, images and literary work³². The owners of these creations are granted exclusive rights and protection under IP law³³. These rights protect the concerning creations.

The characteristics of IP concerning IP law are in other words:

- The IP concerns a creation of the mind;
- The owners of the IP are granted formal legal protection.

2.6 The definition of IP for treaty purposes³⁴

Article 12 of the OECD Model treaty defines the term royalty as the compensation for the right to use IP:

“The term Royalties as used in this article means payments of any kind received as a consideration for the use of, the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience (know-how).”³⁵

These examples are not exhaustive, but give an indication of IP for treaty purposes. A third party would pay, in accordance with the examples mentioned in this article, for intellectual property or for know-how. The OECD defines know-how as the following:

“It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.”

In accordance with the definition above, IP in case of royalty payments clarifies the following criteria:

- A formal legal protection is of main importance when defining the term IP;
- IP is designed to increase the profitability of the enterprise (in other words, the IP has the ability to earn future economic benefits);
- The IP is used/exploited in the operation of the enterprise;
- Services cannot qualify as IP³⁶.

2.7 The definition of IP in several countries

In this paragraph, I will extensively discuss a number of OECD member countries that provide several characteristics of IP for TP purposes in their domestic legislation, guidelines or other governmental

³¹ Every country has her own national IP legislation, but the definition of IP is the same.

³² See for example the website of the WIPO, <http://www.wipo.int/about-ip/en/>.

³³ The rights or protections are based on patents, trade secrets and proprietary technology, copyrights, domain- and trade names and software and mask Works as mentioned by the WIPO, www.wipo.int.

³⁴ For another view with regard to article 12 OECD Model treaty see I. Verlinden 2010.

³⁵ Article 12 under 2 of the OECD Model tax treaty.

³⁶ § 11.3 of the comment to article 12 OECD Model treaty clarifies the distinction between know-how and services. The performance and the intensity of the supplier is of main importance when distinguishing between know-how and services.

decisions. In the last subparagraph I will end up with mentioning some additional characteristics provided for in domestic regulations from countries that do not provide for extensive regulations towards the definition of IP for TP purposes.

2.7.1 Australia

Australia follows as closely as practicable the OECD TP guidelines³⁷. Nevertheless, Australia handles a very broad definition of IP according to their national legislation, namely:

- *“Real property;*
- *A chose in action*³⁸;
- *Any kind of property other than tangible property*³⁹.

Moreover, IP does not include:

- *“A right arising under a contract of insurance; or*
- *A lease or license in respect of real property or tangible property*⁴⁰”

The main factor to define IP for TP purposes according to the tax rulings of the Australian Taxation Office is the question of producing a sustainable competitive advantage or a superior level of profitability with the IP⁴¹.

In conclusion, Australia marks almost all IP as IP for TP purposes if the IP is unique (non-routine) and therefore highly valuable⁴².

2.7.2 Finland

The National Finnish board of taxes handles a very wide definition of IP, namely: *“All income producing assets, which could be sold against payment to an outside enterprise, should be included in intangible assets”*⁴³. IP that cannot be kept separately or is not registered can nevertheless be IP for TP purposes⁴⁴. Further, the National board mentions some characteristics of IP, namely:

- The uniqueness of the IP;
- The duration and degree of any protection;
- The anticipated benefits from the use of the IP.

Further, when defining IP for TP purposes, the IP must have the possibility to be transferred separately⁴⁵. Regarding IP for TP purposes, the National tax board requires an extensive documentation of the concerning IP. Since this extensive documentation, the IP has to be identifiable, because otherwise the IP cannot be taken into account for IP documentation.

In conclusion, the characteristics of IP for TP purposes in Finland are:

- The possibility to be identified, transferred and protected separately from the business;
- The uniqueness (non-routine) of the IP;
- The benefits arising from the use of IP.

2.7.3 Germany

Germany does not mention general characteristics of IP. Nevertheless, Germany indicates certain examples of IP's in different guidelines.

1. *The German commercial Code (Handelsgesetzbuch)*⁴⁶

³⁷ ATO TR 97/20.

³⁸ This is a comprehensive term to describe a property- or possession right that can only be obtained or enforced through Legal action.

³⁹ ATO TR 97/20.

⁴⁰ Section 136 under intangible property of the Fringe Benefits Tax Assessment Act 1986.

⁴¹ ATO TR 98/11 under § 5.40, 5.41 and 5.42.

⁴² This follows implicitly from ATO TR 98/11 under § 5.42. See also IFA 2007, p.69, 70.

⁴³ Memorandum of the Regulation of the National board of taxes concerning the transfer pricing documentation requirements (Dnro 1471/37/2007), under 4.4.6.

⁴⁴ Memorandum of the Regulation of the National board of taxes concerning the transfer pricing documentation requirements (Dnro 1471/37/2007), under 4.3.2.

⁴⁵ IFA 2007, p.238. This follows from the Business Income Tax act, but I couldn't find an English version from this Tax Act.

⁴⁶ Section 266.2.A.I of das Handelsgesetzbuch.

This code marks self-created and acquired IP (rights) and corresponding rights, acquired licenses and other benefits, concessions, goodwill and advanced payments as IP.

2. *The administrative guidelines of 23 February 1983*⁴⁷

These guidelines declare IP (rights), design protection rights, copyrights, unprotected inventions, technology performances, plant variety rights, business secrets and other rights and benefits which are not protected as IP.⁴⁸

3. *Chapter 5.5 paragraph 1 of the 'Einkommensteuerrichtlinie*⁴⁹

This paragraph defines IP as: Rights, similar rights and other advantages which meet the following conditions:

- The IP can be valued separately;
- The IP's are acquired by the enterprise⁵⁰.

4. *The administrative guidelines of 12 April 2005*⁵¹

In this chapter the German Ministry of Finance mentions two implicit characteristics of IP, namely:

- The IP has to be recorded in a contract, by registration or through an agreement. In other words, there has to be tangible evidence from the existence of the IP.
- The IP is of main significance with respect to the affected company. This means that the IP must be used in the operation of a business.

Functions in relation to IP:

The foreign tax act⁵² defines a transfer of IP as a shift of the function and the corresponding risks and chances. A function means "a combination of a certain activity that is executed by a department within a company⁵³". The result of taxing a function shift (Funktionsverlagerung) is that all the IP's concerning the following benefits to the principal company are IP for TP purposes:

- "Business opportunities that a German group company has developed and then transfers to the related principal company;
- Profit potentials which represent the pure profits that could be realized with the transferred risks, chances and functions to the principal company;
- Transfer packages which cover the functions, risks and chances transferred to the related principal company. The criteria for the taxation of this package are that the developing company made costs for the resulting transfer package and the developing company possessed the tangibles and personal to realize the transfer package on his own."⁵⁴

The definition of IP under the German legislation is consequently very broad and vague. Taking into account the different domestic legislation and guidelines mentioned above, Germany characterizes IP as the following:

- The IP can be valued separately;
- The IP is acquired by the enterprise;
- There has to be tangible evidence from the existence of the IP;
- The IP must be used in the operation of a business;
- IP's include business opportunities, profit potentials and transfer packages, because the transfer of IP can be recognized as a shift of the function and the corresponding risks and chances of the IP.

⁴⁷ German Ministry of Finance, 23 February 1983, C5 – S 1341 – 4/83 under 3.1.2.3.

⁴⁸ Köster-Böckenförde 2009.

⁴⁹ Einkommensteuer-Richtlinien 2005, <http://www.einkommensteuerrichtlinien.de/Einkommensteuerrichtlinien.pdf>.

⁵⁰ R. 5.5 paragraph 1 and 2 of the Einkommensteuer-Richtlinien 2005. § 5 under 2 of the EStG mentions the condition that the IP has to be acquired at a consideration. Nevertheless, this consideration is not applicable if the seller already activated the IP and transfers the IP to an associated company.

⁵¹ German Ministry of Finance, 12 April 2005, IV – B4 – S 1341 – 1/05, under immaterielle Wirtschaftsgüter.

⁵² § 1 Außensteuergesetz.

⁵³ Sec.1 of the Decree-law, I BFD transfer pricing Germany or 2.1.1 of the Verwaltungsgrundsätze Funktionsverlagerung.

⁵⁴ 2.1.3 and 2.1.4 of the 'Verwaltungsgrundsätze Funktionsverlagerung and IFA 2007, p. 282.

2.7.4 Japan

The Tax agency of Japan defines IP for TP purposes as the following:

- *“IP’s derived from technical innovation.*
- *Know-how derived from the experience by employees and other human resources through business activities such as management, front-office operations, production, research and development and sales promotion.*
- *Production process, procedures and development, distribution and financing networks.”⁵⁵*

Furthermore, the IP can be defined as IP for TP purposes if:

- *“The IP serves as source of income;*
- *The IP has material value;*
- *The existence of IP can be measured by comparison between the profit margin of an enterprise without IP and with IP;*
- *The existence of IP has to be analyzed by mentioning the activities, functions and so forth in relation to the creation of the IP;*
- *The provision of services and use of IP are conceptually distinct.”⁵⁶*

Following this definition of IP, Japan recognizes a very broad definition of IP, namely every IP that does not qualify as a service, has material value and serves as a source of income when comparing a company with IP and a company without IP. In other words, the following characteristics of IP are essential according to Japan:

- The IP serves as a source of income;
- The IP has material value;
- The IP has the ability to be identified separately, because otherwise you can not compare a company with IP and a company without IP and analyze the activities and functions;
- IP’s concerning human resources can be IP as well, when formulated through business activities.

2.7.5 New Zealand

One of the main questions related to IP, according to the TP guidelines of New Zealand is:

“Is there any perception of profit potential on the IP⁵⁷?” Keeping this question in mind, there are certain factors mentioned in the New Zealand’s TP guidelines to determine the nature of IP:

- *“The expected benefits from the IP;*
- *The terms of the transfer, including the exploitation rights granted in the IP, the exclusive or non-exclusive character of any rights granted any restrictions to use, or any limitations on the geographic area in which the rights might be exploited;*
- *The stage of development of the IP in the market in which the IP is to be exploited, including, where appropriate:*
 - *The extend of any capital investment, start-up expenses or development work required, and;*
 - *Necessary governmental approvals, authorizations, or licenses required;*
- *Rights to receive updates, revisions, or modifications of the IP;*
- *The uniqueness of the IP and the period for which it remains unique, including the degree and duration of protection afforded to the IP under the laws of the relevant countries, and the value that the process in which the IP is used contributes to the final product;*
- *The duration of the license, contract or other agreement, and any termination or negotiation rights.”⁵⁸*

⁵⁵ Commissioner’s Directive on the Operation of Transfer pricing 2-8 and 2-11.

⁵⁶ *Ibid.*

⁵⁷ IRD Tax information Bulletin – Appendix: Transfer pricing guidelines, Vol. 12, No 10 (October 2000), p. 53, Key points.

When distinguishing IP between trade IP and marketing IP⁵⁹ there are some corresponding characteristics given in the New Zealand's TP guidelines, namely:

- A marketing IP may have an indefinite life, depending on the maintenance of the IP. The enforcement of the IP is of main importance when defining IP for TP purposes;
- Marketing IP is associated with the promotion of goods or services, like trade names or trademarks;
- A trade IP may have a limited life. The definition of IP for TP purposes depends on the inherent quality of the trade IP. The trade IP has to be determined by the use to which it can be applied;
- Trade IP's are associated with the production of goods, like research and development⁶⁰.

Looking at all the factors mentioned above, New Zealand handles the following characteristics of IP:

- The IP has the potential to earn future benefits;
- The IP can be transferred (exploited);
- The IP is (periodic) unique;
- The IP can be protected by law or other protection rights and is governmental recognized (approved);
- The stage of development of the IP, taking into account the costs made concerning the IP;
- The exclusivity of the IP. For instance the exclusive granted character, the restrictions to use the IP or a granted exclusive exploitation area.
- There is an owner of the IP;
- The IP knows a limited or indefinite life, depending on the consideration of the IP as trade- or marketing IP.

2.7.6 The United Kingdom

The OECD TP guidelines are imported directly in the English legislation under the Taxation (international and other provisions) act 2010⁶¹. This means that the identification of IP for TP purposes in the United Kingdom ("UK") is in accordance with the OECD TP guidelines. Nevertheless, under the HMRC guidance⁶², the UK department of HMRC uses a very wide definition of IP for TP purposes, namely *"any property that isn't tangible but is none the less still clearly property that could be exploited"*⁶³. This exploitation would have a value between independents⁶⁴. When the IP has the ability to be exploited, we can speak from IP according to the HMRC guidance. When we look to this HMRC definition, most IP's are IP for TP purposes, because they can be exploited. Goodwill, business opportunities and know-how are for instance IP in conformity with the HMRC and profit potential is not⁶⁵. The main question concerning this definition is: *"If IP cannot be protected can it truly be exploited?"*⁶⁶ The right to exploit IP's suggests namely the right to restrict the use of these IP's.⁶⁷ HMRC declares in the same guidance⁶⁸ that IP which is legally protected demonstrably exists, but the existence of other IP merely because any activity has been going on, has to be considered critically. A legal protection is thus no requirement, but without any legal protection the identification of an IP as IP for TP purposes depends on the facts and circumstances and is therefore difficult to prove⁶⁹.

⁵⁸ IRD tax information Bulletin – Appendix: Transfer pricing guidelines, Vol. 12, No 10 (October 2000), p.57, factors in determining the nature of intangible property.

⁵⁹ § 6.3 and § 6.4 of the OECD TP guidelines.

⁶⁰ IRD Tax information Bulletin – Appendix: Transfer pricing guidelines, Vol. 12, No 10 (October 2000), p. 54, 55.

⁶¹ TIOPA 2010, section 164 under 4.A., IBFD 2011 UK, under 14.

⁶² International Tax Manual 464070.

⁶³ *Ibid.*

⁶⁴ IFA 2007.

⁶⁵ Beeton 2010.

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ International Tax Manual 464070.

⁶⁹ See further Beeton 2010.

Furthermore, regarding exit charges on assets arising from business restructurings, the UK limited the need for tax compensation to transfers of identifiable IP⁷⁰. Therefore, the IP needs to be identifiable.

2.7.7 The United States

According to the Internal Revenue Code (“IRC”) Regulations under 1.482-4, “an IP has substantial value independent of the services of any individual.” In conclusion, a service will never be IP. Regulation 1.482-4 gives certain categories of IP, i.e.: patents, inventions, formulae, processes, designs, patterns, know-how, copyrights, artistic-, musical-, literary compositions, trademarks, trade names, brand names, franchises, licenses, contracts, methods, programs, systems, procedures campaigns, surveys, studies, forecasts, estimates, customer lists, technical data and other similar items. An IP is similar to these categories if: “the IP derives its value not from its physical attributes but from its intellectual content or other IP’s”⁷¹. Furthermore, IP does not need to be legally protected by law or contract in the United States for TP purposes⁷². Looking at the IRC⁷³, it is moreover supposed that IP must be controlled by the owner for TP purposes.

The characteristics of IP in accordance with the United States (“US”) legislation are in conclusion:

- The IP has substantial value;
- This value is not dependent of any individual service;
- This value is derived from its intellectual content or other intangible properties;
- The IP does not need to be legally protected by law or contract;
- The owner of the IP has to control the IP.

In case of amortization of a finite IP, Section 197 of the IRC⁷⁴ indicates the depreciable IP’s. The categories mentioned in this section are almost the same as provided in IRC regulation 1.482-4. However, an important difference between the two Regulations is that ‘Soft-IP’s’, such as workforces in place, going concern value and goodwill are also amortizable under Section 197 but are not identified as IP under IRC regulation 1.482-4. Additionally, financial interests, land, computer software, certain interests, interests under leases and debt instruments, mortgage services and certain transaction costs are not depreciable under Section 197⁷⁵. Moreover, self-created IP’s are in principle⁷⁶ also excluded from amortization.

Currently, questions arise in the US regarding the characterization of ‘Soft-IP’s’ as IP for TP purposes⁷⁷. Nowadays, ‘Soft-IP’s’ are excluded from IP for TP purposes, according to the IRC regulation 1.482-4. Nevertheless, finite and acquired ‘Soft-IP’s’ are depreciable and therefore defined as IP under Section 197 of the IRC. The Obama government wants to broaden the definition of IP for TP purposes under the IRC regulation 1.482-4⁷⁸ by including goodwill, going concern and assembled workforces (the so-called ‘Soft-IP’s’) in this definition.

Since this intention is currently not legalized, ‘Soft-IP’s’ cannot be identified as IP for TP purposes in the US.

Furthermore, respecting the code of federal regulations, subchapter 1 of the income tax, under 1.167(a) 3 mentions that IP’s are just deductible for property tax purposes if:

⁷⁰ TCGA 1992, section 21 under 2.

⁷¹ § 1.482-4(b) of the US Treasury Regulation.

⁷² § 1.482-4 (3) (ii)(A)(B) of the US Treasury Regulation.

⁷³ § 1.482-4 (3) (ii)(A)(B) of the US Treasury Regulation.

⁷⁴ Section 197 Amortization of Intangibles and Goodwill of the internal revenue code.

⁷⁵ Section 197 (e) (1) until 7) of the internal revenue code.

⁷⁶ They aren’t excluded if they are described in section 197 subsection (d)(1) subparagraph (D)(E)(F) and (B) of the internal revenue code, concerning rights granted by a governmental unit or agency, a trademark, trade name or franchise or any covenant not to compete entered into connection with an acquisition of an interest in a (part of) a business or trade.

⁷⁷ Kimball 2011.

⁷⁸ See for instance www.pwc.com/gx/en/international-transfer-pricing/assets/united-states.pdf and other on line newspapers.

- The IP is known from experience or other factors to be of any use in the business or in the production of income for only a limited period of time;
- This time can be estimated with reasonable accuracy;
- No deduction is allowed with respect to goodwill.

Since this regulation only deals with the depreciation of IP for tax purposes, these characteristics only serve as a point of origin.

2.7.8 Other countries

The other member countries of the OECD do not define intangibles for TP purposes in their national legislation or guidelines. However, in some countries⁷⁹ IP is considered to be a part of the intangible assets of a company. As a result, these countries consider the definition of IP for accounting purposes to be applicable for TP purposes. Other countries apply the OECD TP guidelines directly in their national legislation and define IP consequently the same as the OECD TP guidelines⁸⁰. Lastly, some countries use the civil law concept of IP for tax purposes⁸¹. Nevertheless, some countries give some relevant characteristics with regard to IP for tax purposes in their domestic regulations, namely:

- The IP is highly valuable and unique⁸²;
- The IP is expected to generate profits⁸³;
- The IP can be touched, weighed or measured⁸⁴;
- The use from the IP must be long-lasting⁸⁵.

2.8 The definition of IP concerning domestic court decisions

Because most countries do not provide for a broad definition of IP for TP purposes or only give some examples regarding IP, case law towards the definition of IP for TP purposes is very rare. There are mainly some court decisions available regarding IP for TP purposes in the US. Furthermore, the UK does not have TP cases specifically concerning the definition of IP, but there are a few court decisions which have some bearing on the definition of IP⁸⁶. Lastly, Germany and France provide for some case decisions concerning IP.

The United States

2.8.1 The Glaxo case⁸⁷

This Case contains one of the most discussed TP cases in history and ended in 2006 with a settlement agreement between the IRS and Glaxo. The case involved a pharmaceutical drug, namely Zantac. This drug was developed by pharmaceutical research. This research was managed in the UK by the Glaxo parent company. In 1983, the drug Zantac was introduced in the US by the Glaxo distribution subsidiary Glaxo US. Subsequently, between 1989 and 1996 a profit was realized of 12,7 billion in the US regarding the Zantac drug. The main question was how to split this profit between the US subsidiary and the UK parent company, taking into consideration the functions performed, the risks assumed and the assets used. Glaxo argued that the profits were attributable to Glaxo UK, since they developed the IP and owned the trademarks concerning the IP. IRS reversely said that the success of the drug was not attributable to Glaxo UK, since the development of the drug was not unique and did

⁷⁹ For instance Belgium, France, Hungary, Luxembourg and Slovenia.

⁸⁰ For instance Spain, Switzerland, Austria, the UK and the Netherlands. The written source of the direct implementation of the OECD TP guidelines in the Dutch legislation can be found in the Transfer pricing decree, IFZ2001/295.

⁸¹ For instance Czech Republic and Denmark.

⁸² Canada Revenue Agency's IC87-2R part 5 § 145.

⁸³ Canada Revenue Agency's IC87-2R part 5, § 140.

⁸⁴ IFA 2007, p.420. This follows from the Mexican Value added Tax Law, but I couldn't find this Tax Law.

⁸⁵ République Française 2005.

⁸⁶ Beeton 2010.

⁸⁷ *Glaxo Smithkline Holdings (Americas) Inc. V. Comr. T.C.*, Nos. 5750-04 and 6959-05. See further Boulogne 2006, Musselini 2007 and <http://www.irs.gov/newsroom/article/0,,id=162359,00.html>.

not consist of a valuable IP because of the uncertainty related to the distribution of the drug. According to the IRS, the IP became valuable after the marketing activities performed by the US subsidiary. Therefore, the US subsidiary should be considered the owner of the IP, instead of UK Glaxo. In conclusion, the main question raised in this case was when an IP starts to exist and if we can speak of a trade IP or a marketing IP concerning the Zantac drug.

The characteristics of IP for TP purposes according to this case are:

- The unique qualities and nature of a trade IP (R&D expenses);
- The expected returns attributable to the IP.
 - When is there a sufficiently expectation that the IP will generate profits in the future?
 - The uncertainty related to the distribution of the IP.

2.8.2 *The Merck-Case*⁸⁸

This case concerned the question if business judgments, including production techniques and organizational structures⁸⁹, are IP for TP purposes. In this case, the taxpayer was the parent corporation of a multinational group of corporations dealing primarily in pharmaceutical products. To establish one of her subsidiaries to exploit a certain pharmaceutical drug market, the parent company exercised sound business judgments, including organizational structures. The court ordered that organizational structures were not IP for TP purposes, because:

“Any IP involved in the 7 percent allocation must be viewed as different and separate from the IP previously licensed to the foreign marketing affiliates.... For purposes of Section 482, the regulation defines IP in terms of a list of items. Each of the items must have substantial value as independent property... Organization structure is not included in the concept of an enforceable property right that would support an arm’s length license agreement.”⁹⁰

In accordance with this case, an IP has to be a commercially transferable interest in the context of TP. Organizational processes that are based on any experience within a multinational group are not commercially transferable and therefore not valuable for TP purposes, unless a third party were to take over the whole multinational group⁹¹.

Based on this case, the following characteristics of IP for TP purposes must be taken into consideration:

- Is the IP direct observable⁹²?
- Is the IP commercially transferable?
- Can the IP be separately identified?
- Is the IP included in the concept of an enforceable property right?

2.8.3 *The Hospital Corp. of America - case*⁹³

This case concerned the qualification of business opportunities and management systems as IP for TP purposes. The Hospital Corporation of America (“HCA”) operated in hospitals in the US through domestic subsidiaries. One day, HCA received the opportunity to manage the construction and operation of a hospital in Saudi-Arabia. To negotiate, perform and execute the contract to manage the Saudi-Arabian hospital, HCA established the LTD subsidiary. HCA entered into a management service

⁸⁸ Merck & Co. V. United States, 24 Cl. Ct. 73 (1991) .

⁸⁹ Namely an affiliate structure, a pricing mechanism structure and a group wide planning structure.

⁹⁰ Merck & Co. V. United States, 24 Cl. Ct. 73 (1991), page 89,733.

⁹¹ Verlinden 2005, p.55.

⁹² IFA 2007, p.23.

⁹³ Hospital Corporation of America v. Commissioner, 81 TC 520 (1983). See further Verlinden 2005, p. 55, 56, Bakker 2009 and Zollo 2009.

agreement with this LTD subsidiary, concerning the transfer of an IP, namely a hospital management system⁹⁴. The following questions occurred in this case:

- Can the opportunity of HCA to manage a hospital in Saudi-Arabia and the resulting formation of the LTD subsidiary be qualified as a transfer of IP for TP purposes?
- Can the transfer of the hospital management system be qualified as IP for TP purposes?

With respect to the first question, the court did not qualify the allocation of the opportunity to the LTD subsidiary as IP for TP purposes, since a mere opportunity should not be considered IP⁹⁵. To qualify a business opportunity as IP for TP purposes, the opportunity has to be made concrete through a binding contract⁹⁶. In this case there was no binding contract. Regarding the second question, the court qualified the system as IP for TP purposes, since HCA made an IP of substantial value available to the LTD that is capable of being commercially transferred, since the system could be sold to an independent owner of another hospital⁹⁷. With reference to the answers given by the court, the following characteristics about IP can be provided:

- A business opportunity does not qualify as IP for TP purposes, unless the opportunity is made concrete through a binding contract which gives the opportunity a clear existence and gives the owner some form of control over the opportunity⁹⁸. When applying this characteristic to IP's in general, the IP has to be made concrete through some form of tangible evidence;
- The IP has substantial value;
- The IP concerns a commercially transferable interest.

2.8.4 VERITAS - case⁹⁹

This case involved the formation of a CCA between the parent company VERITAS US ("V US") and its subsidiary in Ireland ("V Ireland"). Regarding the formation of this CCA, V US transferred 'pre-existing' IP's to V Ireland for which V Ireland paid a buy-in amount to V US. The issue concerned the amount of the buy-in payment with respect to the IP that has to be taken into account for TP purposes. IRS valued the IP's collectively, including an arm's length price for the pre-existing IP's and subsequent developed IP's which are attributable to V US assembled workforces¹⁰⁰, to determine the correct arm's length price. VERITAS nevertheless valued the IP's individually, only including the pre-existing IP's. The court rejected the 'aggregate' valuation of IRS, because:

- The buy-in payment encompasses only pre-existing IP's and not subsequent developed IP's, imputable to the transferred 'assembled workforces', unless there is sufficient evidence from the existence and the substantial value of the 'assembled workforce' at the moment of the establishment of the CCA. Furthermore, the 'assembled workforce' can never be IP, since it does not have 'substantial value independent of the services of any individual' according to the US regulation¹⁰¹;
- Software IP's have finite lifecycles, since the growing technology;
- The IP's have to be valued separately, because the aggregate valuation does not increase the reliability in this case.

According to this decision, the characteristics of IP for TP purposes will be:

- There has to be sufficient evidence of the existence of the IP;
- The IP has substantial value at the moment of the transfer;

⁹⁴ The system covered medical, financial and administrative know-how, based on the experience of HCA.

⁹⁵ Zollo 2009.

⁹⁶ Kroppen 2011.

⁹⁷ Verlinden 2005, p.56.

⁹⁸ Kroppen 2011.

⁹⁹ VERITAS software corp. V. Commissioner, 133 T.C. 14. See further Lin 2010 and http://www.groco.com/readingroom/intl_veritas_software.aspx.

¹⁰⁰ The arm's length price regarding the subsequent developed intangibles can be measured by taking into account the pre-existing body of knowledge of V US, concerning assembled workforces, in particular access to the R&D team and access to the marketing team.

¹⁰¹ Nowadays, workforces in place are qualified as IP under the changed Section 197 of the IRC.

- Software IP's have a finite lifetime;
- In general, IP's can be separately identified.

2.8.5 Other American court decisions

The court cases mentioned above contain the most important decisions regarding IP for TP purposes. Nevertheless, there are more court decisions mentioning some characteristics of IP. These characteristics include:

- The term IP “encompasses whatever may be transferred¹⁰²”;
- An IP is deductible as IP for tax purposes if the IP has a limited useful life and knows an ascertainable duration¹⁰³ (through a contract or the facts available). In the various cases concerning these characteristics, the cases involve most of the time commercial IP's, like patents and copyrights;
- A similar definition on the deductibility of IP is given in the Citizens & Southern Corp.- case¹⁰⁴: *“IP is known from experience or other factors to be of any use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy¹⁰⁵”*.
- An assembled workforce may be IP, because the workforce has an identifiable and measurable value¹⁰⁶.

The United Kingdom

2.8.6 DSG Retail limited - case¹⁰⁷

This case mainly concerned the question which valuation methodology has to be used to value the IP at arm's length. Nevertheless, the case also defined IP for TP purposes. The facts of this case are the following; DSG group comprised TV, audio and computer equipments. DSG also offered their customers the opportunity to purchase an extended warranty contract with the third party Cornhill/ASL regarding the goods sold. DISL, a subsidiary of DSG, insured the liability to customers for the extended warranties. Due to this liability, Cornhill/ASL ceded most of its premium income to DISL¹⁰⁸. Consequently, DISL retained substantial benefits towards the extended warranties. The first question was whether there was the giving of any facility to DISL by DSG for which the parties were obliged to consider an arm's length price. The court came to the following decision:

- *“If DISL had been independent it would have had to pay something to DSG¹⁰⁹”*;
- The warranty contract gave the firm a competitive advantage;
- DSG had given DISL a business facility, namely the opportunity to enter into contracts with unrelated parties;
- The provision of this business opportunity was informal and unenforceable¹¹⁰.

In conclusion, the following characteristics of IP for TP purposes can be determined:

- A business opportunity may be an IP, if it is identifiable and if the owner could realize value from the opportunity;
- An IP does not have to be enforceable;

¹⁰² Hempt Bros Inc. V. USA, 354 F. Supp. 1172, 1175, 490 F.2d 1172 (1973). This case contains the oldest case concerning IP and is consequently not very relevant today anymore. This definition of IP is very broad and has no distinguishing character.

¹⁰³ Houston Chronicle publishing company v. USA, 481 F.2d 1240.

¹⁰⁴ Citizen & southern corp. V. commissioner, 91 T.C. 463, 479 (1988).

¹⁰⁵ Ibid.

¹⁰⁶ Ithaca industries inc. v. commissioner, 97 T.C. 253, aff'd 17 F.3d 684 (1994).

¹⁰⁷ DSG Retail limited v. HMRC, 2009 T.C. 00001.

¹⁰⁸ Clayton 2009.

¹⁰⁹ DSG Retail limited v. HMRC, 2009 T.C. 00001.

¹¹⁰ Beeton 2010.

2.8.7 Other UK court cases

In accordance to UK court cases, the transfer of IP is only subject to compensation if the IP could be owned by someone¹¹¹ and if this person could realize value from the IP¹¹².

Germany

2.8.8 German court cases

One of the characteristics of IP for TP purposes is the ability of the IP to be commercially transferable. Furthermore, the German tax court faced the qualification discussion of a business opportunity as IP for TP purposes in accordance to the German legislation. The court decided that business opportunities may be IP for TP purposes if:

- The opportunity is definable;
- The opportunity is certain enough to be valued separately¹¹³¹¹⁴.

France

2.8.9 The Sife – case¹¹⁵

This case concerned the license of a French company to operate an IP. The French Court decides that the company owns an IP for TP purposes if: *“it holds the rights that, taken together, constitute a regular source of profit, are sufficiently permanent and can be transferred.”* In other words, The IP must meet the following characteristics according to the French Court:

- The IP can be owned;
- The IP generates a steady source of profit;
- The IP has a sufficient durability;
- The IP is transferable.

2.8.10 Other French court cases

The French administrative court notes that the transfer of an IP may only be deducted in case: *“the IP is normally foreseeable, either at the time of it was created or when the company acquired it that the IP’s beneficial affect on the business will come to an end at a determined time”*¹¹⁶.

2.9 Literature

There is many literature published on the characteristics of IP for TP purposes. This literature comes from a several countries dealing with these questions. In this paragraph, I will mention a number of characteristics of IP determined in various books and articles. There are broad and narrow definitions of IP for TP purposes. In this paragraph I will start with the broadest definition of IP. After this definition, the characteristics of IP will increase. Lastly, I will discuss the narrowest definition of IP. I will only use this literature as a starting point, since literature contains only the opinion of different authors.

Intangibles: management, measurement and reporting

*“IP’s are nonphysical sources of value (claims to future benefits) generated by innovation (discovery), unique organizational designs, or human resources practices. IP differ from physical and financial assets in the ability of owners to exclude others from enjoying the full benefits of investments.”*¹¹⁷

¹¹¹ Kirby v. Thorn EMI Plc 60 T.C. 519. There has to be a disposal of an asset, containing the transfer of an asset from one party to another. See further Kroppen 2011.

¹¹² O’Brien v. Benson’s Hoisery (Holdings) Ltd 53 T.C. 241. See further Kroppen 2011.

¹¹³ Federal tax court decision of August 30, 1995, I R 155/94, DStR 1995, p.1873. This case concerned the opportunity to acquire a distinct building and to sell it with a profit.

¹¹⁴ Van Herksen, 2008.

¹¹⁵ Conseil d’État, 21 August 1996, no. 154488, SA Sife, see further IFA 2011, p. 337.

¹¹⁶ CE, 14 October 2005, no. 260486, SCA Pfizer.

The Intangibles Research Center

*"IP's are non-physical sources of probable future economic benefits to an entity or alternatively all the elements of a business enterprise that exist in addition to monetary and tangible assets."*¹¹⁸

Transfer pricing and IP¹¹⁹

The author concluded in this article that IP cannot always enjoy protection. Many IP's cannot be registered (for example goodwill) and certain processes (for example manufacturing processes) cannot be patented. Furthermore, there can be strategic decisions within the company not to protect certain IP's, for example because of the secrecy regarding the existing IP's. Furthermore, according to the author, there should be a broad analysis of the functions performed, the risks borne and the IP's which create value to the enterprise to determine IP.

Germany: Transfer pricing of Intangibles by A. Köster-Böckenförde and A. Clauss

*"IP may be understood as identifiable matters of potential benefit without physical substances which may be either legally protected or unprotected and which are used in the operation of a business"*¹²⁰.

The MERITUM project on intangibles

*"They are non-monetary sources of probable future economic profits, lacking physical substance, controlled (or at least influenced) by a firm as a result of previous events and transactions (self-production, purchase or any other type of acquisition) and may or may not be sold separately from other corporate assets."*¹²¹

IP and Tax Planning for Multinational Enterprises¹²²

- The IP has the ability to be protected explicitly or implicitly;
- The intrinsic value of the IP must be attributable to its IP elements.

The author argues these characteristics on the basis of a several American court decisions, namely the Hospital Corporation of America case¹²³ and a number of cases concerning the definition of Software as IP¹²⁴.

Éthique, biens incorporels et prix de transfert¹²⁵

*"IP is made up of a group of information that affects the profit level of an enterprise by modifying its offer or demand curves, without modifying in the same way the offer or demand curves of enterprises that compete directly or indirectly with it"*¹²⁶.

This definition mentions the following characteristics:

- The IP adds value to the enterprise;
- The IP can be exclusively owned.

Intangible assets

- *"They provide benefits to future periods;*
- *They have no physical substance;*

¹¹⁷ Lev 2001.

¹¹⁸ Kristandl 2007.

¹¹⁹ Gelin 2011.

¹²⁰ Köster-Böckenförde 2009.

¹²¹ Meritum 2002.

¹²² T. Zollo 2009.

¹²³ Hospital Corporation of America v. Commissioner, 81 TC 520 (1983).

¹²⁴ Computer & Software v. Commissioner, 64 T.C. 223 (1975) and Ronnen v. Commissioner, 90 T.C. 74 (1988).

¹²⁵ Vidal 2004.

¹²⁶ Roberge 2010, footnote 18.

- They convey a right or privilege;
- They are relatively long-lived assets.”¹²⁷

The intangibles research center

“IP’s are non-physical sources of probable future economic benefits to an entity that have been acquired in an exchange or developed internally from identifiable costs, have a finite life, have market value apart from the entity, and are owned or controlled by the entity.”¹²⁸

General report on intangibles by T. Miyatake¹²⁹

The author mentions three general characteristics of IP’s, derived from multiple sources:

- IP derives its value from its intellectual capacity;
- IP is every non-tangible asset that can be exploited; and
- IP must be directly observable and commercially transferable.

Concerning the last feature of the capacity of being commercially transferable, the author Hamaekers mentions the following additional characteristics:

- “The IP is capable of legal protection (as a patented or registered IP or – more generally – as property) and transfer;
- The IP exists at an identifiable time; and
- The IP is capable of producing future economic benefits”¹³⁰.

Mastering the intellectual property life cycle by A. Smits and others

“Intellectual property rights are the legal rights which aim at safeguarding creators and other producers of intellectual goods and services by granting them certain (limited) rights to control the use made of those creations by other parties.”¹³¹

Fiscal aspects of IP in the Netherlands, France and Germany¹³²

This article discusses the activation and the amortization of some specific IP on the balance sheet of a company and the connection between the fiscal and commercial balance in this respect. Nevertheless, the author mentions some general characteristics of IP provided for in the Netherlands, France and Germany as well. The author discusses the following characteristics of IP, related to the tax deductibility of IP in the Netherlands, France and Germany:

- The IP must be used permanently in the operation of the business;
- The IP has substantial value;
- The IP causes reasonable foreseeable future benefits (in the internal market);
- The IP is independent in nature;
- The owner of the IP bears risks related to the IP;
- The IP is transferable;
- The IP is separately identifiable.

Transfer pricing in Australia by M. Health

- “Non-physical in nature;
- Separately identifiable;
- Transferable;
- Capable of producing future economic benefits; and
- Generally protected legally, or through a de facto right”¹³³.

¹²⁷ http://cobhomepages.cob.isu.edu/boesrich/Acct323/intangible_assets.htm.

¹²⁸ Kristandl 2007.

¹²⁹ IFA 2007, p. 22, 23.

¹³⁰ Hamaekers 2011.

¹³¹ Verlinden 2009.

¹³² Kemmeren 1997

The capability of the IP to produce benefits to the user and the ability to exploit the IP exclusively are of main importance according to this author. Namely, when another party can exploit the same IP without any consequences, there is no real ownership on this IP and a transfer price may consequently be not appropriate.

The five features of IP

- *“Non-physical in nature. However, there should be tangible documentation of the intangible existence (e.g. a contract or trademark registration);*
- *Future economic benefits are expected to flow to the owner;*
- *The value of the IP arises from its intangible nature and not from its tangible nature.*
- *The IP is subject to property rights, legal existence and protection, and private ownership;*
- *Separable and identifiable in order to determine the value of the specific IP.”¹³⁴*

Report on intangibles concerning the United Kingdom by R. Fletcher and S. Panteldaki

- *“The IP is non-physical in nature;*
- *The IP is subject to specific identification and a recognizable description;*
- *The IP is subject to legal existence and protection from infringement, or at least be able to be protected through a de facto right;*
- *IP can be privately owned, which itself can be legally transferable;*
- *The IP is created or comes into existence at an identifiable time, or as a result of an identifiable effort or process;*
- *The IP can be showed by tangible evidence or manifestation of the existence of the IP (e.g. a registration document, a license agreement, a software DVD, a customer list)*
- *The IP is capable of producing future benefits;*
- *The IP is subject to a termination of existence at a predictable point in the future (i.e. when no further economic benefits can be extracted from its use).”¹³⁵*

An American view

- *“The IP must be identifiable, both within the specific company or context, as well as identifiable in a general sense;*
- *The IP can be legally owned;*
- *The birth and development of the IP must be able to be traced;*
- *The IP can be protected (this would include, of course, all intellectual property);*
- *There should be some proof of its existence in the form of a contract, registration, database, etc.;*
- *The IP has a lifespan that can be determined, and/or a specific lifespan that can be renewed (e.g. the renewal of trademarks every 10 years);*
- *The IP has similar or comparable assets to be found elsewhere in the marketplace or in other companies; and*
- *The value of the IP can be quantified”¹³⁶.*

The characteristics mentioned above are part of a legal definition but in the opinion of the author they mark the general definition of IP as well. In my opinion, this definition of IP is too narrow to apply in case of TP studies.

Identifying intangibles¹³⁷

¹³³ IBFD 2011.

¹³⁴ Jie-a-Joen 2007.

¹³⁵ IFA 2007, p. 611.

¹³⁶ <http://www.apps.americanbar.org/buslaw/newsletter/0058/materials/book.pdf>.

¹³⁷ Van Herksen 2008.

- The IP adds abnormal and excess value to the company;
- The IP contains a non-routine intangible;
- The IP leads to an “*obvious and clear-out performance*”¹³⁸;
- The IP has a convincing link with the definition of IP under intellectual property law, and ideally can be defined under these law principles;
- The IP is not a mere business opportunity;
- The IP ought to be protected (through law or contractual arrangements) and this protection is enforceable in court.

2.10 The OECD Meeting regarding the definitional issues of IP¹³⁹

In November 2011 several business representatives from all over the world met each other to discuss the definitional and ownership issues regarding IP for TP purposes to achieve starting points for the current OECD project concerning intangibles.

The different business representatives mentioned the following characteristics of IP:

- The IP is separately identifiable as an asset/activity¹⁴⁰;
- The IP clearly exists¹⁴¹;
- The IP is (separately) transferable (legally or contractually)¹⁴²;
- The IP is valuable to third parties¹⁴³;
- The IP results from conscious actions and decisions¹⁴⁴;
- The IP must be owned by the transferor¹⁴⁵;
- The IP can be controlled by the owner (the transferor and transferee are able to exclude others from using the IP)^{146/147}.

2.11 A comparison

The paragraphs above handled many different characteristics of IP for TP purposes. There are governments, judges and authors relying on the same characteristics, but in most cases the opinions with regard to the characteristics of IP differ. In table 1, the handled characteristics of IP are stated in the vertical column. In the horizontal column the different sources which mentioned the given characteristic are provided.

¹³⁸ *Ibid.*

¹³⁹ http://www.oecd.org/document/4/0,3746,en_2649_37427_49015364_1_1_1_37427,00.html.

¹⁴⁰ Tax executives institute, <http://www.oecd.org/dataoecd/5/35/49013825.pdf>.

¹⁴¹ Baker and Mc Kenzie.

¹⁴² Tax executives institute, Baker and Mc Kenzie, Ernst & Young, Business Europe.

¹⁴³ Tax executives institute, Ernst & Young.

¹⁴⁴ Tax executives institute, <http://www.oecd.org/dataoecd/5/35/49013825.pdf>.

¹⁴⁵ Baker and mac Kenzie, Ernst & Young, Business Europe.

¹⁴⁶ Baker and Mc Kenzie, Business Europe.

¹⁴⁷ Soft-Intangibles fall outside the scope of this thesis. Nevertheless, I would like to point out that all business representatives did not define soft-intangibles (For instance Goodwill, Workforces-in-place, profit potential and Going Concern) as IP which is compensable for TP purposes. They may only be elements that may be connected to the valuation of IP. Subsequently, soft-intangibles may affect the transfer price of IP.

Table 1

Characteristics Of IP	OECD	Accounting & Legal	Domestic legislation	Court Cases	Literature	OECD meeting
Identifiable	Yes	Separately identifiable	Japan → The IP must be measurable. Finland → Yes	Directly/separate observable, clear existence, separately identifiable, ascertainable	Yes, direct observable, separately identifiable, recognizable description, the existence of IP must be traceable, quantifiable, obvious and clear-out performance	Yes
Valuable	'Something of value', in case of a bundled package: separately valuable		Germany → Separately valuable. UK → valuable. Japan → source of income and material value. Australia → Sustainable value/competition advantage Other → highly valuable	Substantial value, the ability to realize value, separately valuable	Sources of value, market value apart from the business, abnormal and excessive value	Yes
Transferable	Mentioned in case of trade IP	Yes	Germany → Yes: function shift. UK → the ability to exploit. New Zealand → Yes. Finland → Separately transferable	Commercially transferable, transferable	Yes, but not separable, exploitable and commercially transferable, legally transferable	Yes
Protection able	This is not a condition, but nevertheless generally applicable Royalties → Yes	Legal formal protection	New Zealand → by law or other protection rights. Finland → separately protection able		No always possible/desirable, Yes → implicitly or explicitly, protected legally or through a de facto right, ought to be (enforceable) protected	exclusion
Definite and/or Indefinite			US → only definite IP is deductible. New Zealand → Trade IP: limited life, Marketing IP: limited/indefinite life		Long-lived IP, finite life, specific lifespan	
Potential to earn future benefits	This is of main importance	'The IP causes future economic benefits'	New Zealand → Yes. Finland → anticipated benefits. Other → Generate profits	Expected returns, a steady source of profit	Probable future economic benefits, potential benefit	
Services	Royalties → Distinguish between		US → A service can never be IP. Japan → services and IP. are			

	services and IP		conceptually distinct			
Characteristics Of IP	OECD	Accounting & Legal	Domestic legislation	Court Cases	Literature	OECD meeting
Ownership or control¹⁴⁸	Ownership of trade intangibles	Ownership and control	US → ownership and control. New Zealand → Ownership	Ownership and control, ownership	Controlled or influenced, exclusively own able, owned and controlled, certain rights to control the IP, subject to private ownership	Yes, both
Existence → Tangible evidence			Germany → Yes	Contract or other agreement, sufficient evidence from the existence of IP	Tangible documentation of the IP existence, existence can be showed by any tangible evidence, any proof of existence	Yes, through registration or contract/agreement
Legal enforceability	No condition	Accounting → no condition, but desirable Legal → Yes	UK → no condition, but desirable. US → No. New Zealand → exclusivity is of main importance	Concept of an enforceable property right, No condition	Capable of legal protection, subject to legal existence/protection, ideally be legally enforceable	
Costs	In case of trade IP costs are made				Self developed IP → identifiable costs	
Acquired and self developed IP¹⁴⁹			Germany → Acquired		Irrelevant	
Uniqueness	Most of the marketing IP are unique/rare		Australia → without uniqueness in most cases no substantial value. Finland → Yes. Other → Yes	Unique quality and nature	Non-routine IP	
Quality and reliability	In case of tangible property. Probably also applicable in case of IP	Measurement with sufficient reliability	New Zealand → inherent quality and uniqueness			

¹⁴⁸ Control means the power to obtain future economic benefits earned by the owner of the IP and/or the ability to restrict others from using the IP and/or generating benefits regarding the same or similar IP.

¹⁴⁹ IP can be divided between acquired and self-developed IP. This distinction does not play an important role when determining the characteristics of IP. Moreover, this distinction is very important when looking at the moment when an IP starts to exist for TP purposes. This question will be answered in chapter three of this thesis.

Characteristics Of IP	OECD	Accounting & Legal	Domestic legislation	Court Cases	Literature	OECD meeting
Functions performed, assets used and risks assumed	Compensation reflects the functions, assets and risks by using a functional analyses		Germany → A function shift classifies the transfer of IP. Japan → analyzing by mentioning activities, functions and so forth		Broad analysis on these points. These points create value to IP.	
Remaining characteristics		Several creations of the mind	US → The IP derives its value from its intellectual content or other IP. Other → the IP can be touched, weighed or measured, different countries → Used in the operation of a business.	sufficient durability, the intangible is normally foreseeable	Nonphysical, innovation, unique organizational designs and human resources, used in the operation of a business, income deriving from other IP	The IP results from conscious decisions/actions

2.12 Conclusion

Looking at the paragraphs above, every government, judge and author handles different characteristics to define IP for TP purposes. On the one hand, many sources embrace very broad characteristics of IP as wide as possible in our globalizing dynamic world. However, on the other hand other sources utilize a very narrow definition of IP, using many characteristics to define IP for TP purposes, because otherwise every potentially contributing aspect can be qualified as IP¹⁵⁰.

To determine clear and practical characteristics of IP for TP purposes, there is one question of main importance that should be considered every time when defining IP:

- **Is there a value attributable to the IP for which an unrelated party would pay a certain price?**

In case the IP is valuable to independent companies, the IP can be qualified as IP for TP purposes. The main question is in other words: "Can we speak of something of value through the eyes of an unrelated party¹⁵¹?"

The OECD marks a reasonably broad definition of IP for TP purposes. Namely, the OECD indicates that IP which has a considerable value may be IP, independent from the question if the IP has a book value or can be qualified as IP for legal purposes¹⁵².

Taking into consideration these two points, the following characteristics must be taken into account when defining IP for TP purposes:

- **The IP has substantial value;** There has to be a value attributable to the IP for which an independent party would pay a certain price. If there is no value or just a low value attributable

¹⁵⁰ Herksen 2008.

¹⁵¹ § 9.80 of the OECD TP Guidelines.

¹⁵² § 6.2 of the OECD TP Guidelines.

to the IP, the IP cannot be considered IP. For reasons of efficiency and proportionality¹⁵³ this value has to be substantial.

- **The IP will cause reasonably foreseeable future economic benefits;** This condition is in line with the first requirement. If the IP does not have potential to cause future economic benefits it is not valuable to an independent company.
- **The IP is non-physical in nature;** The IP derives its value from its intangible nature.
- **The IP clearly and definitely exists and is therefore identifiable¹⁵⁴;** This means that, looking at the facts and circumstances, it can be proven that an IP exists for TP purposes. This can be shown by documentation of the existence of the IP¹⁵⁵. Nevertheless, it is also possible that there are other (implicit) facts and circumstances, provided by the party who bears the burden of proof, which lead to a clear recognition of IP for TP purposes¹⁵⁶. The IP does not have to be identified separately as long as the IP can be clearly identified as IP and not as tangible property or the provision of a service¹⁵⁷. In other words, the IP can be made concrete by identifying the IP as non-physical capital. The identification is essential when defining IP, because otherwise there is no value which can be measured and therefore, the IP is not valuable to an independent party.
- **The IP can be owned;** The benefits must flow to a specific owner of the IP, because the IP would never be valuable for an independent party when the party cannot own and therefore realize value from the IP. Ownership encompasses legal and/or economic ownership¹⁵⁸.
- **The IP can be controlled, or at least influenced by the owner;** This condition is in line with the requirement of ownership. The exclusivity is of main importance regarding this condition. If an owner cannot influence the IP, for instance (partly) restrict the access of others to this IP, the IP is not valuable, because other parties may exploit the IP as well without any consequences. In the literature authors may also call it 'the IP may be generally protected legally or through a de facto right¹⁵⁹¹⁶⁰, and thus the owner can manage the IP.
- **The IP is transferable to third parties¹⁶¹;** Article 9 of the OECD Model tax treaty and the corresponding OECD TP guidelines deal with the TP of intercompany assets. This condition is subsequently of main importance. When IP is not transferable to third parties there is no transfer that needs to be priced at arm's length according to the OECD TP guidelines¹⁶².

All these conditions can be traced back to the determination of a valuable IP to independent parties. Namely, if the IP cannot be measured and a party cannot realize value from the IP, the IP has no value to independent parties.

There are certain characteristics mentioned in domestic legislation, guidelines, court decisions and literature which are not included in the list above, namely:

¹⁵³ It would not be inefficient and disproportionate if all intangibles which generate some value may be considered as IP for TP purposes, because in this case almost all 'little' intangibles may be IP.

¹⁵⁴ This is in line with the quality and reliability criteria mentioned in § 1.39 of the OECD TP Guidelines in case of tangible property.

¹⁵⁵ For instance through legal registration, contracts, agreements or communication/correspondence between different parties. See <http://www.oecd.org/dataoecd/47/37/49067428.pdf>.

¹⁵⁶ See for instance the criteria of IP in Japan mentioned above.

¹⁵⁷ For instance Goodwill, (this example falls outside the scope of this thesis since Goodwill is a less identifiable concept than intangibles.) Goodwill cannot be identified apart from the entity. Nevertheless, if the relevant party can identify the Goodwill as an intangible asset, it is enough to conclude that the intangible clearly and definable exists. Nevertheless, in most cases Goodwill can not be identified as intangible or tangible property or a service and therefore does not definable exist.

¹⁵⁸ These concepts will be discussed during the second research question of this thesis.

¹⁵⁹ IBFD 2011.

¹⁶⁰ For instance trade secrets.

¹⁶¹ Or, according to the UK legislation: "The intangible can be exploited".

¹⁶² See Zollo 2009. The author discusses the question if goodwill, human acts and assembled workforces can be defined as IP are, since the author argues that these intangibles are not transferable and therefore not IP for TP purposes.

- A service can never be IP; Services and IP's are conceptually different and therefore have to be distinguished from each other¹⁶³. If the IP derives its value primarily from a service by an individual and the IP does not include a material IP component, the IP can never be qualified as IP for TP purposes¹⁶⁴. More precisely, according to the comment to article 12 of the OECD model treaty, the IP (know-how) needs to correspond to information from previous experiences, which have practical application in the operation of the enterprise and from which benefits can be derived with restriction from others (this last criteria encompasses the 'influence' criterion.). This differentiation is very important concerning the identification of IP for TP purposes. Nevertheless, it is not a characteristic of IP, but the differentiation follows logically from the characteristics of IP given in the previous paragraph.
- The IP has to be separately identifiable and separately transferable; regarding the broad definition of IP according to the OECD, these characteristic would lead to a too narrow definition of IP for TP purposes. Moreover, the IP may have significant value for independent parties, even if the IP is not separately identifiable or individually transferable¹⁶⁵. The ability to identify the IP as non-physical in nature and the ability to transfer this IP is enough to define the property as IP for TP purposes.
- There has to be tangible evidence, through legal registration or contract, from the existence of the IP; This condition cannot be used under the OECD TP guidelines, since these guidelines depend on the economic reality and the 'substance over form' doctrine¹⁶⁶. Additionally, not all IP's can be proven by written documents. The IP must clearly exist, but if the party who bears the burden of proof may prove this in some other way, the property can also be qualified as IP.
- Costs made with the development of the IP; Concerning trade IP, most developers made extensive costs when evolving the IP. Nevertheless, these costs merely serve as a clue for the existence of IP and not as a condition when defining IP.
- The uniqueness of the IP. If an IP is 'only' a routine-IP this IP usually does not have substantial value to the owner of the IP, because the IP may be developed in other similar companies as well. Nevertheless, there may be IP's that have substantial value to independent companies irrespective of the uniqueness of the IP. Given that this will occur only limited, the uniqueness of the IP may serve as an important reference point when determining the substantial value of the IP for independent companies. Nevertheless, the uniqueness of the IP does not qualify as a distinguishing characteristic of IP from the characteristic of substantial value and future economic benefits.
- The functions performed, assets used and risks assumed or in other words, the application of the functional analyses when defining IP. On the one hand, only the assets used are central when defining IP. The risks assumed and the functions performed are nevertheless of main importance when determining the owner and transfer of IP and subsequently valuing the IP. Furthermore, we can only speak of IP for TP purposes in case there are assets used, risks managed and functions performed concerning this IP. Therefore, the functional analyses may serve as a starting point for all the given characteristics of IP, for example the ownership, identification and valuation characteristics, but it is not an individual character of IP.
- The IP may have a limited life or an indefinite life. Some countries, courts and authors qualified a trade IP as IP if the IP had a limited life and qualified marketing IP as IP if the IP had an indefinite life. In most of the cases, this will be applicable. Nevertheless, it is irrelevant when defining IP for TP purposes, because the marketing or trade IP has substantial value

¹⁶³ When distinguishing services from IP, § 11, especially § 11.3 of the commentary to article 12 OECD Model treaty can be used. This paragraph mentions characteristics to distinguish know-how from services.

¹⁶⁴ This distinction encompasses a broader view than the criterion according to the US Regulation and Court Decisions, namely *'independent from the services of any individual'*.

¹⁶⁵ For instance in case of a transfer package or certain types of know-how.

¹⁶⁶ This aspect will be handled in chapter four of this thesis.

independent from the lifetime of the IP. However, in case of amortization of IP's, the lifetime is of main importance as IP cannot be deducted if the IP is indefinite.

3 The existence of IP

The application of chapter 2

3.1 Introduction

The international competition, the constantly innovating markets and the continued technological developments all over the world proceed in an ongoing process of IP creations through the multinational enterprises, because the enterprises have to create distinctive advantages in the enterprises' products to sustain competitive advantages¹⁶⁷. This creation process may be accompanied by high costs and high risks in the development process, leading to a successful creation of an IP or a failure to create an IP¹⁶⁸. One of the main questions in the creation process involves the question when an IP for TP purposes starts to exist, because "*When applying the arm's length principle, the question is whether there is a transfer of something of value (rights or other assets)*"¹⁶⁹. For instance, when a company transfers a business opportunity, may this transfer be qualified as the transfer of a valuable IP for which an arm's length price would be paid or are we not dealing with IP for TP purposes?

This chapter is a specification of chapter two, including examples of the correct application of the characteristics given in the second chapter to determine the 'moment of existence' of IP for TP purposes¹⁷⁰. In the second paragraph the distinction between self developed and acquired IP will be explained. In paragraph three the OECD notes on the 'moment of existence' of IP will pass. The fourth paragraph handles the questions raised by the OECD letters on the 'moment of existence' of IP. Thereafter discusses the fifth paragraph the progress of an IP creation and at what progress point there may be spoken of an IP. The sixth paragraph deals with the question when a business opportunity may be classified as IP for TP purposes according to the characteristics given in chapter two. Namely, the characteristics given for business opportunities to qualify as IP for TP purposes may also be applicable in other development stages of several IP's¹⁷¹. Lastly, the seventh paragraph handles an example of the application of the characteristics when defining some specific property as IP for TP purposes.

3.2 Self developed and acquired IP

In a few OED letters the authors asked about the difference between self developed and acquired IP¹⁷² and between base and incremental IP¹⁷³. The distinction between self developed and acquired IP is very important, because the question when an IP starts to exist for TP purposes plays especially when companies develop potential IP's by themselves. The moment of existence of an acquired IP is in fact always clear, because the moment of purchasing the IP can be classified as the moment of existence of a transfer of IP and can therefore be qualified as IP for TP purposes. Acquired IP exists in conclusion at one specific point, namely the transfer. After the acquisition we can simply speak from IP. This IP can be regarded as a base or platform IP. Nevertheless, self developed IP does not exist at one specific point, but may be characterized as IP after certain subsequent undertaken activities. Such

¹⁶⁷ Przysuski 2006.

¹⁶⁸ Markham 2005.

¹⁶⁹ § 9.65 of the OECD TP guidelines.

¹⁷⁰ Astrazeneca 2010.

¹⁷¹ For example R&D expenses when developing a potential pharmaceutical drug.

¹⁷² WTS 2010.

¹⁷³ VNONCW 2010.

IP's can be regarded as incremental IP's¹⁷⁴. The central question in this chapter is when the transfer of an incremental IP may be IP for TP purposes.

3.3 The moment of existence of IP according to the OECD TP guidelines

The OECD guidelines mention the difficulty in determining the existence of IP, i.e.:

“Care should be taken in determining whether or when a trade or marketing intangible exists. For example, not all R&D expenditures produce a valuable trade intangible, and not all marketing activities result in the creation of a marketing intangible. It can be difficult to evaluate the degree to which any particular expenditure has successfully resulted in a business asset and to calculate the economic effect of that asset for a given year”¹⁷⁵.

Furthermore, the OECD mentions many undertaken activities that may lead to a short-term effect without any impact beyond the year in which they are performed, and activities that lead to a long-term effect, being capitalisable expenditures attributable to the existence of IP. The functional analysis may be carried out to decide which activities lead to IP for TP purposes¹⁷⁶.

The OECD does not mention which activities may lead to the creation of IP, but only mentions that some activities may lead to IP and some activities may not. It seems to be that according to the OECD it is not the nature of the activity, but the effect of the activity that leads to the existence of IP.

3.4 Notifications from the written letters to the OECD

A few authors asked in the OECD letters for a more clear and practical guidance as when internally developed IP actually becomes IP for TP purposes, i.e.:

- What activities may lead to the creation of a marketing IP and which considerations are most relevant in the determination of the existence of such IP's (*“i.e. who made the decision to develop or enhance the value of the IP locally, who managed the risks of that decision, who provided the services, who bore the costs”*)¹⁷⁷.
- When is an IP created¹⁷⁸?
- What are the facts on whether transactions of IP exist¹⁷⁹?
- *“Another challenge is determining whether or when R&D activities lead to a new or incremental IP that might require an independent valuation (or separate CCA) from the original base or platform IP”¹⁸⁰.*
- What functions or activities may lead to the creation of an IP¹⁸¹?
- Internally-developed IP → “At what point yields a R&D activity a result that can be considered IP? In the pharmaceutical industry → at what point in time is IP created; after the identification of a potentially active substance? After the preclinical trial? Or not until the successful phase III of the clinical test (approval of the active substance)?”¹⁸²

3.5 The process of the creation of IP for TP purposes

Before IP starts to exist there may have been a very long development process accompanied by high costs¹⁸³. The main question is at what turning point in the creation process we can speak from the

¹⁷⁴ VNONCW 2010.

¹⁷⁵ § 6.6 of the OECD TP guidelines.

¹⁷⁶ § 6.7 of the OECD TP guidelines.

¹⁷⁷ Barsalou Lawson 2010.

¹⁷⁸ Grant Thornton 2010.

¹⁷⁹ Japan Foreign Trade Council 2010.

¹⁸⁰ Tax executives Institute 2010.

¹⁸¹ VNONCW 2010.

¹⁸² True partners consulting 2010.

¹⁸³ HMRC report 2010.

'existence moment' of the IP and therefore a compensable item for TP purposes. The question will be answered by giving an example.

Example 1:

Company A is the parent company of the X Group, operating in highly sophisticated pills. In 2006 company A, after approval of the board of directors of company A, started a R&D operation concerning the development of a pill against cancer. During this process, company A developed in December 2006 a process management method. Furthermore, company A developed in August 2008 some unique substances. These substances serve as a starting point for the creation of the pill. In October 2009, substance C was tested on several animals and people. The results came in December 2009, concluding that substance C consisted of the right substance against cancer. In January 2010 substance C was shaped in the pill 'Manzio' and from April 2010 'Manzio' was sold to several pharmaceutical companies all over the world. The benefits attributable to 'Manzio' were firstly received in April 2010.

When developing the pill, there are a few stages that can be differentiated, namely:

1. The searching and identification process, containing the seek for a potential valuable IP and the identification of this IP;
2. The evaluation process, concerning the potential substantive benefits arising from the development of the IP;
3. The decision making process, containing the decision to pursue the development of the IP¹⁸⁴;
4. The development process, involving the development of the IP;
5. The 'moment of existence' of the IP;
6. The distribution process, for instance patenting the IP.

The stages represent the conditions made in chapter two to define IP as IP for TP purposes, i.e.:

1. After this stage, the IP can be qualified (identified) as IP.
2. This question involves the potential economic benefits which the owner derives from the IP if the IP will be created. This condition only marks the ability of the IP to cause future benefits if created but does not assume a sufficiently expectation that the benefits actually will be received because the IP is not created yet. Consequently, there is no substantial value attributable to the potential IP yet.
3. This decision presumes that there is an owner of the IP who can influence the development process of the IP. Nevertheless, from this point it is not certain that the owner will actually utilize and therefore derive income from the IP.
4. This process includes the creation process of the IP. During this process it may be possible that the owner creates important derivate IP's, such as know-how or management systems. These created IP's must be qualified as (incremental) IP separate from the main potential IP and must therefore be compensated for TP purposes if they meet the conditions mentioned in the conclusion of chapter two.
5. At an identifiable point it is certain that the potential IP is being created. More precisely, at one point the IP definable and clearly exists. This can be proven through tangible evidence or through the facts and circumstances. From this point we can speak from IP for TP purposes, because currently the last condition, namely the clear and definable existence of the IP, is being fulfilled and therefore the IP is of substantial value and the owner can actually realize value from the IP.

It is important to note that it is possible to develop the IP by one or more enterprises, entering into a CCA. The conclusion of a CCA is possible in every process stage.

¹⁸⁴ *Ibid.*

Looking at the example, December 2009 can be considered the 'existence moment' of the main IP for TP purposes, since the IP definable and clearly exist from that moment and therefore a substantial value can be assigned to the IP for TP purposes.

The unique substances

August 2008, i.e. the development moment of the substances, cannot be marked as the 'moment of existence' of the cancer pill, because it is not certain that the substances will lead to the desired cancer pill. Nevertheless, the unique substances must be compensated, because they can be qualified as valuable IP's for TP purposes apart from the main potential IP, i.e. manufacturing know-how, because:

- The substances have potential to cause reasonably foreseeable future economic benefits. The uniqueness of the substances can lead to the conclusion that there is substantial value attributable to the substances, because there may probably be no other company developing the same substances. Furthermore, it will be uncertain if the substances will lead to the intended cancer pill, but the substances may nevertheless probably lead to another important invention;
- The substances are non-physical in nature;
- The substances can be owned, controlled and transferred to third parties.

3.6 Business opportunities

There are almost no OECD countries that include the example of business opportunities as IP for TP purposes in their domestic legislations. Nevertheless, there are some countries who define every business opportunity as IP for TP purposes according to the broad definition of IP in their domestic legislation¹⁸⁵. However, this classification is not consistent with the characters given in the previous chapter of this thesis, the previous paragraph and chapter nine of the OECD TP guidelines¹⁸⁶. Further, this classification would lead to an inexhaustible qualification of IP for TP purposes since the business days of enterprises are full of opportunities which may or may not be classified as valuable IP¹⁸⁷. Therefore, only 'qualified' business opportunities are IP for TP purposes. The qualification of a business opportunity as IP may be determined by applying the characters given in the previous chapter. In the first subparagraph the relevant court decisions on business opportunities will shortly be repeated. In the second subparagraph the literature on business opportunities will pass and in the last subparagraph the characters of IP mentioned in the first chapter will be applied to business opportunities.

3.6.1 Court Cases:

In several court cases the question raised if business opportunities may be IP for TP purposes. The court decisions mentioned the following characteristics to remark business opportunities as IP:

- The opportunity can be owned¹⁸⁸;
- The owner can realize value from the opportunity¹⁸⁹;
- The opportunity can be controlled^{190,191};
- The opportunity can be concretely identified¹⁹² (as independent IP¹⁹³);
- The opportunity clearly and certainly exists¹⁹⁴ (through a binding contract¹⁹⁵);

¹⁸⁵ For instance Germany and Finland .

¹⁸⁶ § 9.65 of the OECD TP guidelines.

¹⁸⁷ IFA 2011, p.40.

¹⁸⁸ Kirby v. Thorn EMI Plc 60 T.C. 519.

¹⁸⁹ O'Brien v. Benson's Hoisery (Holdings) Ltd 53 T.C. 241.

¹⁹⁰ Hospital Corporation of America v. Commissioner, 81 TC 520 (1983).

¹⁹¹ The Danish ABCD case, TFS 2003.802. See further IFA 2011, p. 286.

¹⁹² DSG Retail limited v. HMRC, 2009 T.C. 00001.

¹⁹³ IFA 2011, p.114. See further EAS 2987, july 23, 2008.

- The opportunity may be transferred¹⁹⁶;
- The opportunity cause for certain (above normal) future benefits¹⁹⁷¹⁹⁸.

3.6.2 Literature:

The object of article 9 OECD¹⁹⁹

A business opportunity may be compensated at arm's length if:

- The opportunity clearly exists;
- The opportunity belongs to a company;
- The shareholder or a related person has exploited the opportunity for its own account.

The OECD guidelines²⁰⁰

The moment of existence may be determined through an analysis, taking into account the following sources:

- An annual report;
- Inter-company contracts;
- A premium return over a period of time attributable to the owning company;
- A functional analysis (analyzing the reasons why a company is successful)²⁰¹

Business opportunities²⁰²

The author mentions three characteristics of opportunities which must be met in order to qualify as IP through evaluating the Austrian Ministry of Finance statements, several court decisions from different countries and the German and Austrian literature, namely:

- The opportunity clearly and definitely exists;
- The opportunity is so concrete that it can be qualified as an asset (in other words, the opportunity is identifiable);
- The opportunity is at the disposal of the taxpayer (in other words, the opportunity could be owned by someone), i.e. has been created by the taxpayer which can make use of the opportunity (the owner can realize value from the opportunity).

In conclusion, from the perspective of the several court decisions and literature, a business opportunity may be qualified as IP if it can be proven that the IP clearly and certainly exists, the opportunity may be transferred and if the owner of the opportunity can derive substantial value (abnormal economic benefits) from the opportunity when executing the opportunity.

Example 2:

In September 2010 company A created a (unique) fluid substance leading to the loose of weight when taking the substance for a few weeks. In the same month company B, a subsidiary of company A, referred the opportunity from company A to further develop the fluid substance and selling the substance all over the world.

This opportunity must be compensated, because the opportunity can be defined as IP for TP purpose, since:

¹⁹⁴ Federal tax court decision of August 30, 1995, I R 155/94, DStR 1995.

¹⁹⁵ Hospital Corporation of America v. Commissioner, 81 TC 520 (1983).

¹⁹⁶ *Ibid.*

¹⁹⁷ Federal tax court decision of August 30, 1995, I R 155/94, DStR 1995.

¹⁹⁸ The Danish ABCD case, TfS 2003.802. See further IFA 2011, p. 286.

¹⁹⁹ Wittendorff 2010.

²⁰⁰ Jie-A-Joen 2007.

²⁰¹ Jie-A-Joen 2007.

²⁰² IFA 2011, p. 40.

- The opportunity causes reasonable foreseeable future economic benefits since the selling of the created substance will probably lead to significant profits;
- The substance derives its value from its IP nature;
- The substance clearly and definable exists, i.e. a substance that may lead to the loss of weight;
- The substance can be owned and controlled by company B given that company B can exploit the substance with exclusion of others, for instance by patenting the substance;
- The substance can be transferred to third parties.

3.7 Some examples of intangibles which may or may not be defined as IP

In this paragraph I will give some examples of IP's that may or may not be classified as IP, taking into consideration the characteristics given in the previous chapter and the development stages of incremental IP's as mentioned in the fifth paragraph of this chapter.

Example 3

In January 2008 company B entered into a CCA with company A, concerning the development and the distribution of the earlier mentioned potential cancer pill. In connection with the CCA company A transferred the access to marketing and R&D teams and a management method to company B.

Can we speak of the transfer of IP for TP purposes at the moment of concluding the CCA regarding the access to marketing and R&D teams and a management method?

Note:

This example only involves the question if the transfer of the specific IP must be compensated for TP purposes in relation to the conclusion of the CCA regarding the development of the cancer pill. It is nevertheless possible that the IP's may be defined as IP when defining the IP's independently from the CCA.

Access to marketing and R&D teams ("teams")

These IP's may be qualified as IP for TP purposes, if:

- The teams cause reasonable foreseeable future economic benefits and have therefore substantial value. This must be proven through the facts and circumstances. Is there specific relevant knowledge present in the teams? And does company B already dispose of this knowledge or not? In other words, there has to be evidence that the teams provide for relevant specific knowledge that lead to the creation of the cancer pill.
- Furthermore, the teams must clearly and definable exist. This has to be proven through the facts and circumstances, for instance documentation from the teams²⁰³.

Conclusively, the teams may have substantial value and can therefore be qualified as IP, depending on the facts and circumstances concerning the condition of economic future benefits and the clear existence of the teams²⁰⁴.

The management method ("method")

This property is IP for TP purposes, i.e.:

- The method has substantial value for company B since company B can derive substantial economic benefits by using the management process method in the development and potential distribution of the cancer pill;
- The method is non-physical in nature;

²⁰³ § 11 of the commentary to article 12 of the OECD Model tax treaty.

²⁰⁴ See also VERITAS software corp. V. Commissioner, 133 T.C. 14 where the transfer of assembled workforces because of entering into a CCA agreement is not qualified as IP since it can not be proven that the workforce has sustainable value and clearly exists at the moment of transferring the workforce.

- The method can be identified as an IP and clearly exists;
- The method can be owned and controlled exclusively by company A and B and;
- The method is transferable to third parties.

Looking at the examples, the management method and the access to marketing and R&D teams have to be qualified as IP for TP purposes at the moment of concluding the CCA between company A and company B. More precisely, the IP's need to have identifiable, substantial value at the moment of the transfer of the IP's to company B to compensate the transfer for TP purposes.

Example 4

Company A and company B distribute 'Manzio' from March 2010. To increase the potential buyers, company A transfers a customer list to company B into the CCA.

Can we speak of the transfer of IP for TP purposes towards the transfer of the customer list into the CCA?

This customer list can be defined as IP for TP purposes if:

- The customer list includes new customers for company B. It is possible that company B already has the same third parties as customers. In that case, the customer list does not have substantial value to company B and therefore does not cause economic benefits²⁰⁵.

The other criteria for determining the list as IP are fulfilled since:

- The list derives its value from its IP nature;
- The list can be identified as an IP and clearly exists;
- The list can be owned and controlled, because only the owner of the list has access to the concrete list and can use the list and;
- The list is transferable.

²⁰⁵ IBFD 2011.

4 The ownership of IP

4.1 Introduction

Within multinational enterprises there are different ways to develop, enhance and maintain IP. It is possible that only one enterprise is responsible for the development, maintenance and enhancement of IP in its own name and account. This company bears all the risks and costs related to the IP and will therefore be the legal and economic owner of the IP. Consequently, this company should receive the commercial returns arising from the developed IP. However, it is also possible that one enterprise develops IP on behalf of another group company under a contractual arrangement. This other company bears the risks and costs related to the IP and consequently can be considered the legal and economic owner of the IP, receiving the returns arising from the IP. Nevertheless, it is also possible that different group companies of a multinational enterprise develop and enhance IP together by entering into a CCA²⁰⁶ or different members of the group assist the legal owner of the IP in developing or enhancing the value of the IP²⁰⁷. Furthermore, certain members of the group may enter into contractual license agreements with other group companies, involving the distribution of IP's and consequently contribute in the further development of these IP's overseas²⁰⁸. In conclusion, there are different members of the group bearing the risks and costs related to the IP and therefore there are several economic owners but only one legal owner of the IP. The question in these cases is who should enjoy the returns from the IP for TP purposes²⁰⁹? Can only the legal owner be considered as the owner of the IP for TP purposes or may all the economic owners be entitled to the income from the IP and therefore owner of the IP?

The determination of the group member who should enjoy the returns from the IP, i.e. the correct tax owner of the IP, is the decisive factor for the allocation of income attributable to the IP since only the owner of the IP is consequently entitled to the income stream flowing from its use, license or transfer²¹⁰. Furthermore, the owner of the IP is exposed to the associated tax consequences²¹¹. The ownership of IP is also of main importance to determine how the income from the IP is divided among different related parties who benefit from the IP in different tax jurisdictions in which they operate²¹². For instance, when transferring IP, the distributor has to pay an arm's length price to the owner of the IP. Furthermore, the owner may amortize the expenditures on the development and enhancement of the IP²¹³. The main question in this chapter is consequently:

“Which member of a controlled group will be considered the owner of the valuable IP, and therefore the appropriate recipient of its income under the arm's length principle?”²¹⁴

Currently, several OECD countries provide for a different ownership concept resulting in different allocation of income from IP. This leads to double or non-taxation. Therefore, one of the main problems that were raised in the OECD letters was which concept of ownership, i.e. legal ownership or economic ownership, must be applied when allocating the income from the IP for TP purposes.

This chapter consequently focuses on the different ownership concepts of IP, namely:

- Legal ownership;

²⁰⁶ § 6.3 of the OECD TP guidelines.

²⁰⁷ Wills 1999.

²⁰⁸ Verlinden 2005, p. 133 and further.

²⁰⁹ Deloitte, <http://www.oecd.org/dataoecd/6/2/49014409.pdf>.

²¹⁰ Markham 2005.

²¹¹ Przsuski 2004.

²¹² *Ibid.*

²¹³ Wittendorff 2010, p. 624.

²¹⁴ Mentz 1997.

- Contract-based ownership;
- Control ownership;
- Functional ownership;
- Beneficial ownership;
- Economic ownership.

Additionally, this chapter will answer the question which ownership concept should be recognized and therefore which owner should be entitled to the income from the IP for TP purposes. The ownership issue concerning marketing activities performed by enterprises not owning the marketing IP will be discussed more closely in chapter six.

The second paragraph will explain the substance over form doctrine with a view to ownership, because this concept may be relevant when identifying the correct owner of IP for TP purposes. The different concepts of ownership will be explained in paragraph three. In paragraph four I will discuss the preferred ownership concept and the factors to determine the ownership concept according to the current OECD TP guidelines. The definition of ownership in the Report on permanent establishments (“PE’s”) will be discussed in paragraph five. Several domestic legislations/guidelines will be reviewed in paragraph six. The domestic court decisions concerning the ownership of IP for TP purposes will be discussed in paragraph seven. Some authors gave their opinion on the prevailing ownership concept. These views will be handled in paragraph eight. Since there has been an OECD meeting in November on the ownership concept of IP, the ninth paragraph will focus on the results from this meeting. Lastly, the conclusion will be drawn in paragraph nine of this chapter.

4.2 The different concepts of ownership²¹⁵

Most domestic legislation/guidelines, court decisions and literature use the terms legal ownership and economic ownership. Nevertheless, the economic ownership concepts mentioned in these sources differ from each other. This paragraph will explain the different legal and economic ownership concepts that I have encountered during my review.

Legal ownership concepts:

4.2.1 Legal ownership

The legal owner of IP is the recognized owner in law through legal registration. Thus, legal ownership can be obtained through formal registration. The legal protection resulting from the legal title of the IP is the essential aspect when determining legal ownership.

4.2.2 Contract – based ownership

Ownership may also be determined by contractual agreement between different members of the group. The contract has to define the rights to use and exploit the IP. The group member, who owns the rights attributable to the IP and therefore has the power over the use of the IP according to the agreement, can be defined as the ‘legal’ owner of the IP.

Economic ownership concepts:

4.2.3 Control ownership

Ownership may also be based on the question which company possesses the practical control over the IP. This criterion can be filled by handling the control characteristic mentioned in chapter two. The group member who actually controls the IP by performing the functions related to the IP, using the IP

²¹⁵ See for instance Wittendorff 2010, van Herksen 2008, Verlinden 2005, Boulogne 2006 and IBFD 2011.

and exclude (restrict) others from using the IP may be considered the owner of the IP. This ownership concept can be linked to the economic ownership concept mentioned under 4.3.6.

4.2.4 Functional ownership

The functional ownership is based on the economic reality of the ownership of IP. When valuing IP for TP purposes, the functional analysis plays an important role. The functional analysis analyzes the functions performed (taking into account the assets used and the risks assumed) by associated enterprises in controlled transactions²¹⁶. When applying this analysis for the determination of the owner of the IP, the group member who actually performs the functions, bears the risks and uses the assets regarding the IP may be seen as the functional owner of the IP. This ownership concept can also be linked to the economic ownership concept mentioned under 4.3.6.

4.2.5 Beneficial ownership

This ownership concept is in line with the control- and economic ownership concept. According to this concept the group member who actually enjoys the benefits from the IP may be considered the beneficial owner of the IP.

4.2.6 Economic ownership

The concept of economic ownership is based on the economic reality and may be placed in line with the functional and control ownership. Under this concept the group member who actually bears the costs and assumes the risks on the development of the IP is treated as the economic owner from the IP, because this owner is entitled to the income attributable to the developed IP.

4.3 Substance over form

This doctrine plays an important role for accounting and tax purposes when countering tax evasion in case of transactions. This doctrine involves the question of the economic reality of the information shown when entering into a transaction. In my opinion, this doctrine may also be applicable in ownership cases of IP for TP purposes. The doctrine indicates that not the legal form in which the ownership appears is decisive, but the underlying contractual agreement, the intention of the parties and facts and circumstances concerning the ownership of the IP are crucial when determining the correct owner of the IP²¹⁷. More precisely, the doctrine requires that only the actual owner in conformity with the economic reality must be taken into account for TP purposes.

4.4 Article 9 of the OECD Model Treaty and the OECD TP Guidelines

Article 9 of the OECD Model tax treaty mentions the application of the arm's length principle in case of transfers between associated companies. The arm's length principle states that the amount charged by one related party to another regarding the transfer of IP has to be the same as the amount charged in case of independent companies. The OECD TP guidelines expose the way to come to this correct arm's length amount. The crucial factor in the determination process is the functional analysis. This means that each company ought to earn a return commensurate with the functions performed, assets used and risks assumed concerning the IP²¹⁸. In case of applying this analysis for ownership purposes, the correct owner of the IP, according to the OECD TP guidelines and article 9 of the OECD Model tax treaty, is the functional owner, because this is the owner who should receive the income attributable to the IP developed through the functions exercised²¹⁹.

²¹⁶ See the definition of the functional analysis in the OECD TP guidelines under Glossary and § 1.42 of the OECD TP guidelines and further.

²¹⁷ Wittendorff 2010, p. 153.

²¹⁸ Levey 2006.

²¹⁹ See for instance chapter D.1.2.2, § 2.63, § 2.86, § 3.20, § 5.23 and § 9.138 of the OECD TP guidelines

Secondly, article 9 of the OECD Model tax treaty and the OECD TP guidelines seem to prioritize the economic reality doctrine for TP purposes. Namely, the price has to be consistent with the economic reality. Further, the emphasis on the economic reality can be traced back to the different paragraphs in the OECD TP guidelines mentioning economic reality as the decisive factor for TP purposes²²⁰.

Chapter nine of the OECD TP guidelines

The new chapter nine of the OECD TP guidelines recognizes risk allocation by contractual agreement but gives preference to the economic substance doctrine in case the facts differ from this agreement, namely:

“a tax administration is entitled to challenge the purported contractual allocation of risk between associated Enterprises if it is not consistent with the economic substance of the transaction²²¹”.

Concerning the allocation of risks, the OECD puts also emphasis on the company which controls the transaction when implementing the economic substance doctrine. Control means the company who takes the decisions on the risks and manages the risks through people that could perform these functions²²². Further, the company must have the capacity to assume the risks. These factors lead, according to chapter nine of the OECD TP guidelines, to an arm’s length allocation of risks. Chapter nine also mentions that the economic substance can be determined through examining the facts and circumstances, such as the commercial context of the arrangement, its object and the conduct of the parties, including the functions performed, assets used and risks assumed by them²²³. Further, chapter nine mentions some examples of the application of § 9.12 of the OECD TP guidelines²²⁴. These examples indicate also that if the legal owner has no people with the skills and competences to perform the functions in relation to the risks, the owner lacks any control and management over the risks, or the owner has no financial capacity to assume the risks respecting the development of brand names and a comparison with independent parties leads to the conclusion that an independent party would never act in the same manner²²⁵, this legal owner differs from the economic substance of the arrangement and therefore, the economic substance should be followed for TP purposes.

When applying chapter nine analogous to the ownership issue of IP, the legal registration or contractual agreement serves as the starting point. Nevertheless, if the contractual agreement is not consistent with the economic reality because the IP can be attributed to another group member who can be defined as the economic owner of the IP, taking into consideration the risks assumed and the control over the IP, this last enterprise must be treated as the owner of the IP.

Other relevant chapters of the OECD TP guidelines

Further, the OECD mentions the legal and economic ownership concept in the OECD TP guidelines²²⁶ but gives no definition of these two concepts of ownership. Furthermore, the OECD does not explicit prefer one of these two ownership concepts. The OECD also mentions the concept of contract-based ownership as a starting point when allocating the risks of a transfer²²⁷.

The OECD emphasizes economic ownership in cases of CCA’s involving IP, i.e.:

²²⁰ See for instance § 1.19, § 8.29 and § 8.30 of the OECD TP guidelines.

²²¹ § 9.12 of the OECD TP guidelines and further.

²²² § 9.22 of the OECD TP guidelines and further

²²³ § 9.170 of the OECD TP guidelines

²²⁴ § 9.188 of the OECD TP guidelines and further

²²⁵ § 9.194 of the OECD TP guidelines

²²⁶ § 6.3 of the OECD TP guidelines

²²⁷ § 9.11 of the OECD TP guidelines

“under an arrangement in which the members involved are engaged in a joint activity and have economic ownership of the intangible²²⁸”.

It may be that only one of the participants is the legal owner of the IP, but economically all the participants are co-owners. In case were a participant has an effective ownership interest in any IP developed by the CCA and the contributions are in the appropriate proportions, there is no need for a royalty payment or other consideration for use of the developed IP consistent with the interest that the participant has acquired.”

In conclusion, each participant of a CCA is an economic owner of the IP. This economic ownership concept refers to the participant’s proportionate share of his overall contributions to the arrangements made on the development of the IP and the subsequent effective ownership interest the participant has in the IP. Therefore, the OECD gives preference to the economic ownership concept. Nevertheless, with respect to marketing IP, the OECD seems to prefer legal ownership:

“Marketing activities are undertaken by enterprises that do not (legally²²⁹) own the trademarks or trade names²³⁰²³¹”.

Nevertheless the OECD seems to mark economic ownership as well by asking the following question in the same section:

“Should the marketer be compensated as a service provider, i.e. for providing promotional services, or should the marketer share in any additional return attributable to the marketing intangibles²³²?”

According to the OECD, the compensation must be compared to the compensation an independent party would obtain. The OECD is not very clear towards the form of compensation, but it seems the OECD does not recognize ownership towards the marketer in this case, but only compensation from the owner through a reduction in the purchase price or in the royalty rate for the marketing activities she performed.

Important to note is that not all IP can be legally registered. The OECD does not mention what the correct ownership concept should be in this case.

Unfortunately, the definition of economic ownership cannot be found in article 9 of the OECD Model tax treaty or in the OECD TP guidelines. Therefore, we have to take a closer look at other relevant sources like the Report on the Attribution of profits to PE’s, domestic legislation/guidelines and domestic court decisions to come to the correct ownership of IP.

4.5 The OECD Report on the Attribution of profits to PE’s (“the Report”)²³³

For purposes of article 7 of the OECD Model tax treaty, dealing with the attribution of profits between the head office of an enterprise and its PE’s, the economic owner of the IP can be determined as the relevant and correct owner for article 7 purposes. To determine the economic owner of IP, the ‘significant people function’ (“SPF”) test is relevant. According to the Report, the key issues to determine the economic owner of IP under the SPF test, taking into account the specific facts and circumstances, are:

²²⁸ § 6.3 and § 8.6 of the OECD TP guidelines

²²⁹ § 6.38 of the OECD TP guidelines.

²³⁰ § 6.36 of the OECD TP guidelines and further.

²³¹ IFA 2007, p.454.

²³² *Ibid.*

²³³ The OECD Report on the attribution of profits to PE’s (iii) (c) intangibles.

- What are the functions performed below the strategic level of the senior management?
 - What is the level at which the active management regarding the development of the IP occurs?
 - Where lays the ability to actively manage the risks inherent in such a development?²³⁴
- Who bears the risk related to the loss (costs) of the IP and does this developer have sufficient free capital to support this assumed risk²³⁵?

In conclusion, the PE/head office that can be determined as the economic owner, taking into consideration the SPF test, i.e. the place of the active decision making process relating to the taking on and management of risks that are undertaken²³⁶, is the right owner according to the Report. In conclusion, the Report reflects the functional ownership concept.

Could this concept of economic ownership be applied by analogy for TP purposes?

The Report is written for article 7 of the OECD Model tax treaty purposes, dealing with the attribution of profits between head offices and PE's. PE's are not separate entities that possess legal personality. Therefore, PE's can never possess legal ownership of IP. This may be an important distinguishing factor between the ownership of IP for TP purposes and for purposes of article 7, because subsidiaries may well possess legal ownership of IP for TP purposes.

Nevertheless, according to the Report, chapter six of the OECD TP guidelines may also be limited applicable for article 7 purposes when dealing with IP. More specific, the OECD mentions that the functional analysis of the OECD TP guidelines is by analogy applicable when characterizing the article 7 economic ownership concept, namely:

“For transactions between associated enterprises, Chapter VI of the Guidelines provides ... and could be applied by analogy in the PE context. In particular, the concept of the functional and factual analysis would be applied in order to determine which, if any, part of the enterprise could be identified as having performed the function of creating the intangible.”²³⁷

This application leads to the assumption that the functional analysis must be taken into account when determining the ownership of IP for TP purposes. The use of the functional analysis presumes the preference of the OECD to apply the functional ownership concept of IP for TP purposes. According to the OECD, this functional analysis should describe and evaluate the decision making process and the level at which the decisions on the development of the IP are taken²³⁸. Further, it can be argued that the fundamental idea behind the economic ownership doctrine of article 7 may also be valid under article 9 of the OECD Model tax treaty, independent from the legal personality of the entities, namely the application of the functional and risk profile to determine the ownership of IP²³⁹.

In conclusion, the Report gives preference to the concept of economic (functional) ownership of IP, i.e. the place of the effective decision making process relating to the taking on and management of the risks that are undertaken. This Report is primarily written for article 7 purposes, but it is arguable to state that this economic ownership concept, focusing on the functional and factual analysis of the ownership of IP, is also applicable when determining the ownership of IP for TP purposes.

²³⁴ The OECD Report on the attribution of profits to PE's, p. 31, under 87.

²³⁵ *Ibid.*

²³⁶ The OECD Report on the attribution of profits to PE's, p. 31, under 94.

²³⁷ The OECD Report on the attribution of profits to PE's, p. 31, under 79.

²³⁸ The OECD Report on the attribution of profits to PE's, under 88.

²³⁹ The OECD letter from Bonn 2010.

4.6 Domestic legislation/guidelines²⁴⁰

4.6.1 Australia

The Australian taxation ruling²⁴¹ mentions the importance of legal ownership and the identification of the parties who participated in the development process of the IP, resulting in shared economic ownership. According to the Australian Tax Office (“ATO”) the economic owner has to be appropriately rewarded. Therefore, the ATO recognizes both ownership concepts.

The ATO booklet *Marketing Intangibles*²⁴² provides for examples of different appropriate rewards for marketing activities undertaken by enterprises not owning trademarks and trade names, according to the OECD TP guidelines²⁴³. In case the contractual agreement meets the following characteristics, the distributor has acted to increase the value of the IP²⁴⁴ and might therefore obtain an additional return attributable to the IP²⁴⁵, i.e.:

- The agreement consists of a long-term, renewable contract;
- The arrangement consists of exclusive marketing and distribution rights for the distributor;
- The distributor bears all the costs and risks related to the development of the IP in the specific market;
- The distributor incurs marketing expenses far beyond those of comparable independent enterprises²⁴⁶;
- These expenses lead to significantly lower profits for the distributor than would be made by comparable independent enterprises²⁴⁷.

These characteristics in the booklet assume taking into account the economic ownership concept in case of increasing the value of marketing IP for TP purposes through the distributor. A connecting factor for assuming this notion of the economic ownership concept may also be found by looking at one of the adjustments described in example three. This example gives the legal and economic owner both a basic return for the functions they perform and then splits the residual profit on a basis that takes into account ‘the part of the IP’ owned by the legal and the economic owner and the relative contributions of both the legal and economic owner to the value of the trade name²⁴⁸. Furthermore, the booklet notes that the distributor may also develop independent IP, namely valuable distribution rights the distributor has under its contract with the legal owner concerning the trade name²⁴⁹.

In conclusion, the ATO seems to take the legal ownership as a starting point, but gives preference to the economic ownership concept in case the facts lead to the conclusion that another company than the legal owner of the developed IP has acted to increase the value of the IP.

4.6.2 Germany

Germany recognizes the legal and the control ownership concept. The legal owner is the company who has the economic control over the IP by legal registration or contractual agreement, independent from the question which company bears the risks and costs concerning the development of the IP²⁵⁰. In principle, this legal owner is the correct owner for TP purposes²⁵¹. Nevertheless, if the control owner, i.e. the company who “*exercises effective control over an economic good in such a way that he can, as a rule, economically exclude the owner from affecting the economic good during the normal*

²⁴⁰ IFA 2007, van Herksen 2008, IBFD TP 2011, Boulogne 2008, Eriksson 2010 and Levey 2006.

²⁴¹ ATO TR 98/11 under § 5.40 and § 5.41.

²⁴² http://www.transferpricing.com/pdf/Australia_TR%2098-11.pdf.

²⁴³ § 6.36 until 6.39 of the OECD TP guidelines.

²⁴⁴ ATO 2005, example 3, tax office approach.

²⁴⁵ IFA 2007, p. 26.

²⁴⁶ Because the marketing activities carried out by the distributor go far beyond those of comparable independent Enterprises, we can assume that the distributor participates in the IP itself.

²⁴⁷ ATO 2005, example 3 and example 6.

²⁴⁸ ATO 2005, example 3, tax office approach under adjustment 1.

²⁴⁹ ATO 2005, example 3, tax office approach, last sentence.

²⁵⁰ IFA 2007, p. 283.

²⁵¹ Section 39 § 1 of the fiscal code of Germany.

period of its useful life, is another company than the legal owner²⁵², this company must be considered the correct owner for TP purposes.

Germany gives in conclusion preference to the control owner of the IP for TP purposes²⁵³.

4.6.3 Japan

Japan recognizes legal and economic ownership, but gives preference to the economic ownership concept. This concept refers to the contribution to the activities for the formation, maintenance and development of the IP. To come to this contribution the functional analysis, i.e. the functions performed, assets used and risks assumed, shall be taken into account²⁵⁴. The following functions must be taken into account when applying this functional analysis:

- *“The decision-making process of creating the IP;*
- *The functions performed by foreign related companies in providing services;*
- *The bearing of expenses;*
- *The managing of the risks²⁵⁵²⁵⁶.*

Therefore, the actual economic conditions of the contribution of the relevant party in the formation, maintenance and development process of the IP is decisive to determine the correct owner for TP purposes. Thus, the party who bears the expenses, risks and performs the functions related to the development and maintenance of the IP can be considered the owner of the IP for TP purposes.

Further, a director for international taxation at the Japanese’s tax agency expressed the following view on IP:

“In Japan, it is generally thought that IP, irrespective of whoever has legal rights thereto, belongs not to the registered owner thereof but to the party who has developed or enhanced the value of the IP²⁵⁷.”

The director mentioned also that the party who developed or enhanced the value of the IP is the party who has made the decision to develop/enhance the value of the IP, managed the risks thereof, provided the services and borne the costs related to the IP²⁵⁸.

Regarding CCA’s, the Japanese tax agency agrees to the view of the OECD and other domestic countries that the ownership of the participators has to be in accordance with the proportion of the total costs borne by the participators and therefore the proportion of the total amount of expected benefits from the developed IP²⁵⁹.

Conclusively, Japan gives priority to the economic ownership concept of IP in combination with the functional ownership concept, namely the party who assumes the risks, bears the costs and performs the functions related to the IP, can be considered the owner of the IP for TP purposes.

4.6.4 The Netherlands

The Netherlands recognizes legal ownership, namely the company that is registered as the legal owner of the IP under intellectual property law²⁶⁰, but gives preference to the concept of economic ownership for tax purposes in case:

- The user of the IP bears all the risks of increase and decrease of the value of the IP;
- The user of the IP bears all the risks of extinction of the IP²⁶¹.

²⁵² Section 39 § 2 of the fiscal code of Germany.

²⁵³ Van Herksen 2008.

²⁵⁴ National tax agency of Japan, Commissioner’s Directive on the Operation of Transfer pricing § 2.12.

²⁵⁵ *Ibid.*

²⁵⁶ IFA 2007, p. 388.

²⁵⁷ Yamakawa 2004.

²⁵⁸ Levey 2006.

²⁵⁹ National tax agency of Japan, Commissioner’s Directive on the Operation of Transfer pricing § 2.14 and 2.15.

²⁶⁰ IFA 2007, p. 436.

Furthermore, the Dutch State Secretary of Finance stated that in case of a contract research, the following aspects are relevant to determine the owner of the IP:

- The functions performed, assets used and risks assumed, namely aspects concerning:
 - The decision making process;
 - Planning and budgeting;
 - The measurement of performance;
 - The remuneration;
 - The adjusting/redefining of the work environments;
 - The determination of the commercially valuable areas;
 - The determination of the chances of unsuccessful research²⁶²²⁶³.
- The company who performs the functions must possess the capacity to bear the risks financially and have the knowledge and skills to manage the risks and functions.

In other words, the company who actually manages and controls the development process of the R&D activities and has the capacity to bear the risks related to the development of the IP is the correct owner for TP purposes. Furthermore, in case of CCA's, the ownership of the IP, and therefore the allocation of benefits arising from the developed IP, must comply with the relative share of the participant's overall contributions to the arrangements made for the development of the IP²⁶⁴. It is important to note that the CCA participants must receive benefits arising from the potential developed IP for their own purposes. Otherwise the CCA participants are not economic owners of the IP, but merely service providers.

In conclusion, the Netherlands give priority to the concept of economic ownership, taking into account the control and functional ownership concept. The concept of economic ownership refers to the company who performs the functions, uses the assets and assumes the risks towards the IP. The risk factor is of main importance. This means that the economic owner must bear all the risks of increase/decrease of the value of the IP and the extinction of the IP. Furthermore, the economic owner must de facto have the capacity to bear the risks related to the development of the IP.

4.6.5 *New Zealand*

The tax authorities of New Zealand note the importance of economic ownership, i.e. the party that bears the expenses and risks associated with the (direct or indirect) development of the IP, because an independent party should not be prepared to bear the expenses and risks regarding the IP if it were not going to benefit from the income attributable to these costs and risks²⁶⁵. Nevertheless, in case the legal owner and the developer of the IP are not the same, the legal owner is considered to be the correct owner of the IP for TP purposes. However, the developer must be compensated at an arm's length price by the legal owner for its development services²⁶⁶. Excessive marketing activities undertaken by companies not owning the IP should be treated as a service to the legal owner of the IP as well under the New Zealand's TP guidelines²⁶⁷.

Conclusively, the New Zealand's guidelines give priority to the legal ownership concept, but recognize the economic ownership concept as well, i.e. the party that bears the risks and costs associated with the development of the IP. In case the legal owner of the IP is not consistent with the party bearing risks and costs that go beyond the extent to which an independent distributor would bear, the distributor will never be considered an economic owner of the IP, but merely a service provider

²⁶¹ There is no Dutch legislation regarding the economic ownership concept for TP purposes. Furthermore, there are no Court Decisions on the ownership concept in case of IP. Nevertheless, the Dutch focus on the economic ownership concept for tax purposes can be found in different Court Cases, i.e. Supreme Court October 19, 1955, BNB 1955/377, Supreme Court October 12, 1983, BNB 1984/87 and Supreme Court October 16, 1985, BNB 1986/118.

²⁶² Decree of August 21, 2004, IFZ2004/680M.

²⁶³ Van Herksen 2008.

²⁶⁴ Decree of August 21, 2004, IFZ2004/680M.

²⁶⁵ IRD Tax information Bulletin – Appendix: Transfer pricing guidelines, Vol. 12, No 10 (October 2000), p. 56, 57.

²⁶⁶ *Ibid.*

²⁶⁷ § 500 of the inland revenue guidelines and further.

respecting the IP. Therefore, this party should be compensated arm's length for the services he rendered by the owner of the IP.

4.6.6 The United Kingdom

The UK recognizes legal ownership, referring to the registration of the IP in the name of the legal owner, and beneficial ownership, referring to the person who incurs the expenditures on the IP and has the rights over the IP, such that he can exploit, develop and use the IP in the same way a legal owner may, but without the legal title. In case there are for instance three beneficial owners and just one legal owner regarding the IP, the UK favors the three beneficial owners for TP purposes and therefore gives priority to the beneficial ownership concept²⁶⁸. Furthermore, the International tax manual defines two cases towards ownership issues²⁶⁹. The first issue marks the marketing of branded goods. In case the legal owner distributes for instance a brand name to a subsidiary and this subsidiary incurs massive advertising and marketing expenditures to promote the sales of this brand name, the question arises who the owner of the brand name should be for TP purposes. In case the brand name is valuable at the moment of distribution and the subsidiary only incurs expenditures that an independent party also would incur, the legal owner of the brand name should be considered the right owner for TP purposes. Nevertheless, in case the brand name is (almost) worthless at the moment of the distribution and the development of the brand name can be entirely attributed to the subsidiary, the subsidiary can claim beneficial ownership and the corresponding reward²⁷⁰. The second example involves the sale and marketing of branded goods. On the basis of the comparability analysis the HMRC answers the following question: Who is the economic owner of the IP? The HMRC mentions that:

- *“It is possible that one company owns some of the marketing IP and another company owns the remaining IP;*
- *It is possible for a company to lay claims to certain IP if the legal owner has done nothing to maintain those IP rights;*
- *An independent company would expect to share in the potential rewards if it is obliged to spend large sums of money each year promoting a brand it has no legal ownership interest in”²⁷¹.*

Conclusively, the UK gives preference to the economic ownership concept. Economic ownership refers to the person who incurs excessive expenditures to develop, maintain and enhance the IP and has the rights over the IP, such that he can exploit, develop and use the IP and therefore has the control over the IP. In case the legal owner is not consistent with the economic owner of the IP, the economic owner is given priority for TP purposes.

4.6.7 The United States

The issue on the ownership concept in US law knows an extensive and unclear history. Nowadays, the IRC uses the legal or contractual ownership as a starting point unless the economic substance differs from this ownership, i.e.:

“The legal owner of IP pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an IP pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective IP for purposes of this

²⁶⁸ International tax manual 464070.

²⁶⁹ International tax manual 467160.

²⁷⁰ IFA 2007, p.614.

²⁷¹ International tax manual 467160, example involving the sale of branded products.

*section unless such ownership is inconsistent with the economic substance of the underlying transactions.*²⁷²

The economic substance differs from the legal ownership in case the risks towards the IP are borne by another group member than the legal owner of the IP. The correct allocation of risks between controlled parties may be determined through:

*“- the consistence of the pattern of the controlled taxpayer’s conduct over time with the purported allocation of risk between the controlled taxpayers; – the financial capacity of the taxpayer to fund losses that might be expected to occur as the result of the assumption of a risk; - the exercised managerial or operational control over the business activities that directly influences the realized income.*²⁷³

If these conditions are inconsistent with the contractual agreement or legal registration, the group member who actually bears the risks concerning the IP will be regarded as the owner for TP purposes. If no legal owner can be identified the control owner may be considered the owner of the IP for TP purposes. According to the regulation the control owner is the group member who, looking at all the facts and circumstances, has the control over the IP. According to this concept, the group member who has practical control over the use and dissemination of the IP²⁷⁴ can be considered the owner of the IP for TP purposes. Further, the regulation of 2006 mentions that parties who did not bear the largest costs in development of the IP, but spent costs and risks on the development or enhancement of this IP beyond the level of independent parties, can also be considered the owners of the IP and therefore entitled to the income from the enhanced IP²⁷⁵.

Before 1968, the US applied the ‘commensurate with income’ standard when determining the owner of IP. This standard meant that the income with respect to any transfer or license of IP should be commensurate with the income attributable to the IP²⁷⁶. This standard required that each party earned the income from the IP that reflected the economic activities undertaken by this party with respect to the IP²⁷⁷. The economic ownership concept, i.e. the place where the actual economic activities related to the IP took place, prevailed.

The 1968 regulations of the US nevertheless provided for the ‘developer-assister’ rule, meaning that only one member of a group could be identified as the owner (developer) of the IP, while the other members of the group that contributed to the development of the IP were merely assisters and therefore only entitled to an appropriate compensation from the owner of the IP for the value of their assistance²⁷⁸. To determine which company could be considered the developer of the IP and therefore the owner of the IP, the following factors were relevant:

- The location of the development activities;
- The capabilities of the various members of the group to perform the development activities;
- The degree of control over the project exercised by the various members of the group²⁷⁹.

Therefore, the US seemed to give preference to the functional ownership concept in 1968. This meant that the party who mainly performed the functions and exercised the control over the IP and had the ability to bear the risks and costs related to the development of this IP could be considered the owner of the IP for TP purposes²⁸⁰. Further, the tax authorities of 1968 paid attention to the situation that for instance a parent company grants her US subsidiary a long-term exclusive right to distribute products

²⁷² § 1.482.4T (f) (3) of the US Treasury Regulation.

²⁷³ § 1.482.4T (1) (d) (3) (ii) (B) of the US Treasury Regulation.

²⁷⁴ § 1.482.4T (f) (3) (B) (ii) example 2 of the US Treasury Regulation.

²⁷⁵ Wrappe 2007.

²⁷⁶ 26 U.S.C.A. § 482.

²⁷⁷ Martinez 2011.

²⁷⁸ Boulogne 2008.

²⁷⁹ § 1.482.4 (f)(3)(i)(c) of the US Treasury Regulation of 1968 and Wrappe 2007.

²⁸⁰ Markham 2006.

in the US under the parents' trade name. Consequently, the subsidiary undertakes excessive marketing efforts. In this case, no compensation should be paid to the subsidiary since the marketing efforts include the development of marketing IP around the trade name. Therefore, the US subsidiary should be considered the owner of the IP in the US²⁸¹.

The temporary regulations of 1993 lay emphasis on the economic ownership concept, i.e. the company that had borne the greatest share of the costs of development of the IP²⁸² where the 1994 regulations lay emphasis on the legal ownership concept, i.e. the company that could be considered the owner of the IP based on its legal title or contract in case of registered IP. The economic ownership concept should still prevail in case of non-registered IP²⁸³. Nevertheless, the tax authorities could impute the legal ownership concept in case the economic substance differed from this legal title²⁸⁴. This rule is consistent with the current US Regulation.

In conclusion, the legal ownership concept should prevail according to the current US legislation, unless the economic/control owner differs from this legal owner, i.e. the risks of the IP are borne by another company and the managerial or operational control over the development process of the IP can also be attributed to this other company. The control conditions are very important when determining the correct and relevant owner of IP for TP purposes in the US.

4.6.8 Other countries

Most of the other countries of the OECD do not specifically determine the ownership concept for TP purposes. There are many countries that refer to the OECD TP guidelines when determining the ownership concept for TP purposes²⁸⁵. Nevertheless, many countries give preference to different ownership concepts in their own general tax legislation. For instance:

- Many countries²⁸⁶ do not recognize the economic ownership concept but only approve the legal ownership concept, i.e. ownership by legal registration, legal title or by legal contractual agreement²⁸⁷.
- Some countries give preference, in conformity with their civil code, to the legal ownership concept, but refer to the economic ownership concept in case there is no legal owner of the IP²⁸⁸.
- Austria and Slovenia prefer the control/beneficial ownership concept for tax purposes, namely the party who is entitled to use, to give in charge and to sell IP to independent parties. Further, the owner must have the respective income from the IP under his own disposal²⁸⁹. The Austria's Federal Fiscal Code also recognizes the substance over form doctrine which entitles the tax administration to look to the economic reality instead of the artificial arrangements²⁹⁰.
- Denmark gives preference, in conformity with their civil code, to the legal ownership concept, but refers to the control ownership concept in case it is difficult to determine a legal owner from the IP²⁹¹. Further, Denmark gives priority to economic ownership in case of CCA's.
- Norway gives preference to the economic ownership concept. Nevertheless, the enhancement of the value of an already existing IP through the subsidiary not owning this IP, could never lead to economic ownership²⁹².
- Portugal applies the substance over form doctrine²⁹³.

²⁸¹ § 1.482.2 (d)(1)(ii)(c) of the US Treasury Regulation of 1968.

²⁸² § 1.482.4T (e)(3)(i) of the US Treasury Regulation of 1993.

²⁸³ § 1.482.4 (f)(3)(ii)(B) of the US Treasury Regulation of 1994.

²⁸⁴ § 1.482.4 (f)(3)(ii)(A) of the US Treasury Regulation of 1994.

²⁸⁵ For instance Sweden, Belgium, Czech Republic and Switzerland.

²⁸⁶ For instance France, Greece, Italy, Mexico.

²⁸⁷ For instance Canada, Poland and van Herksen 2008.

²⁸⁸ For instance Chile.

²⁸⁹ Section 24 of the Austria's Federal Fiscal Code and

http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ir_dir_au_en.pdf.

²⁹⁰ Section 21 of the Austria's Federal Fiscal Code.

²⁹¹ IFA 2007, p. 220 and 221 and IBFD 2011, Denmark report.

²⁹² IFA 2007, p. 481, 482 and 483.

- Spain recognizes the legal ownership concept, except in cases where this is not in conformity with the substance over form doctrine. In this case, the economic ownership can be considered the correct owner for tax purposes. Moreover, in case of CCA's, the economic ownership concept prevails²⁹⁴

4.7 Domestic Court decisions

There are not much domestic court decisions related to the determination of the ownership of IP. Nevertheless, some countries, especially the US, provide for lower or Supreme court decisions involving the ownership of IP, most of the time in combination with the transfer of IP.

This paragraph will handle the different court decisions in the US and in the other countries that provide for factors and principles leading to the determination of the correct ownership of IP.

4.7.1 *The absolute Vodka & Adidas – case*

Both cases referred to the importance of legal ownership. The cases involved long-term license agreements between parent companies and subsidiaries to manufacture and sell IP in the countries of the subsidiaries in exchange for certain fees. Since the subsidiaries incurred excessive efforts to promote and maintain the IP in their countries, the IP's became very valuable in these countries. Nevertheless, the court decided in both cases that only the parent company could be considered the owner of the IP, since she was the owner of the IP rights and thus had the legal title over the IP. The subsidiaries were only entitled to service compensation²⁹⁵.

4.7.2 *The Eli Lilly - case*²⁹⁶

This older case involved the transfer of the ownership of pharmaceutical patents and know-how from the parent company Eli Lilly US, to her subsidiary situated in Puerto Rico. According to the contractual arrangement, the subsidiary became the owner of the IP after the transfer and therefore became entitled to the income from the transferred patents and know-how. The IRC argued that, according to the substance over form doctrine, the parent company remained the owner of the IP because she had borne the risks and costs related to the development of the IP. Nevertheless, the court rejected this opinion by focusing on the contractual agreement between the parent and the subsidiary. Therefore, the subsidiary could be considered the owner of the IP.

4.7.3 *The DHL - Case*²⁹⁷

This case concerned two related companies, namely parent company DHL and subsidiary DHLI. At one moment, DHL granted DHLI a royalty free license concerning the DHL trademark. DHL was registered as the legal owner of the DHL trademark in the US and overseas. Nevertheless, DHLI possessed the exclusive rights to use the trademark outside the US and DHL possessed the exclusive rights to use the trademark in the US. In 1990, DHL purchased the DHL trademark. The question involved was if DHL only transferred the ownership of the trademark with respect to the US market or if DHL also transferred the ownership of the trademark related to the overseas markets. In other words, who was the owner of the overseas trademark for TP purposes? The tax Court decided that the legal owner of the trademark, i.e. DHL, was the correct owner for TP purposes. Nevertheless, the court of appeal applied the developer – assister rule and thus overruled this decision by deciding that DHLI must be considered the owner of the overseas trademark, since she borne all the costs and risks

²⁹³ IBFD 2011, Portugal report.

²⁹⁴ IBFD 2011, Spanish report and IFA 2007, p. 534 and further.

²⁹⁵ Boulogne 2008 and Przysuski 2004.

²⁹⁶ *Eli Lilly & Co. V. Commissioner*, 84 T.C. 101 (1986), aff'd, 856 F.2d, see further Boulogne 2008, Przysuski 2004 and Verlinden 2005.

²⁹⁷ *DHL Corporation v. commissioner*, TC memo 1998-461, Aff'd, 285 F.3d 1210.

of development of the trademark outside the US. Important to note is the fact that DHLI had spent 340 million on promoting the trademark outside the US, while DHL only spent 150 million on the promotion of the trademark inside the US. Further, the following aspects are of main importance:

- DHLI had borne all the risks related to the trademark overseas;
- DHLI had incurred all the costs related to the trademark overseas;
- DHLI incurred excessive costs and risks (non-routine expenditures) in the development of the trademark overseas when comparing these risks and costs with the costs and risks an independent party would bear in the same circumstances. → *“Here the trial Judge espoused his bright line test which notes that, while every licensee or distributor is expected to spend a certain amount of cost to exploit the items of IP to which it is provided, it is when the investment crosses the bright line of routine expenditure into the realm of non routine that, economic ownership likely in form of a marketing IP is created.”*²⁹⁸

Therefore, the excessive development activities performed by DHLI were decisive to determine the ownership of the trademark²⁹⁹³⁰⁰.

4.7.4 The Glaxo – case

The facts of this case are already set out in the second chapter of this thesis concerning the definition of IP. Nevertheless, this case is also important towards the determination of the ownership for TP purposes. Namely, the main question in this case was how to split the US profit of 12,7 billion regarding the patented Zantac drug between the US subsidiary and the UK parent company, taking into consideration the marketing activities the subsidiary performed and the manufacturing activities the parent performed. In other words, who is or are the owners of the IP and to what proportion? And consequently, who is entitled to the income stream flowing from the exploitation of the IP? The following questions emerged in this case:

- Is the US profit of 12,7 billion attributable to the marketing IP or the manufacturing IP?
- Are the different marketing IP’s related to the patented Zantac drug, i.e. trademarks and other marketing IP, developed in the country where the marketing expenses are implemented or in the country where the research expenses are implemented?
- Is the marketing IP developed by the subsidiary itself or did the subsidiary enhance the value of the patented Zantac drug by performing the marketing activities?
- Who contributed to the creation of the value in the Zantac drug?
- Had Glaxo UK already become the owner of a valuable IP at the moment of licensing the patented drug to Glaxo US?
- Does it matter that Glaxo UK reimbursed most of the marketing costs to Glaxo US?
- Does it matter that Glaxo UK was the legal owner of the IP?
- Who performed the functions, used the assets and assumed the risks related to the IP?
- Who had borne the costs and risks related to the production of the patented Zantac drug?
- Did the marketing activities performed by Glaxo US differ from the activities an independent party would perform in the same circumstances (non-routine/routine functions)?
- Was Glaxo US a co-developer of the marketing IP?

The case was settled between the tax authorities and Glaxo and therefore there is no court decision available. The questions mentioned above are thus not solved. Nevertheless, according to the settlement, we can assume that the tax authorities took the position that the economic ownership concept should prevail, i.e. the company that had borne the costs, risks and performed the functions related to the patented Zantac drug. Since both companies performed functions and had borne costs

²⁹⁸ DHL Corporation v. commissioner, TC memo 1998-461, Aff’d, 285 F.3d 1210, § 7.13.4.

²⁹⁹ Boulogne 2008, Wittendorff 2010 and Przynski 2004.

³⁰⁰ The case Medieval Attractions NV v. comm’r, 72 TCM 1996-455 handled the same developer – assister rule with the same Court decision related to the economic owner of the IP.

and risks in relation to the IP, both companies were entitled to a part of the income stream and therefore owner of the IP³⁰¹.

4.7.5 *The G D Searle - case*³⁰²

This older case handled the transfer of the ownership of different IP's from a parent company situated in the US, to its Puerto Rico's subsidiary. The court decided that the subsidiary could be considered the owner of the IP's after the transfer, since there were business purposes involved for the transfer. The court thus favored the legal ownership concept by contractual agreement.

4.7.6 *The H Group Holding – case*³⁰³

This case involved royalties paid by a foreign subsidiary to its US parent company for the use of trademarks and trade names. The court decided that the parent company could be considered the owner of the IP, since she was the legal owner of the IP and the foreign subsidiary only incurred routine costs to promote and maintain the IP. Therefore, the subsidiary enhanced the value of the IP and therefore participated in the development process of the IP, but nonetheless could not be regarded as an economic owner because the costs she had made were not extraordinarily³⁰⁴.

Other countries

4.7.7 *The Supreme Court of Denmark*³⁰⁵

This case handled a distribution agreement concerning a trademark between a manufacturer and a distributor. According to the agreement, the manufacturer was entitled to terminate the agreement with six months prior notice and the distributor's rights and obligations required the permission of the manufacturer. At one moment the manufacturer terminated the agreement and paid the distributor goodwill associated with the establishment of a customer portfolio during the agreement. The Supreme Court decided that this payment was not goodwill for tax purposes, since the manufacturer was the owner of the customer portfolio. The manufacturer was in fact at all time entitled to terminate the agreement and could therefore cut off the access of the distributor to the customer portfolio. The manufacturer could thus be considered the correct owner of the IP in case there was no legal owner of the IP, since he controlled the IP.

4.7.8 *The lower court of Finland*³⁰⁶

This case concerned royalty payments from a Finnish subsidiary to a foreign parent company regarding a licensed trademark. The court ruled that the royalties were not deductible, since the subsidiary was the economic owner of the IP. There was in fact no evidence that the parent company would have borne any risks and costs in making the trademark valuable in Finland³⁰⁷.

4.7.9 *The lower court of the Netherlands*³⁰⁸

This case concerned the transfer of a trademark between different associated enterprises. The case will be discussed more extensively in chapter five. Nevertheless, it is important to note that the court decided that, although the legal ownership was transferred to an associated company, this company was not the owner of the trademark. The functions were namely de facto performed by the parent company, i.e. the management and control of the IP lied with the parent company.

³⁰¹ Wittendorff 2010, Boulogne 2008 and Musselli 2007.

³⁰² G D Searle & Co. v. commissioner, 88 T.C. 252 (1987).

³⁰³ Boulogne 2008 and Wittendorff 2010.

³⁰⁴ *Ibid.*

³⁰⁵ Supreme Court TfS 2001, 231 and IFA 2007.

³⁰⁶ IFA 2007, p. 240 regarding the Court Decision of May 4, 2005.

³⁰⁷ The article mentioned that this case was pending before the Supreme Administrative Court in 2007. Unfortunately, I could not find the decision from the Supreme Administrative Court.

³⁰⁸ Court of Breda May 26, 2007, AWB 05/1352.

4.7.10 *The Appellate court of the Netherlands*³⁰⁹

This case handled the transfer of license rights concerning a brand name between affiliated companies for ten years. According to the contractual agreement, the licensee paid the licensor 19 million for the economic ownership of the IP, were the legal ownership was worth about 200.000 and was sold at the same moment to an independent party. The question raised how to split the value of the economic and legal ownership towards the brand name. The following factors were taken into consideration:

- After the 10 years period of economic ownership the brand name would be worthless;
- The economic owner bore all the costs and risks related to the promotion and maintenance of the IP during the 10 years period;
- During the contractual agreement on the licensing rights, the economic owner was entitled to the income stream flowing from the IP.

In conclusion, the economic ownership concept, i.e. the company who bears the costs and risks related to the promotion and the maintenance of the IP and the company who has the control over the income flowing from the IP, can be considered the correct owner of the IP for Dutch purposes.

4.7.11 *The Maruti-Suzuki India Ltd v. ACIT - case*³¹⁰³¹¹

This court decision concerned TP in India and thus no OECD country. Nevertheless, this court decision is very important for TP purposes in OECD countries as well. The case handled the license of the brand logo 'Suzuki' from Suzuki Japan to a subsidiary named Maruti in India. According to the contractual license agreement, Maruti had the exclusive right to use the brand logo 'Maruti-Suzuki' (a joint trademark) in India including the right to sublicense the brand logo prior to a written consent of Suzuki. Maruti had to pay Suzuki a substantive royalty fee for the brand logo 'Suzuki' during the agreement. The case concerned the question of the correct arm's length royalty price for this international license transaction. The court took into consideration the following factors:

- Suzuki owned the Suzuki marketing IP;
- Maruti owned the Maritu marketing IP;
- The Maruti IP had more value than the Suzuki IP;
- Maruti possessed the exclusive right to use the brand logo 'Suzuki-Maritu';
- Maruti had incurred huge expenditures which went beyond the bright line test on marketing activities for the promotion of the brand logo 'Maritu-Suzuki';
- Suzuki had piggybacked on the Maritu trademark, without payment of any compensation;
- A comparison must be made between the marketing activities an independent party would undertake and the activities Maruti undertook;
- Maritu had performed all the functions and borne all the risks and costs related to the development of the brand logo in India;
- Would any prudent third party allow piggybacking of his established brand logo without any compensation³¹²?
- The arm's length price needs to be determined through all the rights obtained and obligations incurred by the parties, including the value of marketing IP.

In conclusion, the court came to the decision that, since the expenditures from Maritu exceed the bright line test and therefore enhanced the value of the brand logo of Suzuki through developed marketing IP, Suzuki had to suitable compensate Maritu for the efforts she made.

³⁰⁹ Appellate Court of Amsterdam, February 18, 2004, V-N 2004/39.9.

³¹⁰ Maruti – Suzuki v. ACIT, 2010-(236)-CTR-0225-SC.

³¹¹ http://www.us.kpmg.com/microsite/taxnewsflash/tp/2010/TNFTP10_39India.html.

³¹² Maruti – Suzuki v. ACIT, 2010-(236)-CTR-0225-SC, p.51.

4.8 Literature

Most authors only gave definitions of the different ownership concepts provided for in the OECD countries and the OECD TP guidelines and advised to come to one harmonized ownership definition of IP. There are nevertheless some authors who provided for an opinion on the correct ownership concept of IP. I will handle a few of these opinions in this paragraph.

The tax ownership of IP³¹³

This author gives preference to the legal ownership concept. According to the author:

- *“The legal owner of IP is always the tax owner of the IP;*
- *IP rights cannot be acquired by companies only performing assistance in the development process of the IP;*
- *The interest of a long-term licensee or distributor in IP may result in significant IP rights, but may never result in co-ownership of the IP;*
- *A short-term agreement results in no significant rights in the licensee unless the licensee may be considered to be the equivalent of a long-term agreement; and*
- *A long-term agreement may never lead to be the subject of renegotiations at arm’s length³¹⁴.*

In conclusion, the author gives priority to the legal ownership concept of IP in all cases. Long-term agreements may lead to significant IP rights, but not to co-ownership of the IP.

Determination of IP ownership in TP analyses³¹⁵

The author recognizes the existence of legal ownership. The protection of IP arising from legal title, is namely very important when valuing IP. Therefore, legal ownership may only be ignored in case a detailed functional analysis, i.e. the quantity of the costs made by the parties, the contributions made by the relevant parties in the development process of the IP and a due diligence report, lead to the conclusion that another party than the legal owner of the IP must be considered the economic owner of the IP.

The transfer pricing of IP³¹⁶

The author favors the economic ownership concept, since this concept most closely matches with the economic reality. According to the author, the legal ownership concept may be convenient to use, but is problematic from a transfer pricing point of view, since this concept does not match with the independent party treatment of the IP.

The ownership of IP³¹⁷

The author gives priority to the economic ownership concept. In case a party without legal ownership of the IP had made significant (economic) contributions to the development of the IP, this owner should override the legal owner of the IP.

Developing IP rights³¹⁸

The author argues that the income should stream to the company who merits this income, as she has made the efforts to develop, maintain or enhance the value of the IP. Therefore, the author gives preference to the economic ownership concept.

Public comments on the TP aspects of IP³¹⁹

³¹³ Mentz 1997.

³¹⁴ *Ibid.*

³¹⁵ Przynski 2004.

³¹⁶ Markham 2005, p.51.

³¹⁷ IFA 2007, p.25.

³¹⁸ Verlinden 2005, p.134.

³¹⁹ OECD letter from Richter Consulting Inc 2010.

This author says that there are three tests that should be applied to determine the owner of IP, i.e.:

- The legal owner of the IP (party which has the legal claim to the IP);
- The economic owner of the IP (party which bears the costs and risks with respect to the development of the IP);
- *The party that exercises the practical control of the IP through its use in the business activities*³²⁰.

4.9 The OECD meeting on the ownership issues of IP³²¹

The meeting focuses mainly on the definitional aspects of IP. Nevertheless, some members of the meeting gave their opinion upon the correct ownership concept on IP for TP purposes, i.e.:

*“The commercial right to enjoy the economic benefits associated with the IP”*³²²

Deloitte says that IP is valuable because the owner has the ability to stop others from using the IP and thus has the ability to earn income from the IP. Therefore, the commercial right to enjoy income from the IP is the decisive factor when determining the ownership of IP. This ownership concept can in principle be determined by following the contractual agreement between the related parties.

Nevertheless, if the factual analysis, taking into consideration the entitlement to the income from the IP, differs from this agreement, the agreement should be ignored. Further, Deloitte advises the OECD to seek to identify key factors that may lead to ownership rights.

*Legal ownership is key but if economic ownership is proposed, the definition must be harmonized*³²³

BIAS took the position that legal ownership is crucial, because this owner possesses protection rights towards the registered IP and may therefore claim indemnity or sue the abusive user. Further, only the legal owner has the ability to transfer or license the IP.

*The contractual agreement serves as a starting point, provided that the risks and control lies with this contractual party*³²⁴

Grand Thornton (“GT”) defines the current economic ownership concept as following:

- *“Paid to invent and develop an asset;*
- *Earns the right to use the asset;*
- *Can prevent others from using the asset or claiming title”*³²⁵.

To come to the correct concept of ownership GT puts emphasis on the new chapter nine of the OECD TP guidelines. According to GT the contractual agreement should not be ignored, but if the actual actions of the parties differ from the agreement, these actions should be followed. To define these actions GT applies chapter nine by analogy, namely:

- Who bears the risks? (An increased risk assumes increased returns);
- What is the contribution of the parties to the IP?
- Does the owner have the capacity to bear the costs and risks related to the IP?
- Where is the control over the IP situated? (Capacity to take on risks and to manage the risks. This condition requires also employees who can manage the IP development);
- Where are the functions performed?

The risks and the control over the IP should conclusively be decisive when determining the ownership of the IP.

³²⁰ Cottani 2008.

³²¹ http://www.oecd.org/document/4/0,3746,en_2649_37427_49015364_1_1_1_37427,00.html.

³²² Deloitte.

³²³ BIAC, the voice of OECD business.

³²⁴ Grand Thornton.

³²⁵ *Ibid.*

4.10 A comparison

The paragraphs above handled five different ownership concepts of IP for TP purposes. The opinions of the different governments, judges and authors vary significantly. In table 2, the handled ownership concepts of IP are stated in the horizontal column. The vertical column shows the different opinions concerning the correct ownership concept of IP for TP purposes.

Table 2

	Legal ownership			Economic ownership		
	Legal ownership	Contractual ownership	Control ownership	Functional ownership	Beneficial ownership	Economic ownership
OECD TP Guidelines & article 9 Of the OECD Model Treaty	Starting point	Starting point	Who takes the decisions on the risks and manages the risks regarding the IP.	The functional analysis.		Economic reality and the economic substance doctrine. The shares of the parties' contributions to the development of the IP.
Article 7 Report				Functional and factual analysis: Who performed the functions of creating the IP?		Significant people function: place of the active management and decision making process related to the risks that are undertaken in the development process of the IP.
Australia	Yes → starting point					Limited, in case the company acts to increase the value of the IP significantly.
US	Starting point, legal title	Starting point, contractual agreement	In case there is no legal owner → the party who has the control over the use and dissemination of the IP.	The developer-assister rule → (ability to) perform functions, exercise control and bear risks and costs related to the development of the IP.		Economic substance of the underlying transactions: control and risks. Commensurate with income doctrine: the actual economic activities. Bear the risks and costs of development of the IP.
UK	Starting point → activities to maintain the IP rights.	Starting point			Incur the expenditures and having the rights over the IP	Bear costs
Germany	Starting point	Starting point	Effective control: exclude the owner from affecting the IP.			

	Legal ownership	Contractual ownership	Control ownership	Functional ownership	Beneficial ownership	Economic ownership
The Netherlands	Starting point			Place of actual economic activities, i.e. control and management of the development process of the IP → Capacity to bear the risks and possess the skills and knowledge to manage & control the functions.		Bear the costs and risks of decrease/increase of the value and extinction of the IP.
Japan				Decision making process, functions performed, bearing the expenses, managing the risks.		The contribution to the activities for the formation, maintenance and development of the IP. Developed/enhanced the value of the IP.
France, Greece, Italy, Mexico, New Zealand	Yes					Only in cases there is no legal owner of the IP.
Belgium, Sweden, Czech Republic, Switzerland	Yes → only approvable ownership concept.					
Austria and Slovenia					Entitled to give in charge and sell the IP. Income from the IP under his own disposal.	Substance over form doctrine
Denmark	Yes		When it is difficult to determine a legal owner.			In case of CCA's.
Portugal						Substance over form
Spain	Starting point					CCA's and substance over form
US court decisions	Yes → owner of the IP rights and legal title. Are there business purposes?	Yes → decisive		Bearing excessive risks/costs.		The excessive development activities undertaken.

	Legal ownership	Contractual ownership	Control ownership	Functional ownership	Beneficial ownership	Economic ownership
Other court decisions			Cut of the access of using the IP.	Functions performed: management and control	Entitled to the income from the IP.	Bear risks and costs in making the IP valuable
Literature	Yes → protection arising from the legal title is important.			Functional analysis		Economic realities, significant contributions to the development of the IP, efforts made to develop/maintain/enhance the value of the IP.
OECD meeting	Crucial → protection rights towards the registered IP are important	Starting point	Entitlement to the income from the IP → ability to stop others from using the IP (prevent others from using the IP)	Bear the costs and risks to invent and develop the IP, capacity to bear these costs/risks, control over the IP, functions performed.		

4.11 Conclusion

The table demonstrates the very wide variety of ownership concepts and definitions used concerning IP in several OECD countries, literature, court cases, the OECD Model tax treaty and the OECD TP guidelines. Therefore, it is not possible to draw a clear conclusion based on all the different concepts and definitions that emerge. Nevertheless, it is possible to draw a general line and give a number of key factors to determine the correct owner of the IP for TP purposes.

Nevertheless, one main question should be answered every time a related party undertakes certain activities to develop, enhance or maintain IP she does not legally own:

- **Would an unrelated party undertake the same activities regarding the IP without entitlement to the income (i.e. ownership) arising from (the use and exploitation of) the IP?**

In case the unrelated party would undertake the same activities concerning the IP in a comparable independent transfer without being the owner of the IP but merely a service provider or a licensee, the related party cannot be considered the (co-)owner of the IP regarding this transfer. When the activities nevertheless exceed the activities an unrelated 'not owner' party would undertake without any entitlement to the income arising from the IP in a comparable independent transfer, leading to non-routine risks and costs, the related party may be considered the (co-)owner of the IP.

Further, the general line and key factors to determine the owner of IP should be:

1. **Legal ownership, i.e. ownership by legal title or contractual agreement, serves as the starting point.**

According to the most sources, the legal owner of the IP, i.e. ownership by contractual agreement or legal registration thus ownership by form, is very important and may therefore not be ignored. The importance of legal ownership can be traced back to one of the main characters to define IP for TP purposes mentioned in chapter two of this thesis, namely: "The IP can be controlled, or at least influenced, by the owner". When an IP is legally registered, the legal owner may use and exploit the IP

exclusively because the IP is protected by legal procedures, involving the right from the owner to (partly) exclude others from using or exploiting the IP. Therefore, the legal owner can claim an indemnity or may sue an abusive user of the protected IP. This protection condition is the main factor when determining the owner of the IP.

2. In case the economic ownership of the IP lies (partly) with another party, which can be determined by the application of a detailed factual and functional analysis, this party should be considered the (co-)owner of the IP for TP purposes.

The general line is that the economic ownership concept must have priority, taking into account all the characteristics of the functional and control ownership concept, in case the implementation of this concept leads to the conclusion that the substance varies from the legal owner of the IP. Further, the kind and the volume of the performed activities by the different group members should also be taken into consideration when determining the owner of the IP.

a. The kind of activities:

The extensive activities performed by the related party may include:

- Development activities of the IP;
- Maintenance activities of the IP;
- Enhancement activities of the IP.

The relevance of the different kind of extensive activities differs. In case the activities concern a trade IP, for instance a patented drug, the undertaken activities in the development process of the IP are of main importance, because developing a pharmaceutical drug is very expensive, risky and time-consuming. The income stream arising from the patented drug must therefore be attributed to the party who performed the relevant development activities. Nevertheless, when the activities refer to a marketing IP, for instance a trademark, the activities concerning the enhancement and maintenance of the trademark are crucial, because the development process of the trademark was not very expensive and therefore risky, but making the trademark valuable may be a risky and time-consuming process accompanied by high costs³²⁶³²⁷.

In conclusion, this economic ownership test will sometimes be broader than the economic ownership concept handled by different countries, since besides the party who developed the IP, parties who contributed to the enhancement or maintenance of the IP may also be considered the owner of the IP in case the activities significantly contributed to the value of the IP.

b. The factual and functional analysis

The fundamental analysis used in the OECD TP guidelines to determine an arm's length remuneration is the functional analysis of the activities undertaken, i.e. the place where the functions are performed, the assets are used and the risks are assumed, because this analysis best reflects the economic reality. Most countries, judges and authors apply the functional analysis or a part of the functional analysis to come to the correct owner of IP for TP purposes. Furthermore, the OECD applies the functional analysis when determining the owner of IP for article 7 of the OECD Model tax treaty purposes. Therefore, the functional analysis should be applied when determining the correct owner of IP for TP purposes. The functional analysis consists of:

- The functions performed;

This aspect concerns the place where the actual functions with respect to the IP are performed. To determine this place the following questions are important:

³²⁶ Visser 2005.

³²⁷ § 6.9 of the OECD TP guidelines.

- Where does the active management, or in other words the decision making process over the IP occur? This issue also relates to the question which party manages the risks of the IP.
- Who controls the IP? This issue involves the question who possesses the rights to use or exploit the IP exclusively.
- What is the actual location of the relevant development, enhancement or maintenance activities towards the IP? The place of the actual knowledge and skills to perform the functions related to the IP is therefore decisive.

- The assets used;

This aspect is not mentioned in the different handled sources. Nevertheless, this aspect is in line with the functions performed aspect and may therefore serve as a starting point. According to this aspect, the party who possesses the relevant assets to develop, enhance or maintain the value of the IP should be considered the owner of the IP. For instance, when a drug is developed through R&D activities, the company who possesses the factory, employees and other assets to develop this drug should be considered the owner of the patented drug.

- The risks assumed;

This aspect concerns the party who bears the costs and risks related to the development, enhancement or maintenance of the IP. The risks refer to the party who incurs the risks with respect to the failure of the development, enhancement or maintenance (extinction) of the IP, the risks of increase or decrease of the value of the IP or the risk that the IP becomes worthless. The costs are related to the expenses the parties bear.

The main questions to ask when analyzing the risk factor are:

- Who bears the excessive expenses related to the IP?
- Who incurs the excessive risks associated with the IP?
- Which party possesses the capacity to bear the costs and risks related to the IP?

In conclusion, the legal ownership concept serves as a starting point. Nevertheless, in case the functional and factual analysis lead to the conclusion that another party than the legal owner of the IP can be considered the economic owner of the IP, this economic owner should prevail for TP purposes.

5 The recognition and characterization of transfers of IP

5.1 Introduction

Transfers of IP between associated parties take place every day. Tax authorities pay great attention to transfers of IP, since transfers are often used for tax planning purposes. Namely, multinational enterprises try to shift highly-taxed income from IP into low-tax countries³²⁸. There are different ways to achieve these results. The UK parent company that developed and enhanced the value of the IP may for example transfer the ownership of the IP to a subsidiary situated in the Bahamas and this subsidiary may license the IP back to the parent company. Subsequently, the income stream arising from the IP will not be taxed³²⁹ and the royalties paid may be deducted from a high-tax basis in the UK. Another way to achieve an efficient tax structure is shifting income from the UK to the Bahamas by licensing worthless or fictitious IP from the Bahamas to the UK. Consequently, the UK's licensee may deduct royalty payments. Further, there may be a license agreement on IP between the Bahamas subsidiary and the UK company, where the actual transaction consists of a sale of this IP and consequently the change of the allocation of the income from the IP from the Bahamas to the UK. In conclusion, many legal transfers may not be consistent with the actual transactions undertaken.

Further, different OECD letters ask questions related to the recognition of transfers, the distinction between services and transfers³³⁰ and examples of correct transfers and license arrangements³³¹.

Taking these points into consideration, the main questions in this chapter will be:

1. A. Has the IP actually been transferred to an associated party or not?
1. B. Is the transfer a sale of IP, a license of IP or some other transaction³³²?
2. When is the transfer of the IP made?³³³

It should be noted that this thesis does not discuss the different disputable examples related to the transfer of IP, for instance package deals or assignments of employees. The thesis merely focuses on the recognition of transfers of IP for TP purposes.

The recognition of transfers of IP is in line with the previous chapters. Therefore, most OECD notes and some court decisions handled in the previous chapters are also applicable for transfer purposes. Further, most countries do not provide for any regulation on the recognition of a transfer³³⁴, since the transfer of IP broadly follows the ownership and definition issues around IP. Therefore, the domestic court decisions based on the specific facts and circumstances provide better outcomes on the characterization of transfers of IP. That is why this chapter will not contain a country comparative research. Moreover, this chapter will not repeat the moves already handled.

The second paragraph will set out the two commonly used ways to transfer IP between associated parties. Thereafter, the relevant OECD TP guidelines, article 12 of the OECD Model tax treaty and the article 7 Report notes on the transfer of IP will be handled. Paragraph four will note the importance of the different anti-abuse provisions, which fall outside the scope of this thesis but should nevertheless be kept in mind when characterizing a transfer. Subsequently, paragraph five will discuss a few domestic court decisions on the transfer of IP. Some literature and the IAS definition of a transfer will

³²⁸ Boulogne 2008 and OECD letter MTC 2010.

³²⁹ Since the Bahamas do not consist of a corporate income tax or other withholding taxes.

³³⁰ For instance OECD letter Altius alliance 2010 and KPMG 2010.

³³¹ OECD letter JFTC 2010 and Richter Consulting 2010.

³³² Zollo 2009.

³³³ These questions are also asked in the different OECD letters. For instance Taxand 2010, Mc Dermott 2010, MTC 2010 and CMS 2010.

³³⁴ IFA 2007, p. 28.

be discussed in paragraph six. Additionally, a comparison will be made in paragraph seven. The chapter ends with the conclusion in paragraph eight.

5.2 The definition of different ways to transfer IP

There are many ways to transfer IP. The two main ways to transfer IP between two or more associated parties are:

- The outright sale of the IP;
- The transfer of the rights related to the IP, i.e. licensing the IP³³⁵.

5.2.1 The definition of an outright sale of IP

According to different dictionaries³³⁶, an outright sale of IP means the transfer of the ownership of IP from one party to another associated party, including the possession and the management over the IP³³⁷. This is a logical conclusion and therefore the OECD TP guidelines should recognize the transfers which lead to the change of ownership.

An outright sale may therefore only be recognized in case the ownership of the IP actually changes. The change of ownership should be tested by the application of the key lines and factors mentioned in the fourth chapter of this thesis. The notes from the different sources handled in the following paragraphs will underline this statement.

The consequence of an outright sale of IP is the realization of a (arm's length) capital gain. This capital gain will be taxed in the country of residence of the seller, because this company is entitled to the income from the sale of the IP, since she is the owner of the IP at the moment of the transfer.

5.2.2 The definition of the license of IP

On the basis of the definitions laid down in different dictionaries, licensing means that the owner of the IP gives the other associated party permission to use the licensed IP in its territory³³⁸. In case of licensing, the first owner remains the owner of the IP and therefore remains entitled to the income stream from the IP³³⁹. The recognition of license arrangements involves the following questions:

- Should the license arrangement actually be considered an outright sale of the IP?
- Should the licensed IP be considered a fictitious or worthless IP and thus the license arrangement a fictitious arrangement?

To answer the first question the key lines and factors mentioned in the conclusion of chapter four should be taken into consideration. To answer the second question, the characteristics of IP handled in the conclusion of the second chapter of this thesis should be tested. This conclusion will be substantiated by the following paragraphs.

The consequence of the license of IP is a royalty stream. Depending on the facts and circumstances of the license arrangement, the licensee pays the licensor a certain royalty fee as a consideration for the right to use the IP³⁴⁰. These royalty payments may be deducted from the tax-base in the licensee's country and may be taxed in the country of the licensor.

³³⁵ § 6.16 of the OECD TP guidelines and IFA 2007.

³³⁶ http://dictionary.cambridge.org/dictionary/british/transfer_1?q=transfer.

³³⁷ <http://oxforddictionaries.com/definition/transfer?q=transfer>, [http://en.wikipedia.org/wiki/Transfer_\(patent\)](http://en.wikipedia.org/wiki/Transfer_(patent)).

³³⁸ <http://dictionary.cambridge.org/dictionary/british/license?q=license>, <http://en.wikipedia.org/wiki/License>.

³³⁹ Jie-a-Joen 2007.

³⁴⁰ Article 12 of the OECD Model Tax treaty and § 6.16 of the OECD TP guidelines.

5.3 The OECD approach

5.3.1 Article 12 of the OECD Model tax treaty

The OECD mentions in the commentary to article 12 of the OECD Model tax treaty³⁴¹ that the article does not apply in case the royalty fee may actually be considered a payment for the alienation of the full ownership of the IP. This alienation depends on the specific facts and circumstances of the transfer, taking into consideration the domestic legislation on alienation. Further, the OECD notes that the transfer cannot be altered by the form of the consideration. Conclusively, article 12 of the OECD Model tax treaty applies the factual analysis to distinguish license agreements from outright sales of IP, taking into consideration the domestic tax rules on transfers.

5.3.2 The OECD TP guidelines

Paragraph 2.2 and 4.4 of this thesis can also be applied in this paragraph. Therefore, I will only mention some additional remarks and not repeat the factors mentioned in paragraph 2.2 and 4.4.

Chapter one of the OECD TP guidelines

Firstly, the OECD mentions the importance of the functional analysis in case of transactions, because the compensation in case of transfers between independent parties usually reflects the functions performed, assets used and risks assumed³⁴². Further, the OECD indicates that the contractual terms and structure serve as a starting point in case of transfers, but that the transfers must always be based on the transfers actually undertaken³⁴³. Nevertheless, the terms and structure must only be disregarded in exceptional cases. The tax authorities may disregard the contractual transfer only in case:

- The economic substance of the transfer differs from its form, taking into consideration the risks associated with the IP³⁴⁴; or
- The contractual transfer between the associated companies differs from those which would have been adopted by independent companies behaving in a commercially rational manner³⁴⁵.

In both cases the tax authorities may re-characterize the transfer, because the associated transfer is not at arm's length according to article 9 of the OECD Model tax treaty.

Chapter six of the OECD TP guidelines

The OECD seems to give preference to the specific facts and circumstances when characterizing the transfer of IP. This means that the OECD embraces the factual analysis when recognizing transfers of IP³⁴⁶.

Chapter nine of the OECD TP guidelines

Business restructurings sometimes involve the transfer of IP. The OECD mentions the transfer of risks related to the IP as the decisive factor for the recognition of the transfer, involving the costs of the IP, the management of the risks, and the costs related to the realization of the risk³⁴⁷. Furthermore, the OECD mentions the importance of the functional analysis in case of the transfer of IP³⁴⁸. The OECD mentions also that multinational enterprises are free to structure their business operation as they want and act in their own best economic interests. Therefore, the form of the transfers presented by the multinational enterprises must only be disregarded in the exceptional circumstances mentioned in

³⁴¹ § 8.2, § 15 and § 16 of the commentary to article 12 of the OECD Model Tax Treaty.

³⁴² § 1.42 of the OECD TP guidelines and further.

³⁴³ § 1.52 and § 1.64 of the OECD TP guidelines.

³⁴⁴ § 1.69 of the OECD TP guidelines.

³⁴⁵ § 1.65 of the OECD TP guidelines.

³⁴⁶ § 6.16 and § 6.17 of the OECD TP guidelines.

³⁴⁷ § 9.39 of the OECD TP guidelines and further.

³⁴⁸ § 9.85 of the OECD TP guidelines.

chapter one of the OECD TP guidelines, involving the recognition of the actual undertaken transfers³⁴⁹.

5.3.3 Article 7 of the Report on the attribution of profits to PE's

Since paragraph 4.5 of this thesis can also be applied in this case, I will only discuss the recognition of dealings as mentioned in the article 7 Report.

According to the article 7 Report, *“the functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise³⁵⁰.”* Further, the comparison with independent parties dealing under the same circumstances is very important when recognizing transfers³⁵¹ and the transfer of risks, responsibilities and benefits towards the IP are relevant³⁵².

In conclusion, according to the OECD the economic reality, i.e. the substance over form doctrine, is of main importance when recognizing a transfer between a head office and PE's, since the transfer should be based on the actual transfer undertaken by the associated parties. The functional analysis, taking into account the risks and functions associated with the transfer, should be tested. Lastly, a comparison has to be made with independent parties operating in the same circumstances.

5.4 Domestic anti-abuse provisions

In general, multinational enterprises try to shift income streams to low-tax subsidiaries to avoid taxes every day. Therefore, many countries provide for anti-abuse provisions through legislations, guidelines or court decisions. For example, the Netherlands possess of the 'fraus-legis' jurisprudence, Germany provide for an anti-abuse rule and an anti-treaty shopping rule and the US includes the substance over form doctrine. Further, the OECD TP guidelines also seem to apply anti-abuse provisions in paragraph 1.65 and further in case of the transfer of IP. Moreover, the European court of justice seems to apply an anti-abuse provision as well through the court decision Cadbury Schweppes in which purely artificial arrangements must be neglected for tax purposes. The anti-abuse provisions seem to disregard the transfer of IP in case the economic reality does not change and the motive to transfer this IP seems to be the avoidance of taxes. These different anti-abuse provisions fall outside the scope of this thesis. Nevertheless, it should be noted that in case of transfers of IP between different OECD countries, these countries should consider the different anti-abuse provisions as well.

5.5 Domestic court decisions

Domestic tax authorities pay much attention to potential fictitious or otherwise 'wrong' transfers of IP. Therefore, I will handle a few domestic court decisions on the refusal or re-characterization of transfers through legal registration or contractual arrangements.

The US

5.5.1 Bell intercontinental corporation - case³⁵³

The parties in this case were company Bell and its different subsidiaries. Bell received payments from its subsidiaries for the transfer and the right to use IP by contractual agreement. The question was if the payments should be considered long-term capital gains or payments for the license of the rights to use the IP. According to the court, a sale should contain the transfer of all the substantial rights of value in the IP. If not, the transfer merely consists of a license of IP. This should be determined by the substance of the transaction, the intention of the parties and the surrounding circumstances. The form,

³⁴⁹ Part VI of chapter nine of the OECD TP guidelines.

³⁵⁰ § 35 of the Report on the attribution of profits to PE's and Peeters 2011.

³⁵¹ § 50 and § 59 of the Report on the attribution of profits to PE's.

³⁵² § 178 of the Report on the attribution of profits to PE's.

³⁵³ Bell intercontinental corp. v. US, 381 F.2d 1004, 1010 (Ct. Cl. 1967).

the right from the grantee to terminate the contract or the method of payments is irrelevant. Taking these points into consideration, the court re-characterized the license arrangements as outright sales in case:

- The substantial rights include the right to exclude others from making, using or selling the IP under the patent grant;
- The license agreement is exclusive;
- The licensee may sub-license the IP in some way;
- The possibility of the transferor to cancel the arrangement in case of solvency or failure to meet the minimum payments is irrelevant for the characterization of the transfer;
- The characterization depends on all the actual facts and circumstances;
- The full and complete control over the use of the IP lies with the transferee;
- The whole beneficial ownership is being transferred;
- The license consist of a transfer for the remaining life of the IP³⁵⁴;
- The transferor does not possess the power to cancel the agreement (this right should have practical value to the grantor³⁵⁵);
- The substance of the transaction contains a sale³⁵⁶.

Further, it should be noted from this court decision that not the legal form, but the transferred nature of the rights over the IP should be taken into consideration when characterizing the transfer of IP³⁵⁷.

5.5.2 *The Bausch & Lomb - case*³⁵⁸

This case involved the license of the right to use technology to manufacture lenses from an US parent company to its Irish subsidiary. The subsidiary sold the produced lenses back to the parent company. The case covered the question if the subsidiary could actually be considered the licensee of the technology or merely a contract manufacturer of the production of the lenses. This situation is called the roundtrip problem. The court decided in this case that the allocation by legal title should be followed for TP purposes, except in cases the transfer is capricious, arbitrary or unreasonable and thus the facts distinguish significantly from the form. Further, each transaction should be consistent with the economic reality that would obtain between independent parties performing the same transaction at arm's length. The recognition of the economic reality and the comparison with independent parties is thus of main importance. The court consequently decided that the Irish subsidiary bore price and volume risks related to the production benefits and therefore, the subsidiary could not be classified as a contractual manufacturer³⁵⁹.

5.5.3 *Other US court decisions*

Different court decisions repeated one or more points set out in the Bell – case. For instance:

- The mutual intention of the associated parties is decisive, taking into account the terminology (language of the agreement) used in the contractual agreement as the decisive starting point³⁶⁰;
- In principle, the total factual setting and the total language of the agreement are important and not the legal form of the transfer³⁶¹;
- To highlight something as a sale, all the substantial rights of value must be transferred. Further, in case the transferor did not transfer a right of no practical value, the transfer can still be considered a sale³⁶²;

³⁵⁴ See also Zollo 2009.

³⁵⁵ Young v. commissioner, 269 F.2d 89, 92-94 (2d Cir. 1959).

³⁵⁶ Hooker Chem. & Plastics Co. V. US, 591 F.2d 652 (Ct. Cl. 1979).

³⁵⁷ Zollo 2009.

³⁵⁸ Bausch & Lomb v. US, 933 F.2d 1084 (2d Cir. 1991).

³⁵⁹ IFA 2007, p.640.

³⁶⁰ Pickren v. US, 378 F.2d 595, 599 (5th Cir. 1967).

³⁶¹ Kronner v. US, 110 F.Supp. 730, 734 (1953).

³⁶² E.I. du Pont de Nemours and Co. v. US, 432 F.2d 1052, 1055 (3d Cir. 1970).

- The transferee should retain all rights, titles and interests over the IP in a particular geographic territory³⁶³.

Further, the court decided in the Hooker – case that the control over the IP, namely the right to exclude others from using, disclosing or exploiting the IP was the main difference between a sale and a license³⁶⁴. It should also be noted that the US court puts much emphasis on the legal (through legal registration or contractual agreement) transaction. In different court cases the court decided that a transfer may only be re-characterized when the transfer lacks any business purpose, according to the intention of both parties³⁶⁵.

The Netherlands

5.5.4 The Supreme court of the Netherlands³⁶⁶

This case handled the transfer of a patented ‘slubcatcher’ and the corresponding patent rights from the Dutch group member 1 to its foreign subsidiary A, situated in the Netherlands Antilles. The development, manufacturing and maintenance process related to the ‘slubcatcher’ took actually place in the Netherlands through company 1. Namely, company 1 gave TNO the order to develop the ‘slubcatcher’, using the equipment of company 1, and the manufacturing process of the ‘slubcatcher’ also took place by using the equipment of company A. Further, the directors involved were in some way linked to the Dutch group member. The costs and risks related to the IP are nevertheless borne by company A. The question involved was if the royalty payments related to the IP should be attributed to subsidiary A, or if the Dutch company 1 was entitled to the royalty payments. The supreme court discussed merely the arm’s length remuneration of the transfer, since company A only paid company 1 the costs made by company 1 related to the IP. This discussion falls outside the scope of this thesis. Further, the Supreme Court handled the ignorance of company A as a legal entity, discussing the anti-avoidance provision of the Netherlands. The court decided that company A could never be ignored, even if the structure lacks any business purpose, since only legal transactions may be ignored, but not legal entities. Therefore, the contractual agreements should be followed in this case.

5.5.5 The lower court of Breda 2007³⁶⁷

This case handled a taxpayer who possessed the shares in a holding who subsequently owned the shares in company 1, company 2, company 3 and company 4. This case concerned the roundtrip problem, i.e. the sale of a trade name within a fiscal unity (from company 1 to company 4) and the subsequent exclusive license agreement of this IP between company 4 and the taxpayer. The court decided that the royalty payments were not deductible, since the license arrangement lacked any business purpose. Further, the ownership over the IP did not lay with company 4, since the taxpayer actually controlled and managed the IP instead of company 4.

5.5.6 The lower court of Breda 2010³⁶⁸

This case concerned a license agreement on IP between a Dutch taxpayer and an associated company (“J”), established in Liechtenstein. Additionally, the Dutch taxpayer deducted the royalties paid to J from its taxable income. The court came to the decision that the licensed IP’s were in fact not valuable and therefore did not exist, i.e. were fictitious. The court took into consideration that J did not possess any specific knowledge regarding the exploitation of IP’s and the facts and circumstances point out that J did not perform activities to develop IP’s. Conclusively, the court decided, taking into

³⁶³ Hooker Chem. & Plastics Co. V. US, 591 F.2d 652 (Ct. Cl. 1979).

³⁶⁴ *Ibid.*

³⁶⁵ Boulogne 2008 .

³⁶⁶ The supreme court of the Netherlands, June 25, 1969, *BNB* 2010/93

³⁶⁷ Lower court of Breda, March 26, 2007, *AWB* 05/1352.

³⁶⁸ Lower court of Breda, March 24, 2010, *AWB* 09/2639.

consideration the factual and functional analysis and not the legal form of the license that the license agreement was fictitious and thus should be disregarded for tax purposes.

Other countries

5.5.7 The Belgian court of appeal³⁶⁹

This case concerned the license of a trade name from the French parent company to its Belgian subsidiary which the subsidiary already possessed. The court came to the decision that the royalty payments were fictitious, since no valuable IP was being transferred, because the IP was not valuable from the perspective of the Belgian subsidiary. The court decided also that the agreement was artificial and that the French shareholder had free disposal over the name after the license.

5.5.8 Danish court decisions

The Danish court provides for two relevant decisions on the transfer of IP. Firstly, the court decided that the moment of the transfer of the right to use IP is the time the licensor acquires the right to the license fee³⁷⁰. Further, one case involved the sale of licenses from a Danish company to its Swiss subsidiary. Since the Danish company continued to perform all the activities related to the licenses, including the control and management over the licenses, and no business activities were performed by the Swiss company, the substance over form doctrine prevailed. Therefore, the transfer should be disregarded, since the Danish company remained the owner of the licenses³⁷¹.

5.5.9 Norwegian court decisions

The Norwegian court came to a few decisions related to the transfer of IP, namely:

- The change of the legal title over the IP is of main importance when characterizing a transfer³⁷²;
- The form of the payments is irrelevant and the transfer should be based on the actual facts of the case concerned³⁷³.
- In case of package deals, some IP may be sold, i.e. the IP has been taken over by another company, including the legal title, the risks and the functions related to the IP³⁷⁴.

5.5.10 The Israeli court decision³⁷⁵

This case involved commission payments towards the transfer of pharmaceutical products from a foreign company to an offshore company. The court decided, in accordance with the substance over form doctrine, that the payments were artificial and therefore contrary to the civil law. In case the transfer payments were also fictitious and therefore did not exist, the case would be criminal. Conclusively, the court challenges transfers which are artificial because they lack any economic purpose³⁷⁶.

5.6 The IAS and literature

According to the IAS, the sale of goods encompasses:

“The transfer to the buyer of the significant risks and rewards of ownership of the goods, the entity retains neither continuing managerial involvement to

³⁶⁹ IFA 2007 and IBFD 2011, the Brussels court of appeals, 4 October 1972, JPDF 1972, p.311.

³⁷⁰ IFA 2007, p. 226.

³⁷¹ IBFD 2011, Danish TP report.

³⁷² The Osram case, see IFA 2007, p. 477.

³⁷³ The Mercuri International case, IFA 2007, p. 477.

³⁷⁴ The Cytec case, IBFD 2011, Norwegian report and IFA 2007, p. 476.

³⁷⁵ IBFD 2011, Israeli report.

³⁷⁶ <http://tax.uk.ey.com/NR/rdonlyres/ecs27uzg2m6zetuy5kmxjxk6jijuh76rbs43nsgeo2wapyxuc4gg2ayqpsm4juawui2ntygj7yncm qdx3kmdit7vpub/ITS+in+the+News+2.pdf>.

the degree usually associated with ownership nor effective control over the goods sold, the amount of revenue can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the entity". To reflect the economic substance of the transaction.³⁷⁷".

Therefore, the functional ownership of the IP must be transferred before recognizing the transfer of IP for accounting purposes. Further, the IAS mentions that royalty fees may only be recognized if:

"It is probable that the licensee receives the economic benefits associated with the transaction, the amount of revenue can be measured reliably and the royalties are recognized by the substance of the contract³⁷⁸".

Conclusively, the substance over form doctrine plays a significant role when determining the license of IP. Further, the IAS does not mention anything about the definition of a license arrangement.

Transfer or license of IP³⁷⁹

According to the author, it is essential to characterize a transfer of IP as a license or as a sale. Full transfer of IP is nevertheless very difficult to achieve when dealing with IP. The difference between a sale and a license has to be made through a factual analysis, taking into consideration the underlying facts and circumstances. Further, the author mentions that the main difference between a transfer and a license is:

"(a) a complete assignment of rights necessarily involves an ownership change, entitling the new owner to freely exploit the acquired rights and to prevent others from exploiting them (including the former holder of the rights); (b) on the other hand, a licensor retains the ownership in all the intellectual property rights, and simply "authorizes" the licensee to carry out specific acts that would otherwise be prohibited by the holder."

Transfer or license of IP³⁸⁰

The author mentions that the difference between a sale and a transfer of IP is that in case of the licensing IP, the licensor remains the owner of the IP, including the risks of decrease in value of the IP or enjoyment of the benefits in case the IP becomes more valuable or has a longer life expectation.

The transfer of IP³⁸¹

The first Italian author links the transfer of IP to the transfer of the risks and functions towards the IP, depending on the actual facts and circumstances of the case. Additionally, the functional analysis may be evident when determining the transfer of IP. The second Dutch author reviews the transfer of the functions, the risks assumed and the assets used related to IP as the decisive factors when recognizing a transfer of IP.

Transferring IP³⁸²

The author does not give his own opinion on the transfer of IP, but gives important notes, taking into consideration the different OECD notes and domestic regulations/court decisions. The author says that if the owner of the IP grants an exclusive right to use the IP for the entire life of the IP, the license will be re-characterized as a sale by most countries. Further, the author mentions that in most countries all the rights in the IP must be transferred at least within a geographic area or a particular

³⁷⁷ IAS 18 § 13 and further.

³⁷⁸ IAS 18 § 29 and further.

³⁷⁹ Van Herksen 2008.

³⁸⁰ IBFD 2011, Finnish report.

³⁸¹ IFA 2007, p. 369, 370 and IFA 2007, p. 437.

³⁸² Zollo 2009.

field of use of the IP to recognize the transfer as an outright sale of IP. Thereby is the form of the agreement not relevant but rather the rights which are transferred.

The general report on IP³⁸³

According to the author, the IP is transferred at the moment the IP is in some way made available to an associated company. Further, the recognition of a transfer of IP depends on a factual analysis, taking into consideration the actual activities according to the arm's length principle. Moreover, the transfer should include the transfer of the whole value of the IP from one party to the other.

The OECD letters³⁸⁴

From the perspective of the letter from Bonn, the transfer of IP must have significant impact on the function and risk profile of the associated parties. According to Altus Alliance, the OECD should provide for guidance on the business purpose and economic substance of a transfer and the consequences of not recognizing a transfer. Lastly, Astra Zeneca takes the view that the lack of a commercial basis serves as the main point for re-characterization of the transfer of IP.

The OECD meeting with business commentators³⁸⁵

The author takes the view that, according to paragraph 1.64 of the OECD TP guidelines, a transfer of IP between associated companies may only be re-characterized in case the transfer lacks a commercial basis based on the facts and history. In other words, the contract must in principle be followed, because multinational enterprises should be able to structure transfers in the way they think it is appropriate for them. Further, transfers should also satisfy different (non-tax) regulations. When it is possible to price the structured transfer in an economically rational manner, the author is in doubt whether there is a legitimate role for re-characterization of the transfer.

5.7 A comparison

The different sources previous handled in this chapter, will be set out shortly in table 3.

Table 3

	Sale	License
Character	The owner of the IP changes	Only the right to use the IP changes. The licensor remains the owner of the IP
Consequence	Realization of a capital gain in the country of residence of the transferor	Royalty payments. Taxable in the country of the licensor, deductible in the country of the licensee.
Article 12 of the OECD Model Treaty	Specific facts and circumstances, form of the transaction irrelevant	Royalty fee or alienation of the full ownership of the IP?
The OECD TP guidelines	Functional and factual analysis, comparison with independent parties, presented structure serves as the starting point since enterprises are free to transact the way they think it is appropriate, but actual transaction decisive. Substance over form doctrine, commercial purpose, risks transfer,	
The Report on the attribution of profits to PE's	Functional and factual analysis, economic substance, comparison with independent parties,	
US court decisions	Sale: The transfer of all substantial rights of value in the IP → the control over the IP, the license is exclusive, the right from the licensee to sub-license the IP, factual analysis, transfer of the beneficial ownership, transfer	

³⁸³ IFA 2007, p. 28.

³⁸⁴ Bonn 2010, Altus Alliance 2010, AstraZeneca 2010.

³⁸⁵ AstraZeneca, <http://www.oecd.org/dataoecd/20/23/46366888.pdf>.

	for the remaining life of the IP, substance over form doctrine, possibility to cancel the agreement. Further, the presented transaction should be followed except in cases the transaction is fictitious, economic reality, comparison with independent parties, intention from the parties decisive, transfer of all the rights, interest and title over the IP.
The Dutch court decisions	Business purpose of the transaction, transfer of the control ownership, factual and functional analysis, the existence of the IP at the moment of transfer: is the IP valuable?
Other countries	Transfer of the control ownership, functions transferred, substance over form, change of the legal title over the IP, actual transaction, transfer of risks and functions, is there a valuable IP being transferred?
IAS	Sale: Transfer of the risks, benefits, control and management, interest and ownership related to the IP, reliable measurement, and economic substance of the transaction. License: interest and substance over form.
Literature	Full transfer of IP. Sale: the transfer of the complete rights including the entitlement to freely exploit the IP and prevent others from using the IP. License: licensor retains the (functional) owner of the IP and authorizes the licensee the right to use the IP. License for the entire life of the IP is a sale. The nature of the rights transferred is decisive. Factual and functional analysis, actual transaction. Moment: IP is made available to the other party.
OECD business commentators	Business purposes and economic substance of the transaction, transfer of the risks and functions, commercial basis of the transaction. The presented structure must in principle be followed; since enterprises are free to transact the way they think it is appropriate. Rational manner.

5.8 The conclusion

The table demonstrates that the conclusions drawn in the second and fourth chapter of this thesis are broadly in line with the factors to determine the transfer of IP. Therefore, the key characters mentioned in chapter two and the key lines and factors handled in chapter four will also emerge in this chapter. Nevertheless, the emphasis and the arguments behind the key lines on the characterization and recognition of the transfer of IP differ from the other chapters.

The purpose of the characterization of transfers of IP

The emphasis of this chapter is the prevention of aggressive tax planning transfers by multinational enterprises. Multinational enterprises may try to deduct their tax burden by shifting IP to countries with low or zero tax rates through outright sales or license agreements related to the IP. In principle, the multinational enterprises are free to transfer the IP in the way they feel it is appropriate. Therefore, tax planning is not prohibitive and the presented structures should be respected. Nevertheless, there are exceptional situations in which the domestic tax authorities are able to disregard or re-characterize the transfer. These situations will be set out through the key lines and questions as will be discussed below.

One main question should be answered every time two associated enterprises transfer IP:

- **Would unrelated parties enter into the same transfer had they been dealing at arm's length³⁸⁶?**

The transfer must be compared with the same transfer between independent parties. For instance, in case as a result of a license agreement the licensee bears excessive risks and costs and controls all the activities related to the licensed IP, an unrelated party would never sign the license agreement, because the benefits from the license agreement would never be beneficial for the licensee. Further, the transfer of a worthless IP would for example never occur between independent parties.

³⁸⁶ IBFD 2011, Canadian Report.

Further, the following key factors should also be taken into consideration when recognizing and characterizing a transfer of IP:

Disregarding the transfer of IP

1. Does the IP exist at the moment of the transfer?

This question involves the identification of IP. In case the transfer includes IP that does not exist, the transfer should be disregarded, because there is no valuable IP being transferred. The characteristics to define IP are:

- The IP has substantial value;
- The IP will cause reasonable foreseeable economic benefits;
- The IP is non-physical in nature;
- The IP clearly and definitely exists and is therefore identifiable;
- The IP can be owned;
- The IP can be controlled, or at least influenced by the owner of the IP;
- The IP is transferable to third parties.

The most relevant and most important factors that should always be tested to define IP at the moment of the transfer are the substantial value and the reasonable foreseeable economic benefits related to the IP.

Characterizing and re-characterizing the transfer of IP

2. The legal transfer, i.e. the presented structure through legal registration or contractual agreement by the multinational enterprise, serves as the starting point.

Since multinational enterprises are free to structure their business and therefore their transfers the way they feel it is appropriate, the legal structure as presented by the enterprise should be followed. Further, in case of an outright sale, the transfer of the legal ownership, i.e. ownership as presented by the enterprise through contractual agreement or legal title, should serve as the starting point, since the legal owner can control the IP. Therefore, the legal owner can exclude others from using or exploiting the IP through a claim of indemnity or sue the abusive user of the IP.

3. In case the substance of the transfer significantly distinguishes from the presented form, which can be determined by application of a detailed factual and functional analysis, the transfer should be re-characterized for TP purposes

In principle, the form of the transfer, i.e. an outright sale or a license, as presented by the multinational enterprise will be consistent with its substance. Nevertheless, it may be possible that the presented form is not in conformity with the actual transfer undertaken by the associated companies, taking into account the functional and factual analysis as presented in chapter four. In this case, the form of the transfer must be re-characterized to reconcile the transfer with the actual transfer and thus the economic reality of the transfer.

a. The factual and functional analysis

We have already seen this analysis in the previous chapter. In transfer cases, the question of the substance of the transfer must also be solved by applying the functional analysis. This is implicit laid down in the OECD TP guidelines, domestic court decisions and also article 7 and article 12 of the OECD Model Treaty take into consideration the functional analysis when characterizing the transfer of IP. Moreover, the previous chapter may also be relevant to understate the application of the factual and functional analysis. Therefore, the factual and functional analysis set out in the previous chapter should also be applied when determining the correct transfer of IP for TP purposes, i.e.:

- The functions performed;

This aspect concerns the place where the actual functions with respect to the IP are performed after the transfer. To determine this place the following questions are important:

- Where does the active management, or in other words the decision making process over the IP occur?
 - Who controls the IP?
 - What is the actual location of the relevant development, enhancement or maintenance activities towards the IP?
- The assets used;
 - The risks assumed;

This aspect concerns the party who bears the costs and risks related to the IP after the transfer. The risks refer to the risks of increase or decrease of the value of the IP. The costs concern the expenses the parties bear on the IP after the transfer.

The main questions to ask when analyzing the risk aspect are:

- Who bears the excessive expenses related to the IP?
- Who incurs the excessive risks associated with the IP?
- Which party possesses the capacity to bear the costs and risks related to the IP?

In conclusion, the transfer should be re-characterized in case the form of the transfer is not consistent with all the factors of the functional analysis mentioned above. This means:

- In case the form of the transfer constitutes a license, but the licensee performs all the functions, uses the assets and assumes all the risks related to the IP after the transfer, the license transfer should be re-characterized as an outright sale of the IP.
- In case the presented structure contains an outright sale of IP, but the IP remains at the disposal of the transferor, i.e. the transferor still performs most of the functions, uses the assets and assumes some risks concerning the transferred IP, the presented structure should be re-characterized as a license agreement, since the transferor only transfers the right to use the IP.

It should be noted that merely in cases the substance differs *substantially* from its form, and therefore the economic reality regarding the transaction is not consistent with the form of the transaction, re-characterizing is legitimate.

The third question of this chapter, i.e. when is the transfer of the IP made, cannot be found back in any OECD regulations and only in a few domestic court decisions. Nevertheless, when applying the economic reality of the transfer, the transfer is made at the moment the IP is made available to the transferee and therefore at the disposal of the transferee. Consequently, from that moment, the transferor is entitled to the income from the sale or license of IP.

6 CCA's, marketing IP and the roundtrip problem

The application of chapter 4 and 5

6.1 Introduction

The ownership of IP

Chapter four highlights that ownership issues of TP of IP will always arise in case there is just one legal owner within one group but other associated companies perform activities to develop, enhance or maintain the same IP without being the legal owner of this IP. The question in this case is at what point these associated parties who are not legal owners of the IP should be considered the owner of the IP instead of or together with the legal owner of the IP.

There are many different ways to develop, maintain or enhance the IP. The first option is the independent development of the IP. In this case the legal and the economic ownership of the IP lie with the same party, since one party develops the IP in its own name, using its own assets, equipment and employees and bearing its own risks and costs. The second option is that one company within the group is the legal owner of the IP, but the activities are performed by other members of the group through a contractual agreement for which the subsidiaries are paid service fees by the legal owner. In this case, the activities are performed by other group members, but the control and management concerning the IP and the risks and costs related to the IP are borne by the legal owner of the IP³⁸⁷. Conclusively, the legal and economic ownership lies with the same company. Nevertheless, there are two other ways to develop, maintain or enhance IP, namely through a CCA or through the license of marketing IP. These options will be discussed in this chapter, since the economic ownership of the IP in these cases lies most of the time (partly) with another member of the group than the legal owner of the IP.

The transfer of IP

The characterization of a transfer of IP is broadly in line with the ownership issues around IP, since an outright sale of IP means the change of the ownership of the IP. Therefore, the entire economic ownership, taking into account the key lines provided for in chapter four, should be transferred to (re-)characterize the transfer as an outright sale of IP. Further, ownership means the entitlement to the capital gains and royalties received when transferring IP. Therefore, the residence country of the transferor may tax the income stream received on the IP. That is why I will discuss cases related to the transfer of IP together with the ownership issues around IP.

6.2 CCA'S

The development of trade IP mostly involves high costs and risks. That is the reason that many group companies agree to share these costs and risks of the development of IP through a CCA³⁸⁸, i.e. an arrangement for the joint development of IP. Nevertheless, only one member of the CCA group is the legal owner of the IP, since the IP can only be registered at one name. According to the OECD TP guidelines, the economic ownership concept should prevail in this case. This economic ownership can be determined through the appropriate contributions of the different parties in the CCA and the corresponding part of the potential benefits the participants would receive in case the developed IP would be valuable³⁸⁹. The economic ownership percentage of the parties must conclusively be consistent with the contributions of the parties in the development process of the IP. According to the OECD, this remuneration can be determined by making a comparison with the activities independent

³⁸⁷ § 6.3 of the OECD TP guidelines.

³⁸⁸ § 8.3 of the OECD TP guidelines.

³⁸⁹ § 8.6 of the OECD TP guidelines.

parties would perform in the same circumstances³⁹⁰. This OECD concept is consistent with the general lines and key factors that emerged in the conclusion of the previous chapter, which will be demonstrated in the following example.

Example 5:

Group X, which includes company A, company B and company C, entered in 2006 into an agreement under which the associated companies shared the costs and risks related to the development of a potential pill against cancer. They agreed in this CCA that company C would be the registered owner of the IP. Further, company A would receive 50% of the benefits that may reasonable arise from the use and exploitation of the potential pill and company B and company C would derive both 25% of these benefits. After 2009, the 'existence' moment of the IP, the IP was exploited to third parties. During the development process of the IP between 2006 and the end of 2009, company A had borne 60% of the costs and risks related to the IP, company B had borne 25% and company C only incurred 15% of the costs and risks of the IP, because she was not able to manage more risks related to the IP.

In this case, company A is entitled to 60% of the income stream arising from the exploitation of the IP to third parties, company B is entitled to 25% of the benefits received from this exploitation and company C may only derive 15% of the income from exploiting the IP. Consequently, company A is the economic owner of the IP for 60%, company B for 25% and company C can be considered the economic owner of the IP for 15%.

The key factors to come to this conclusion are:

1. Company C is the 100% legal owner of the IP according to the registration. Nevertheless, the contractual agreement serves as the decisive starting point, taking into account the ownership of company A for 50% and company B and C for 25%.
2. The economic owner differs from this starting point, taking into account the factual and functional analysis, i.e.:
 - The activities of the companies only involve the development of the IP. Since the development process is very risky and costly it should be appropriate to reward the developers of the IP by entitlement to the income arising from exploiting the IP in 2010.
 - The functions are performed according to a percentage of 60, 25 and 15% instead of 50, 25 and 25%. This conclusion follows from the actual cost and risk contributions of the companies. Since the facts of the case do not suggest otherwise, we can assume that the functions performed are in accordance with the contributions the different companies made to develop the IP.
 - The assets used: We cannot come to a conclusion which assets are used, since the facts of the case do not mention something about this aspect.
 - The risks and costs are borne by the companies for 60, 25 and 15%.

Further, an independent party would never incur 60% of the costs and risks if she only would be entitled to 50% of the benefits from the IP. The agreement is consequently not at arm's length.

In conclusion, the key factors provided for in chapter four of this thesis are the same as the view of the OECD in chapter eight of the OECD TP guidelines. Both perspectives acquire that the ownership of IP must be consistent with the contributions (the functions performed and the costs and risks borne) the different CCA companies actually make. According to both theories, this contribution and matching benefit can be tested by making a comparison with the activities an independent party would undertake under the same circumstances.

³⁹⁰ § 8.7 of the OECD TP guidelines.

6.3 Marketing activities undertaken by enterprises not owning trademarks or trade names

This paragraph focuses on the case where the legal and economic owner of a trademark or trade name licenses this IP to one of her overseas subsidiaries. This subsidiary undertakes activities to maintain or enhance the IP overseas. The question involves at which level the undertaken activities by the licensee could lead to the (co-) ownership of the licensee over the IP overseas. The ownership issue may also involve the transfer of the IP from the parent company to its overseas subsidiary.

6.3.1 Question one: the compensation for providing excessive marketing activities

Most contractual license agreements involve trademarks or trade names from one related party to another for a certain period. According to the OECD TP guidelines, the licensee could be compensated as a service-provider or share in any additional return attributable to the marketing activities she performs. The analysis of the entitlement to the income stream attributable to the trade name during the life of the license agreement should mark the following factors³⁹¹:

- The rights of the licensee;

This factor involves the following questions:

- Does the contract consist of a long-term or a short-term license agreement?
- Grants the contract the licensee exclusive rights to use the trademark or trade name in its own territory?
- Grants the contract the licensee the right to sub-license (exploit) the licensed trademark or trade name to a third party?

- The size of the marketing activities performed by the licensee;

This factor concerns the bright line test, which means that the performed marketing activities by the licensee should exceed the marketing activities an independent third party would undertake under the same circumstances. In case the marketing activities do not exceed the bright line test, compensation is not necessary, because the undertaking of some marketing activities by the licensee is normal within a license structure.

- The reimbursement by the owner of the trademark or trade name.

This factor refers to the situation the licensee is reimbursed for all the expenses she occurs regarding the licensed trademark or trade name. In this case, the licensee can merely be marked as an agent, and may therefore never be an economic owner of the IP.

Further, the excessive marketing activities performed by the licensee may involve the development of own marketing IP, separate from the trademark or trade name or the activities may enhance the value of the trademark or trade name owned by the licensor. Both cases lead to the development and enhancement of the trade name in the territory of the licensee, but from another perspective.

In conclusion, if the license agreement consist of a long-term agreement, granting the licensee exclusive rights to use and sub-license the IP in her country, the licensee bears all the costs and risks related to the activities performed to make the IP valuable and these costs and risks exceed the amount an independent party would undertake under the same license agreement, the licensee must be compensated through a share in any additional return attributable to the marketing activities she performs. These factors are consistent with the functional and factual analysis as concluded in chapter four.

³⁹¹ § 6.36 and further of the OECD TP guidelines and Boulogne 2008.

6.3.2 Question two: the identification of the way to determine the return attributable to the performed marketing activities by the licensee

According to the OECD TP guidelines, most countries and most authors seem to assume that the owner of the IP should suitably compensate the licensee for the marketing activities she performs by a reduction of the royalty rate or decrease of the purchase price of the product³⁹². Nevertheless, in my opinion, the licensee becomes the (co-) economic owner of the IP and is therefore entitled to a part of the income that arises from the IP instead of receiving any compensation from the owner of the IP. I will illustrate this by the following example:

Example 6:

Company A possesses a valuable trade name, i.e. Manzio, in Germany. In 2006, company A licensed this trade name to company B for an indefinite period of time. Company B is situated in the Netherlands. After the license agreement, company B possesses the exclusive rights to use the trade name in the Netherlands. Further, company B is free to sub-license the licensed trade name to other parties in the Netherlands. In return, company B has to pay company A a royalty rate of 30% of the drugs sold. Since the Dutch public was not aware of the name Manzio and therefore this trade name was not valuable in the Netherlands, company B incurred massive expenditures to promote the trade name. After five years of promotion activities, the name Manzio became the premier drugs brand in the Netherlands.

Who is the owner of the trade name in the Netherlands?

Company B can be considered the economic owner of the trade name in the Netherlands through the excessive marketing activities she performed, since:

- Company A can be considered the legal owner of the trade name for TP purposes;
- Company B performed extensive marketing activities to enhance and develop the value of the trade name in the Netherlands. Nevertheless, company A developed the name itself. As the development process of the trade name itself can be considered less risky and costly than the enhancement and maintenance process of the trade name in the specific country involved, the marketing activities performed by company B in the Netherlands are more important.
- The functional and factual analysis lead to the conclusion that company B can be considered the owner of the trade name in the Netherlands, since:
 - The functions related to the trade name in the Netherlands are performed by company B. Company B also controls and manages the risks concerning the trade name in the Netherlands. Further, company B possesses the exclusive right to use and exploit the licensed trade name in the Netherlands for an indefinite period in time and may receive the benefits that will arise from the use of the trade name.
 - The assets used to enhance the value of the trade name in the Netherlands come from company B.
 - Company B incurs all the costs and risks related to the enhancement of the value of the trade name in the Netherlands.

Further, an independent party would never incur all the costs and risks related to the development and enhancement of the value of the trade name in the Netherlands, without being entitled to the income that would potentially arise from the use of this trade name. The undertaken activities therefore exceed the bright line test.

In conclusion, company B can be considered the economic owner of the trade name in the Netherlands and therefore the paid royalties must be disregarded and the income attributable to the trade name in the Netherlands must be allocated to company B.

Example 7:

Taking the previous conclusion of example 6 into consideration the following questions can also be asked:

- A. Has an IP been transferred from company A to company B in 2006?
- B. Contains the transfer a license or an outright sale of the IP?

There has actually been a transfer between company A and company B in 2006, since the IP transferred is valuable in 2006. In other words, the characteristics to define IP are fulfilled, namely:

- The IP has substantial value;
- The IP will cause reasonable foreseeable economic benefits;

The question is if the IP has a value for the Dutch market at the moment of entering into the license agreement. While the trade name may not be known in the Netherlands in 2006, the IP nonetheless has substantial value in Germany in 2006. Because of the high value of the trade name in Germany, the IP has proven that it may have significant identification and communicational value in other parts of the world³⁹³. Therefore, the trade name will probably cause foreseeable economic benefits in the Netherlands as well.

The other aspects of IP are fulfilled, since the trade name consists of a marketing IP, cannot be qualified as a service, is identifiable, can be owned and can be controlled by company A and is transferable to third parties.

The license contains a sale of IP from company A to company B in 2006, since:

- The legal transfer is presented as a license. Therefore, company A remains the owner and is entitled to the royalties received from the Dutch licensee;
- Nevertheless, the substance substantially differs from the presented form of the transaction, as set out in the previous example.

Further, an unrelated party would never enter into a license agreement under these terms and conditions, since the necessary performances, high risks and huge costs outweigh the potential benefits from the IP.

In conclusion, since the substance differs substantially from its form, the license must be re-characterized as an outright sale of the trade name in 2006 from company A to company B.

6.4 Marketing activities undertaken by enterprises not owning trade IP

We have seen in the previous paragraph that excessive marketing activities performed by a licensee who does not own a trade name may lead to the economic ownership of the trade name in the territory where the licensee has the exclusive rights to use and exploit the trade name. The question in this paragraph involves if the same is true when a trade IP is licensed and the licensee incurs the same excessive marketing activities.

This question will be answered by handling the earlier mentioned Glaxo – case.

Example 7 the Glaxo - case:

This case concerned the distribution of a patented pharmaceutical drug in the US. The parent company, situated in the UK, developed the drug and was therefore the legal owner of the patented drug where its US subsidiary undertook excessive marketing activities to develop and enhance the value of the IP in the US, because the patented drug was almost worthless in the US. The subsidiary developed separate marketing IP during the enhancement process in the US, for instance customer lists and the expansion of the sales network. The UK parent company reimbursed the US subsidiary for almost all the marketing costs she made.

Who is the owner of the patented drug in the US?

³⁹³ De Hosson 1999.

Both parties can be considered the economic owner of the patented drug in the US, since both parties satisfy the conditions under the functional and factual analysis:

- The UK parent company is the legal owner of the IP;
- The UK parent performed the most important activities related to the IP, namely the R&D activities to develop the drug. These R&D activities are very risky and costly and therefore the UK parent company should in principle be entitled to the whole income stream attributable to this IP. Nevertheless, the US subsidiary developed own marketing IP separate from the drug. These separate marketing IP's are of main importance for the development and enhancement of the value of the patented drug in the US and therefore, these activities lead to entitlement to the income stream attributable to the drug as well;
- The functions are performed by both the parent company and the subsidiary. The manufacturing activities are namely performed by the UK parent company, where the marketing activities are performed by the US subsidiary. Both companies controlled their activities and it seems that the US subsidiary possessed the exclusive right to use and exploit the drug in the US;
- The assets used came from both companies;
- The costs and risks are borne by both companies. The R&D risks and costs are incurred by the UK parent company and the marketing efforts are borne by the US subsidiary, which exceed the bright line test.

Further, an independent party would never develop marketing IP distinct from the patented drug if she could not receive the benefits arising from this marketing IP.

In conclusion, both parties can be considered the owner of the IP in the US. It must be noted that an important difference between the case of performing marketing activities towards trade IP or marketing IP is that only if the subsidiary develops own marketing IP's separate from the trade IP and these marketing IP's are of main importance in the exploitation process of the trade IP, this subsidiary may be considered a partial economic owner of the trade IP. When the subsidiary merely performs marketing activities to enhance the already existing valuable trade IP, the subsidiary must be considered a contractual manufacturer and therefore merely be compensated by the UK parent company for the incurred functions, risks and costs.

6.5 The roundtrip problem

One of the main transfer issues around IP is the roundtrip problem. This means that for instance an UK parent company sells her IP to one of her subsidiaries situated in the Bahamas and subsequently licenses the IP back or purchases the products resulting from the IP from the Bahamas' subsidiary. The question is if the structure presented by the associated companies represents an actual transfer of IP.

Example 8:

The parent company ("A") of a multinational Group, situated in the UK, develops a valuable trademark. After the development process, A sells the trademark in 2010 to her subsidiary ("B"), situated in the Bahamas. After the sale, B exploits the trademark to manufacture products. After incurring costs to develop the product, the products came into the market in 2011. Subsequently, A bought 80% of the products back and other customers purchased 20% of the products. There was no contractual or other obligation from the side of A to purchase the products back from B.

Has the trademark been sold to B in 2010 or must the transfer be re-characterized as a license agreement or another transaction, namely a contractual manufacturing transaction?

The trademark is sold in 2010 to B, because:

- The legal structure presented contains the sale of the trademark;

- The substance of the transaction does not substantially differs from its form, because:
 - The functions related to the trademark after the sale are performed by B. Further, the control and management over the trademark lies with B, since there are no obligations with A referring to the exploitation of the trademark and the legal title over the IP lies with B.
 - The assets from B are used after the transfer;
 - The risks and costs concerning the trademark are borne by B, since there is no obligation for A to buy the products related to the trademark back from B. Therefore, B bears the risks that the manufactured products will not be purchased by any (associated) customer and it may also be possible that the price of the products do not outweigh the costs of manufacturing the trademark³⁹⁴.

Further, an unrelated party would enter into the same deal had it been dealing at arm's length.

Conclusively, the legal structure should be followed, because the form of the transfer, namely the transfer of the ownership, is consistent with its form.

³⁹⁴ The case would be different when A commits itself to purchase all of the manufactured products referring to the trademark from B from the moment of the outright sale of the trademark. Namely, in this case B will not incur any risks or costs related to the trademark and could therefore merely be characterized as a contractual manufacturer.

7 Conclusion

7.1 Initial remarks

This thesis discussed three of the main complex issues around IP within the arena of the OECD member countries with the purpose of providing an important framework concerning a clear identification and clarification of IP. By using this thesis, the OECD project committee may have important factors and key lines to change chapter six of the OECD TP guidelines. The problem statement I tried to answer in this context was:

“What should be the identification of IP under the OECD TP guidelines, with regard to the definition, ownership and transfer of IP?”

The first question analyzed in this thesis is what would be the appropriate definition of IP for TP purposes. Questions that arose related to the definition of IP where for instance whether it should be necessary to provide for a clear definition of IP within the OECD TP guidelines, if it would be enough to include a list of IP in the OECD TP guidelines and whether it should be possible to give any general characteristics of IP that could be applied in all the cases concerning the definition of IP. The first part subsequently provided for a clear definition of IP, focusing on the main characteristics of IP for TP purposes. Thereafter, the thesis discussed the ownership issue around IP, since countries and courts apply many different ownership concepts. This part involved which associated company should be entitled to the income stream from the IP for TP purposes and therefore subject to tax. The focus during this chapter was whether the legal ownership or the economic ownership concept should prevail and how these concepts should be construed according to the OECD TP guidelines. To answer this question, questions like the importance of the substance over form doctrine and the legal registration of the IP or the presented contractual agreements were discussed during this part. The second part subsequently provided for key lines and factors to determine the correct owner of the IP for TP purposes. Lastly, the third part of this thesis investigated the recognition of a transfer of IP and the possibility to re-characterize a transfer. The purpose of this last part of this thesis was to avoid aggressive tax planning opportunities within the arena of TP of IP by discussing the exceptional competence from the tax authorities to re-characterize an associated transaction in case the substance differs significantly from its presented form. This part followed from the previous parts of this thesis and therefore only involved the key findings and results.

The arm's length principle, i.e. the question if an unrelated party, operating under the same circumstances, would behave in the same way when comparing with the associated operation at stake, represents the decisive factor in this thesis and must consequently be applied in all the parts of this thesis when determining the characteristics, ownership and transfer of IP for TP purposes.

In the following paragraphs, I will discuss the methods used and answers towards the three research questions of this thesis.

7.2 What should be the definition of IP under the OECD TP guidelines?

Nowadays, different OECD countries characterize IP for TP purposes differently. As a result, there is an international lack of understanding what exactly must be considered IP for TP purposes. Consequently, when multinational enterprises operate in IP in different countries, tax differences appear which result in double or non-taxation. It is therefore essential to describe harmonized characteristics to define IP, because a list of IP can never be exhaustive.

This part investigated the characteristics of IP from the perspective of the OECD, the OECD business meeting, the business commentators written to the OECD, the IAS, intellectual property law, domestic

regulations, domestic judges and different authors. Through the use of the different opinions on the characteristics of IP, the first part of this thesis pointed out several characteristics which must be met in order to speak of IP for TP purposes.

Conclusively, the OECD should include the following paragraph in chapter six of the OECD TP guidelines to provide for a clear and practical definition of IP for TP purposes:

§ 6.1 of the OECD TP guidelines

For the purposes of this chapter, the term “intangible property” includes IP that meets the following characteristics:

- The IP has substantial value;
- The IP will cause reasonable foreseeable future economic benefits;
 - The IP is non-physical in nature;
 - A service can never be IP;
- The IP clearly and definitely exists and is therefore identifiable;
 - The IP can be owned;
- The IP can be controlled, or at least influenced by the owner;
 - The IP is transferable to third parties.

Further, when defining IP, the following question should always be kept in mind:

“Is there a value attributable to the IP for which an unrelated party would pay a certain price?”

The second part of this research question discussed the moment of existence of IP, namely after the moment the IP has substantial value, definitely exist and may be transferred. Further, several examples of definition issues around IP, like business opportunities and R&D teams, were handled. These examples only serve as a clarification of the characteristics to define IP, as provided for in the previous chapter. Therefore, these examples may not be included in the annex to the renewed chapter six of the OECD TP guidelines.

7.3 Who should own the IP under the OECD TP guidelines?”

There are different ways to develop, enhance and maintain IP, for instance through a CCA, a contractual manufacturer or by entering into license or distribution agreements with overseas subsidiaries. These structures result in the question which party or which parties may be entitled to the income stream arising from the IP and who must therefore be considered the correct owner of the IP for TP purposes. Within the regulations and the court decisions of the different OECD member states, there are several different ownership concepts used. Further, different authors and business commentators embrace different ownership concepts. The ownership concepts used may be categorized as following:

1. Legal ownership, including ownership by legal title or contractual agreement.
2. Economic ownership, including control, beneficial and functional ownership.

This part of the thesis analyzed the ownership concepts adhered by the written letters to the OECD, the OECD TP guidelines, the article 7 Report on the attribution of profits to PE’s, domestic regulations, domestic court decisions, OECD business commentators and different authors. Through application of these sources, this part provided for the correct ownership concept for TP purposes, considering legal ownership as a starting point, but giving preference to the economic ownership concept in case the legal owner differs significantly from the economic owner through the application of the functional analysis.

Therefore, chapter six of the OECD TP guidelines should take into account the following paragraph when determining the correct owner of IP for the purpose of chapter six of the OECD TP guidelines:

§ 6.2 of the OECD TP guidelines

For the purpose of determining which party is entitled to the income stream from the IP, the following key factors should be taken into account:

- Ownership by legal title or contractual agreement serves as the starting point;
- In case the economic ownership of the IP lies (partly) with another party, which can be determined by the application of a detailed factual and functional analysis, this party should be considered the economic (co-)owner of the IP for TP purposes.

When applying the functional analysis, the following key factors should be taken into account:

- The functions performed, taking into consideration the place of management and control over the IP and the location of the actual activities related to the IP;
 - The assets used;
- The risks assumed, including the bearing of the costs and risks related to the IP and the capacity to bear those risks.

Further, the kind and volume of the activities undertaken by the associated parties, including the bright line test, should be taken into consideration.

For the activities of owners and non-owners of IP to satisfy the arm's length principle, the ownership or the non-ownership of the IP accompanied with a certain compensation for the performed activities, must be consistent with the activities an independent owner would undertake under comparable circumstances.

7.4 When should we recognize or re-characterize the transfer of IP under the OECD TP guidelines?

The last part of this thesis analyzed the transfer of IP. Multinational enterprises are in principle free to structure their business in the way they feel it is appropriate. Consequently, the presented form of the transfer should be followed for TP purposes. Nevertheless, some presented structures may only be conducted for tax planning purposes. In these cases, it may be possible to disregard the presented transfer and re-characterize or ignore this transfer.

The last part of this thesis investigated when a transfer of IP actually contains valuable IP, taking into consideration the key characteristics previous mentioned. Further, this chapter focused on the character of a transaction, taking into account the factors under which it may be possible for the tax authorities to re-characterize the presented structure, involving the license or outright sale of IP. This investigation analyzed the remarks in the OECD TP guidelines, the article 7 Report on the attribution of profits to PE's, article 12 of the OECD Model tax treaty, court decisions, literature and from OECD business commentators. It should be noted that this chapter is in line with the previous chapter on the ownership issue around IP for TP purposes.

The OECD should record a paragraph in chapter six of the OECD TP guidelines on the recognition and the (re-) characterization of transfers of IP, providing for the following remarks:

§ 6.3 Of the OECD TP guidelines

The presented form of the parties should generally be taken into account, since the presented transfer serves as the best evidence regarding the true allocation of the IP. Nevertheless, there are three circumstances in which it is possible for the tax administration to disregard the presented transfer. First of all, in case the transferred IP cannot be defined as IP according to paragraph 6.1, the transfer must be ignored. Further, when the actual transfer undertaken by the associated parties differs substantially from its presented structure, the tax administration may disregard the structure presented and consequently re-characterize the structure. The actual transfer must be analyzed through the application of the same functional analysis as mentioned in paragraph 6.2, including the functions performed, the assets used and the risks assumed. The last circumstance involves the case when the presented structure would never be made between independent parties dealing at arm's length.

Further, the moment of transfer should be the moment the IP is made available to the transferee.

7.5 Examples related to the ownership and transfer issues around IP

Chapter six of this thesis involved examples on the application of the correct ownership concept, namely CCA's and the license (distribution) of marketing IP to overseas subsidiaries. Further, the last example handled the roundtrip problem, answering the question if we can speak from one of the exceptional circumstances on the transfer of IP that enables the tax administration to disregard the IP. Example 6, 7 and 8 should be included by the OECD in the annex to chapter six of the OECD TP guidelines, because these examples may lead to a more clear application of the ownership and transfer factors as set out in the renewed paragraph 6.2 and 6.3 of the OECD TP guidelines.

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