PRICEWATERHOUSECOOPERS

Intellectual Property Rights from a Transfer Pricing Perspective

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Bart Lieben (Landwell)

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FOREWORD

In recent decades, the importance to businesses of intellectual property rights (mainly trade marks, patents and copyrights) has seen a sharp increase, as a result of which it has become crucial to offer them adequate legal protection. This also means that these rights are increasingly identified as 'key value drivers' within international groups. From a tax point of view, these assets offer significant opportunities for legitimate modular planning of results. Particular transfer pricing techniques can be applied to achieve tax optimisation based on a fair allocation of profit potential according to the economic risk profiles and functions of the group entities. It is precisely these functions that can more easily be re-located in the case of intangible assets, thus giving rise to what are known as 'portable profits'. This is in contrast to generating profits from business activities within a physical infrastructure, which are hard to dismantle, e.g. via production facilities.

Already some 30% of world trade affects goods and services that are in some way associated with intellectual property, and this proportion is ever on the increase. Let us take the example of typical e-commerce businesses, which are started up without any significant investments in equipment and thus are confronted with few or no (financial) hurdles, and therefore contribute to a rapid proliferation of intangible assets.

It is also crucially important to pay attention to the legal protection, tax impact and planning possibilities from these changes.

This book is constructed around the 'life-cycle' of intellectual property rights, seen from a transfer pricing perspective. In so doing, the emphasis from a legal viewpoint is especially laid on copyright, trade marks, know-how and patents. After introducing and describing these rights, we look at their structure (including whether property rights are developed by a company itself, or cost-sharing agreements) and application (i.e. own use, licensing or transferring property rights and combating infringements); subsequently we look at the valuation (with an emphasis on trade marks), migration and extinction of such rights.

These various phases are illustrated throughout using specific examples. The relevant international case law is also referred to, together with administrative practice. In this respect, the authors have also called on the expertise of the worldwide network of tax and legal experts within PricewaterhouseCoopers and Landwell[1].

30 November 2001

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Her activities include dovetailing the tax dimension of the transfer pricing issue into the strategic planning of multinational groups. She also devotes an important part of her time to restructuring projects, concentrating on operational efficiency. She represents the Transfer Pricing group within PwC's multi-disciplinary 'Intellectual Property Planning Group'. From a transfer pricing perspective, the accent here lies on tax optimisation for the location or migration of intangible assets.

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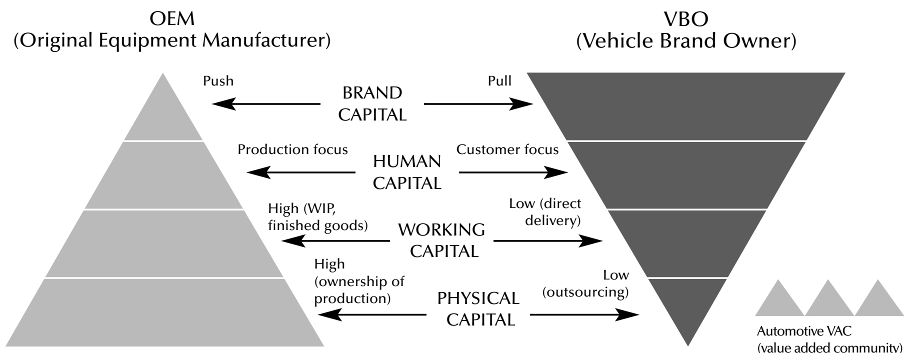
CHAPTER I

INTRODUCTION

1. When Emil Jellinek, the Austrian General Consul in Nice, went looking for a new car in 1900, it was not such a simple matter as nowadays; you couldn't then just walk into a dealership around the corner and place an order or even buy a car from stock. Emil was looking for a decent, comfortable car and he eventually ended up talking to Gottlieb Daimler, a small manufacturer of cars from Germany. The order was given on condition that Daimler named the car after Jellinek's eleven-year-old daughter, Mercedes[1]. The rest is history.

2. You might wonder what relevance this story has to the subject-matter of this book. It is this: in 1900, the accent in Daimler's business lay on producing decent cars, in which ownership of the means of production was central. Since in subsequent years there was still no clear picture of what demand there was for these cars, he went to work on the basis of forecasting and a stock was built up. The major part of the capital was therefore used to finance the means of production and stocks. Employees were also engaged in the production process and, to a much lesser extent, in sales.

3. What we now see is that this model – which reigned for a major part of the 20th century – is slowly changing. Under the impulse of the globalisation of our economy and the ever-increasing use of information and telecommunications technology in companies' business processes, the search is on for models in which costs can be saved, on the one hand, and more attention can be paid to added value, on the other. As we see below in fig. 1, the result is actually a reverse of the traditional pyramid.



Source : MEANS, G., SCHNEIDER, D., Meta-Capitalism, ed. PricewaterhouseCoopers, USA, Wiley, 2000

[1] J. MANTLE, *Car Wars – De Strijd tussen Autogiganten op weg naar de 21e Eeuw*, Weert, Van Buuren, 1996, p. 78.

4. The production process itself has become a 'commodity' in a number of sectors, and is no longer regarded as a core activity for a lot of businesses, which are therefore increasingly looking for partners that are prepared to take over production. An example is Ericsson, which concluded a deal to outsource its entire mobile telephone production. In Business Week's Top 100 Technology Businesses for 2001 even, it was a so-called 'contract manufacturer' that took the laurels, at least for a while: the Canadian company Celestica Inc. produces for Sun Microsystems and Motorola, amongst others[2].

5. Modern information and communications technology (ICT) allows of close working with production partners, including following up production by electronic means. Hence, we see more and more companies forming a sort of value added community with their partners in order to optimise their cooperation. An example of this is Cisco, the majority of whose production is supported by a network of sub-contractors, and which keeps very close tabs on production using technology.

6. Holding stocks was regarded by companies as a necessary evil, since they are expensive; where it is possible to limit them – without thereby jeopardising customer service – there is no hesitation in doing so. Here, as well, the application of internet technology has contributed advice. There is greater transparency throughout the supply chain, as a result of which the producer can more easily obtain information regarding customers' wishes and can make quicker moves to satisfy them. This means production can be limited to when an order has been placed and so-called 'build-to-order' models can be applied (see below in chapter V for the example of Dell, which applies this technique with success). The consequence is a much smaller stocks and savings in funding.

7. Workforce deployment has also changed over the years. For a number of reasons, including the increased outsourcing of production, employees have increasingly been assigned to sales. This does not mean that there were no sales staff previously but that, alongside pure transactional dealings, a lot of importance is being placed on marketing.

8. The most important change – and also the most relevant for this book – is the shift of funds towards businesses intangible assets (intellectual property). By outsourcing

[2] *Business Week*, 18 June 2001, pp. 51-74; the survey update, whereby the companies' stock performance during the previous six months is calculated, shows a drop in ranking to no. 62 however, Business Week, 26 November 2001, pp. 70-74.

production and cutting back on stocks, funds are released for applying to the added value of the business. In the car sector, we would cite the creation of technological advancement by means of research and development (R&D) efforts, design of the car, or even (and in some cases even mainly) development of the brand. In many cases, it is a combination of these intangibles that makes a business successful. To return for a minute to our first example, we can see that, 100 years after Emil Jellinek's purchase, the Mercedes brand has notched up a value of USD 21 billion, and thus takes 12th position in the list of the most valuable trade marks[3]. Nowadays, a great number of people buy this type of car for the sole reason that it is a Mercedes, which clearly demonstrates the brand's value. The trade mark would not of itself, however, be capable of existing in the long term were it not supported by a strong product, so that there remains an important interaction between, say, the R&D efforts of the company and expansion of the brand. Today, it is fair to say that around 70 % of the value of an average car is in fact intangible-related[4].

9. Whereas until recently the words 'intellectual property' were not even in the vocabulary of most business managers, we are now seeing a certain shift and, for many of the foregoing reasons, it is increasingly being viewed as a strategic asset that is much more than a bundle of legal documents that are stored in the archive under a mountain of dust. The successful business of the future will in our opinion be one whose managers not only grasp the fact that intellectual property rights can be the most valuable assets in their company but also succeed in deploying those assets in the most profitable manner. Naomi Klein refers to Tommy Hilfiger in her book 'No Logo' as being 'less in the business of clothes manufacturing than he is in the business of signing his name. The company is run entirely through licensing agreements with Hilfiger commissioning all its products from a group of other companies: Jockey International makes Hilfiger underwear, Pepe Jeans London makes Hilfiger Jeans, Oxford Industries make Tommy shirts, the Stride Rite Corporation makes its footwear. What does Tommy Hilfiger manufacture? Nothing at all'[5].

10. Paying sufficient attention to the legal protection and tax planning surrounding intellectual property rights will contribute in no small measure to this success.

[3] Interbrand, the World's Most Valuable Brands List, August 2001, www.interbrand.com; see also The Best Global Brands report in Business Week, 6 August 2001, pp. 44-55.

[4] K. Nordström, J. Ridderstrale, *Funky Business. Talent Makes Capital Dance*, 2000, London, Pearson, p. 19.
[5] N. Klein, *No Logo*, Flamingo, London 2000, p. 24; see also footnote 175.

11. The fact that a trade mark can constitute a major part of the value of a business is shown, in particular, by the list of the most valuable brands published annually by Interbrand. On the basis of the method of calculation used by Interbrand, for instance, we see that the Coca-Cola brand constitutes some 60% of the market value of the company and that in the case of BMW the share rises to as much as 77%.

12. Over the years, businesses have often built up an impressive portfolio of intellectual property. Frequently, however, insufficient attention has been paid in so doing in following up these assets properly, so that there is no clear picture within many company groups of factors such as what assets there are, which company within the group owns these assets, what their value is, etc. A classic example of this is Dow Chemical, which in 1994 organised an internal audit to take stock of the group's intellectual property[6]. Over the course of a year, it was confirmed, *inter alia* that they owned some 29,000 patents spread over the entire group, some of which were no longer in use (or had even never been used) but for which costs were being incurred. By means of more efficient deployment, Dow managed in a short period to effect considerable savings and generate additional income for the group.

13. In this respect, we also see that more and more groups are licensing out the assets (e.g. patents) that they do not use themselves to third parties in return for royalty payments. Thus IBM managed over a 10-year time-span to raise royalty receipts by some 3,300% to USD 1 billion per annum. These are virtually net receipts, since – other than administrative costs – they do not entail any true costs[7].

14. Globalisation means that businesses will be harmonising their intellectual property. In practice, this is especially the case with trade marks. An example is Frito-Lay, which has started selling its potato crisp products (including Smith's) under the Lay's brand. Another example is Unilever, which is trying to sharpen its focus by trimming the vast array of brands it actively manages to 400 from 1600[8].

15. The protection of intellectual work has figures as a constant item on a variety of political agendas over recent decades. The growing tendency to protect intellectual

[6] K. G. Rivette and D. Kline, *Discovering New Value in Intellectual Property*, Harvard Business Review, January-February 2000, p. 7.

[7] K. G. Rivette and D. Kline, *op. cit.*, p. 4.

[8] S. Reed, *Unilever restocks – It's souping up its portfolio of brands*, Business Week, 6 August 2001, p. 18.

property rights saw its first peak in 1873, when foreign inventors refused to take part in an international inventors' exhibition held in Vienna because they feared that their ideas would be stolen and then be exploited abroad.

16. The sharpened attention for the protection of copyright in an internet context (which came about recently following the enormous success of certain 'peer-to-peer' applications that made it possible to spread illegally copied music files on a large scale), the growing demand – at least in the European Union – for protection for software and the issue surrounding the illicit recording of other people's trade marks as domain names clearly show that the circle has not yet been squared.

On the other hand, certain intellectual property rights and the policy conducted by the holders of such rights can give rise to highly charged arguments and polemic. A good example of this is the politics and legal struggles that were engaged in South Africa concerning the release of certain patented drugs making it possible to delay the manifestation of the HIV virus and/or to slow this process. By releasing these patents – after long consideration and, as it happened, with the approval of the drugs industry – every day larger numbers of people are gaining access to (cheaper) variants of the patented preparation.

CHAPTER II

SETTING THE DEFINITIONS

17. Intellectual property rights have a number of common basic features, which can be summarised as follows :

- *intangible nature*. As 'creations or realisations of the mind', intellectual property rights are intangible in nature, such as literary or scientific works, paintings, logos, etc.;

- *nature of the works that are protected.* Not all intellectual creations can be protected by an intellectual property right – only such works as go beyond the mundane or that which is already known are capable of such protection. This condition is expressed in criteria such as *originality* (in copyright)[9], *novelty* (in patent law)[10] and, to a certain degree, *distinctive power* (in trade mark law)[11];

- *rights of exclusivity.* Intellectual property rights are by definition both rights of exclusivity and, as a direct corollary thereto, rights of prohibition (see below). The holder of an intellectual property right in principle has the right exclusively to utilise the right (rights of exclusivity) and, consequently, to restrain third parties from exercising that right;

- *assignment and grant of licences*. Intellectual property rights may be assigned and can also be licensed, on an exclusive or any other basis. A licence implies that the holder of such intangible assets can grant a right to one or more identified third parties to use the said assets in a certain manner, for instance to incorporate a patented invention in given production processes[12];

[9] Originality is only present where the work manifests a peculiar intellectual activity embodied in such an individual form that in it can be recognised the creation of and identified person (see below).

[10] Art.27.1 of the Agreement Trade Related Aspects of International Property Rights, Schedule 1 C to the treaty setting up the World Trade Organisation (WTO) of 15 April 1994('TRIPs' for short); Art 52(1) EPC (see also below).

[11] Art. 15(1) TRIPs; Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade mark, O.J. L 11, 14 January 1994, p. 1 (hereinafter the 'ETMR'); art. 2 First Council Directive 89/104/EEC of 21 December 1988 to approximate the laws of the Member States relating to trade marks, O.J. L 40, 11 February 1989, p. 1 (hereinafter 'FTMD') (see also below).

[12] See *inter alia* art. 21 TRIPs.

- *rights of prohibition*. Where a third party uses an intellectual property right without the permission of the holder of the right, the holder can take action against such use[13];

- *territoriality*. Although supra- and international legislation underlies the protection of intellectual property rights, in principle it is mainly to the national implementation of these principles that one must look in order to gain insight into the conditions and duration of the protection that is offered and for the procedures that required to be followed[14] [15]. This nationalisation process has the important consequence that intellectual property rights are in principle conferred on a national basis and – consequently – can only enjoy protection within that territory.

For these reasons, treaties are concluded at an international level with the aim of simplifying territorial administrative formalities where the holder of an intellectual property right seeks protection for it. The most important treaties in this context are the Patent Cooperation Treaty, or 'PCT', of 19 June 1970[16] and the Madrid Agreement concerning the International Registration of Marks[17] and the Protocol thereto.

Worthy of note in addition is the twin-track policy of the European Union with regard to intellectual property.

In this framework, in the first instance, a movement has come into being that is trying to harmonise the various national laws on intellectual property in the various Member

[13] See *inter alia* Art 41 *et seq*. TRIPs

[14] See *inter alia* Art 1(1) TRIPs, in which it is stated that the Member States to the treaty may apply more extensive (and hence differing) protection in their national legislation than is required under the TRIPs provisions in so far as such protection is not incompatible with the provisions in the Agreement. Thus, the states are at liberty to lay down the appropriate method for applying the provisions of the Agreement within their own legal system and practice.

[15] The main supra- and international treaties are the Berne Convention for the Protection of Literary and Artistic Works of 9 September 1886 (the last amended version dates from 28 September 1979); the Paris Convention for the Protection of Industrial Property of 20 March 1883 (the last amended version dates from 28 September 1979) and the Agreement on the Trade Related Aspects of International Property Rights (TRIPs), Annex 1C to the Agreement Establishing the World Trade Organisation (WTO) of 15 April 1994.

[16] Belgian official gazette 7 October 1977, corrected Belgian official gazette 28 August 1982, 9897, as amended.

[17] Belgian official gazette 29 January 1975, 904, as amended.

States; this is being done on the basis of a number of Directives[18] in order not to hinder the functioning of the internal market. Second, with the help of Regulations, a new Community legislative basis is being created for 'European' intellectual property rights – in other words, for intellectual property rights that are valid for the whole territory of the Union[19].

18. Since the issue of transfer prices is central to this book and in order not to broaden the complexity of the discussion in this connection by highfalutin technical legal discussions with regard to the terms of certain intellectual property rights, we approach the issue by making use of the 'most current' intellectual property rights, namely trade marks, patents, know-how and copyright (including computer programs and databases)[20]. We shall further delimit the definitions when dealing with the valuation of intangible assets, where we shall look exclusively at what are called 'marketing intangibles'. We do not here look at the issue of the treatment of 'goodwill'.

In order to avoid boundless discussions regarding the specific content of these intellectual property rights, it is sufficient to explain the terms of the aforementioned concepts using the definitions in descriptions that are utilised in international treaties that deal with international property rights. Apart from a few exceptions, we shall therefore not deal in detail with exceptions in national and/or supranational legal rules. Specifically, we shall consequently mainly look to the Agreement on the Trade Related

[18] The main ones are: Council Directive 87/54/EEC of 16 December 1986 on the legal protection of topographies of semiconductor products, O.J. L 24, 27 January 1987, p. 36; First Council Directive 89/104/EEC of 21 December 1988 to approximate the laws of the Member States relating to trade marks, O.J. L 40, 11 February 1989, p. 1 (FTMD); Council Directive 91/250/EEC of 14 May 1991 on the legal protection of computer programs, O.J. L 122, 17 May 1991, p. 42 (Computer Programs Directive); Council Directive 92/100/EEC of 19 November 1992 on rental right and lending right and on certain rights related to copyright in the field of intellectual property, O.J. L 346, 27 November 1992, p. 61; Council Directive 93/98/EEC of 29 October 1993 harmonising the term of protection of copyright and certain related rights, O.J. L 290, 24 November 1993, p. 9; Directive 96/9/EC of the European Parliament and of the Council of 11 March 1996 on the legal protection of databases, O.J. L 77, 27 March 1996, p. 20 (Databases Directive); Directive 98/44/EC of the European Parliament and of the Council of 6 July 1998 on the legal protection of biotechnological inventions, O.J. L 213, 30 July 1998, p. 13; Directive 98/71/EC of the European Parliament and of the Council of 13 October 1998 on the legal protection of designs, O.J. L 289, 28 October 1998, p. 28.

[19] Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade mark, O.J. L 11, 14 January 1994, p. 1 (ETMR); Council Regulation (EC) No 2100/94 of 27 July 1994 on Community plant variety rights, O.J. L 227, 1 September 1994, p. 1.

[20] The field of intellectual property rights also covers *inter alia*: related rights to copyright (rights of performing artists, producers of phonograms and those of the first fixations of films and broadcasting organisations), indications of origin or names of origin (*per se* and also for wines and spirits), designs and models, designs for switch patterns (topographies) of integrated of circuits (see art. 1(2) TRIPs and the references therein), trade names.

Aspects of International Property Rights (TRIPs)[21], the Paris Convention[22] and, as regards copyright, the Berne Convention[23].

With regard to tax, in addition to the relevant doctrine and case law, we first and foremost discuss the rules that the OECD has laid down in its report on Transfer Pricing Guidelines for Multinational Enterprises[24]. Chapter VI of that report is devoted to the tax treatment of 'intangible property'.

Section 1

LEGAL TERMS

§ 1. Patents

19. Under article 27 TRIPs, apart from certain exceptions to which we shall revert later, patents can be granted for inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step and are capable of industrial application. Article 52(1)of the European Patent Convention is worded – at least for European patents – as follows: 'European patents shall be granted for any inventions which are susceptible of industrial application, which are new and which involve an inventive step'.

When we analyse the wording of article 52(1) of the European Patent Treaty more closely, before a patent can be granted, four conditions require to be satisfied: (i) there must be an invention, (ii) that is *new*, (iii) *that involves an inventive step* and (iv) that is *susceptible of industrial application*.

20. *Invention*. The term 'invention' can be defined as 'a creation (an intellectual effort that leads to a result) in the technical domain'[25][26]. A discovery means that the discoverer

[21] Agreement on the Trade Related Aspects of International Property Rights, Annex 1C to the Marrakesh Agreement Establishing the World Trade Organisation (WTO), O.J. L 336, 1994, p. 213.

[22] The Union Convention of Paris for the Protection of Industrial Property, Belgian official gazette, 29 January 1975, p. 885.

[23] Berne Convention for the Protection of Literary and Artistic Works, Belgian official gazette, 13 October 1951, p. 7995.

[24] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, Paris, 1995 (in which regular updates have appeared – hereinafter the OECD Report).

[25] M. Buydens, *Droit des brevets d'invention et protection du savoir-faire*, Brussels, Larcier, 1999, p. 52, no. 96.

[26] See also Title 35 (Patents) U.S.C. 101: *'Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title'.*

has noticed something that had never before been seen; an invention, by contrast, means that something is created that previously never existed.

Moreover, regulators often expressly identify which findings cannot be regarded as such from a technical legal perspective. Article 52(2) of the European Patent Convention lists, in addition to discoveries, also: (a) scientific theories and mathematical methods, (b) aesthetic creations, (c) schemes, rules and methods for performing mental acts, playing games or doing business, and programs for computers, and (d) presentations of information[27].

The patentability of these items or activities is ruled out under article 52(3) of the European Patent Convention, in so far as the European patent application or the European patent relates to any of those items or activities *as such*. These considerations are relevant *inter alia* with regard to the patentability of computer programs.

'Inventions' can be regarded as covering: new products, new processes, new applications and new combinations of already know technical means[28].

21. *Novelty*. Under article 54(1) of the European Patent Convention, an invention is regarded as new *if it does not form part of the state of the art*.

Under article 54(2) of the European Patent Convention, the state of the art is constituted by *everything made available to the public by means of a written or oral description, by use, or in any other way, before the date of filing of the European patent application*. The state of the art is also stated to extent to the content of European patent applications as filed, of which the dates of filing are prior to the date of filing the European patent applications and which were first published on or after that date[29].

Since that rule is very strict and can often lead to problems, article 55 of the European Patent Convention tempers the rule in two cases.

[27] See also articles 27(2) and 27(3) TRIPs.

[28] M. Buydens, *op. cit.*, p. 54, no. 100.

[29] Article 93(1) of the European Patent Convention provides that every European patent application has to be published as soon as possible after the expiry of a period of eighteen months from the date of filing or, if priority has been claimed, as from the date of priority.

For the application of article 54, a disclosure of the invention will not be taken into consideration if it occurred no earlier than six months preceding the filing of the European patent application and if it was directly or indirectly due to, or in consequence of (a) an evident abuse in relation to the applicant or his legal predecessor, or (b) the fact that the applicant or his legal predecessor has displayed the invention at an official, or officially recognised exhibition falling within the terms of the Convention on international exhibitions[30].

Certain countries, such as the United States, grant the inventor a so-called 'grace period' in which he has to file for patent protection after having (erroneously) disclosed the invention.

22. *Inventive step*. Pursuant to article 56 of the European Patent Convention, an invention is *considered* as involving an inventive step if, having regard to the state of the art, it is not obvious to a person skilled in the art.

23. *Industrial application*. An invention is considered as susceptible of industrial application if it can be made or used in any kind of industry, including agriculture[31].

24. *General exclusions from patentability*. Under articles 27(2) and 27(3) TRIPs, the Member States to the Agreement can exclude certain inventions from patentability. Thus Members may prevent the commercial exploitation of inventions within their territory where this is necessary to protect public policy (*ordre public*) or morality, including to protect human, animal or plant life or health or to avoid serious prejudice to the environment, provided that such exclusions are not made merely because the exploitation is prohibited by their law.

Furthermore, Members may also exclude from patentability: *diagnostic, therapeutic and surgical methods for the treatment of humans or animals[32], plants and animals other than micro-organisms, and other, essentially biological processes for the production of plants or animals other than non-biological and microbiological processes*.

[30] In the latter case, the applicant must state when filing his application that the invention has in fact been exhibited, and he must produce evidence of this within a certain period laid down in an implementing order.

[31] See Article 57 EPC, *inter alia*.

[32] This provision was *inter alia* advanced in the South African debate regarding the patentability of medicines that could combat the manifestation of the HIV virus, as a result of which is was not possible according to the drugs industry to obtain exclusive rights for such preparations.

§ 2. Trademarks

25. A great many trade marks have their roots in the name of their founder. In days gone by, however, it was often kings and emperors that made the name of a product well-known. An example of this is Bacardi, which nowadays is the standard when speaking about (Cuban) rum. The brand's breakthrough came in 1892, when the six-year-old Spanish crown prince, Alfonso XIII, was taken ill with a heavy bout of influenza. As a last resort, the royal doctors served up a dose of Bacardi to the young prince. Alfonso fell into a deep sleep and in the morning the power of the fever had been broken. After that the drink was described by the Spanish Court as '*Bacardi, el rey de los rones, el ron de los reyes*' (Bacardi, the king of rums, the rum of kings). This certainly was a worthy advertising slogan[33].

Under modern trademark law, a 'trade mark' has to satisfy a number of conditions in order to be protected as a trade mark; these are explained in the following. The procedures that have to be followed before trade mark protection can be granted are dealt with in the following chapter.

26. Article 15(1) of the TRIPs Agreement provides that 'any sign, or any combination of signs, capable of distinguishing the goods or services of one undertaking from those of other undertakings, shall be capable of constituting a trade mark'.

These signs can include: *words including personal names, letters, numerals, figurative elements and combinations of colours as well as any combination of such signs*[34]. Under article 2 of the First European Trade Mark Directive, trade marks can be formed by 'any sign capable of being represented graphically, particularly words, including personal names, designs, letters, numerals, the shape of goods or of their packaging, provided that such signs are capable of distinguishing the goods or services of [an] undertaking'[35].

27. *Signs capable of being represented graphically*. A first condition for being protected as a trade mark is that the sign must be capable of being represented graphically. Consequently, in the first instance, the sign must be visible[36].

[33] M. Grauls, *De Kroon op het merk*, Leuven, Van Halewijck, 1996, p. 9.

[34] See article 15(1), second sentence, TRIPs.

[35] *Idem*. article 4 Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade mark, O.J. L 11, 14 January 1994, p. 1, as amended by Council Regulation (EC) no. 3288/94 of 22 December 1994, O.J. L 349, 1994, p. 83.

[36] C. Gielen, *Merkenrecht*, 1991, Tjeenk Willink, Zwolle, p. 131, no. 331.

In a number of countries, it is sufficient to file a description or designation of what the holder wishes as a trade mark. Thus, the Metro-Goldwyn-Mayer Corp. was granted protection in the United States for '*a lion roaring*'[37]. In June 2000, following a courtroom dispute that had lasted more than six years, Harley-Davidson Inc. brought an end to its fierce attempt to file the characteristic sound of its *V-Twin common crank pin* motorbike as a trade mark, with the trade mark application foundering against the ardent protest of the predominant competitors of the company, which had brought similar motorbikes onto the market[38]. At the same time, scent marks were accepted in the United States[39].

28. *Capable of distinguishing.* Under Benelux trade mark law, this requirement means that the sign must serve to distinguish the goods or services of one undertaking from the goods or services of another undertaking[40]. This criterion contains both an objective and a subjective element.

The subjective element means that the aim of the user must be to use the sign as a means of distinction for his goods or services. The objective element requires that the sign must be suited for distinctive purposes and that the public coming within the scope of consideration must twig the user's intention and comprehend the sign as a trade mark. The manner in which the user displays the sign can affect the public's understanding.

The distinctive power of a trade mark is by no means a constant. Thus, a trade mark that initially possessed inadequate distinctive character may over time become distinctive, in which event the trade mark is said to be generally perceived as a trade mark[41]. By contrast, a trade mark can lose its distinctive character if it degenerates into a typical name or descriptive indication for the item.

§ 3. Copyright protected works

29. There is no general statutory definition of which works fall within the scope of copyright. The Berne Convention also contains an extensive, but not limiting, summary of the 'literary and artistic works' to which protection is afforded under copyright.

[37] USPTO reg. no. 1,395,550.

[38] USPTO ser. no. 74485223.

[39] C. Gielen, '*Geurmerk in Amerika erkend*', IER 1991, 3.

[40] See also article 15(1) TRIPs.

[41] Amsterdam District Court, 11 July 1984, BIE, 1986, 45 (tag for Levi's jeans); Amsterdam Court of Appeal, 13 April 1984, BIE, 1986, 82 ('Mini' for cars) and President of Utrecht District Court, 18 April 1985, BIE, 1986, 107 ('Quick' for *inter alia* hamburgers).

According to article 2(1) of the Berne Convention, the term 'literary and artistic works' covers *every production in the literary, scientific and artistic domain, whatever may be the mode or form of its expression, such as books, pamphlets and other writings; ... musical compositions with or without words; cinematographic works to which are assimilated works expressed by a process analogous to cinematography; works of drawing, painting, architecture, sculpture, engraving and lithography; photographic works to which are assimilated works expressed by a process analogous to photography,* etc.[42].

In this respect, it is irrelevant how these literary or artistic works are expressed.

Since a literary or artistic work can qualify for protection under copyright, as has already been shown above, it is also required that originality can be demonstrated. A work is original if it bears the traces of an own individual activity, embodied in such an individual form that in it can be seen the creation of a certain person[43].

In judging originality, no relevance is attached to novelty, artistic character, the nature or genre, size or length or aim, etc. of the work.

§ 4. Know-how

30. Under article 39(2) TRIPs, natural persons and legal entities should have the right to prevent information that is lawfully in their possession being made public to, or acquired or used by others without their permission in such a manner as is in conflict with *fair* commercial practices, providing this information meets four conditions:

- *Secret nature:* the information has to be secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;

[42] Computer programs and preparatory material are also regarded as literary works by virtue of the Berne Convention, see art. 10(1) TRIPs and art. 1(1) Computer Programs Directive. Also databases 'which, by reason of the selection or arrangement of their contents, constitute the author's own intellectual creation' are as such protected by copyright, see art. 3(1) Databases Directive.

[43] See in this regard *inter alia* art. 1(3) Council Directive 91/250/EEC of 14 May 1991 on the legal protection of computer programs, O.J. L 122, 17 May 1991, pp. 9 *et seq.*; art. 6 Council Directive 93/98/EEC of 29 October 1993 harmonising the term of protection of copyright and certain related rights, O.J. L 290, 24 November 1993, pp. 9 *et seq.*; art. 3(1) Directive 96/9/EC of the European Parliament and of the Council of 11 March 1996 on the legal protection of databases, O.J. L 77, 27 March 1996, pp. 20 *et seq.*; Court of Cassation, 27 April 1989, Pas. 1989, I, 908; Court of Cassation, 25 October 1989, Pas. 1990, I, 238; Court of Cassation, 2 March 1993, Pas. 1993, I, 234; Court of Cassation, 10 December 1998, A&M 1999, 355, and R.W. 1999-2000, 325.

Under article 10(2) of the Technology Transfer Regulation, the secret character of the information means that the know-how package as a body or in the precise configuration and assembly of its components is not generally known or easily accessible, so that part of its value consists in the lead which the licensee gains when it is communicated to him[44]. The term 'secret' must not be understood in the narrow sense, which means that each individual component of the know-how should be totally unknown or unobtainable outside the licensor's business.

The secret nature of the know-how is crucial to distinguish from patented inventions, since under this latter category, an invention is always made public upon publication of the patent, as a result of which anyone (including competitors) gains access to the technology.

One of the best known examples is the process for making Coca-Cola. Although the ingredients of this soft drink have been worked out a number of times, it still seems to be impossible for the uninitiated to achieve the same result.

- *Commercial value*. The secret nature of the information must have a certain commercial value[45].

Under article 10(3) of the Technology Transfer Regulation, the know-how has to be 'substantial', meaning that the know-how includes information which must be useful. This means that it can reasonably be expected at the date of conclusion of the licence agreement to be capable of improving the competitive position of the licensee, for example by helping him to enter new markets or giving him an advantage in competition with other manufacturers or providers of services who do not have access to the licensed secret know-how or other comparable know-how.

- *Confidentiality obligation*. In information must, given the circumstances, be subject to reasonable measures by the person lawfully in possession of the information for keeping it secret.

- *Identified*. Under article 10(4) of the Technology Transfer Regulation, the technical information furthermore preferably has to be described or recorded in such a manner as to make it possible to verify that the know-how satisfies the criteria of secrecy and substantiality and to ensure that the licensee is not unduly restricted in his exploitation of his own technology. The description of the know-how can either be set out in the licence agreement or in a separate document or recorded in any other appropriate form.

[44] Commission Regulation (EC) No. 240/96 of 31 January 1996 on the application of Article 85 (now 81) (3) of the EC Treaty to certain categories of technology transfer agreements, O.J. L 31, 1992, 2.

[45] See also article 10(2) of the Technology Transfer Regulation.

Section 2

TAX TERMINOLOGY

§ 1. Intangible assets and intangible property (or intangibles)

31. In tax and accountancy jargon, the terms 'intangible assets' and 'intangible property' (or intangibles for short) are frequently interchanged, and in fact for the most part cover the same subject-matter. In this book as well, both terms will be used interchangeably, but they should be clearly distinguished from the more restrictive legal term 'intellectual property rights', as defined above.

A. The term 'intangible' according to the OECD

1. General

32. As has been stated, as regards the tax aspects of this book, our discussion is mainly based on the OECD Transfer Pricing Guidelines for Multinational Enterprises (hereinafter 'the OECD Report'). These guidelines are acknowledged internationally (and nationally in many countries) as the basis for determining fiscally acceptable arrangements between associated enterprises. They are based on the arm's length principle in article 9 of the OECD Model Tax Convention on Income and Capital, which states that associated enterprises must act in their mutual transactions as though they were third parties. In particular, article 9 reads as follows:

'[where] conditions are made or imposed between... two [associated] enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'

33. In chapter 6 of the Report, the OECD mentions a number of specific considerations with regard to intangibles. A definition of the term 'intangible' is also provided.

34. According to the OECD, the term refers to industrial assets such as patents, trade marks and trade names, design and models. Also included are literary and artistic property rights and intellectual property, like know-how and trade secrets[46].

35. In its commentaries, the OECD limits itself to *business rights*, i.e. intangibles that are used for commercial activities, including marketing activities. In this, the OECD emphasises that these intangibles can be of particular value to a business, even though they are of no value according to the company's accounts.

36. It is also important to mention that the OECD does not explicitly restrict the definition of intangibles to business rights although it does limit its commentaries to business rights: 'This Chapter concentrates on business rights, that is intangible property associated with commercial activities, including marketing activities'[47].

2. Trade intangibles v. marketing intangibles

37. With regard to business rights, the OECD draws a distinction in its commentaries between 'trade intangibles' and 'marketing intangibles'.

38. *Trade intangibles* cover patents, designs and know-how that are used in the production of merchandise and provision of services. Trade intangibles are frequently the result of expensive research and development activities (R&D), which may or may not qualify for legal protection.

39. In this context, the aim is that the developer should recoup the research and development costs it has incurred through sales of products or by entering into service or licence agreements.

40. For a description of the concept of know-how, the OECD refers to paragraph 11 of the commentaries on article 12 (referring to royalties) of the OECD Model Convention[48]. There, know-how is described as all the undivulged technical information that is necessary for the industrial reproduction of a product or process. It is important to note here that, according to the OECD commentaries, it is not relevant whether or not this undivulged technical

[46] OECD Report, para. 6.2.

[47] OECD Report, para. 6.2.

[48] OECD Report, para. 6.3.

information qualifies for protection. Hence, know-how can embrace secret production processes or formulae or other secret information that is not legally protected. However, the OECD does point out that there can only be said to be know-how where disclosure of this secret information diminishes the value of the property[49].

41. Know-how mostly concerns inventions, business processes, trade methods, etc., whether or not they are patentable, that enjoy no official protection but have only a contractual basis (confidentiality agreements). Often it is even the case that enterprises consciously decide not to apply for a patent for certain inventions that are even patentable, given the limited length of time for which such intellectual property rights are protected. For instance, no patent has ever been applied for to protect the formula for Coca-Cola.

42. Examples of trade intangibles are easy to find in the pharmaceutical sector, where the development of a new drug often entails years of risky, expensive research work. Once success has been achieved and a patent has been taken out, royalties can be charged for the right to produce the drug (via a licence)[50].

43. An example is the development of custom software, whereby one company in a multinational enterprise implements what is called an 'ERP' (enterprise resource planning) system (such as SAP, Oracle, Peoplesoft, etc.), which will be used by all the members of the group. In the development phase, that company will bear all the costs and risks, but once the development is complete and the software is being used by the other group members, these members will have to pay a fee to the owner of the intangible (i.e. the company that has developed the software).

44. *Marketing intangibles* cover trade names, trade marks, customer lists, distribution channels and unique packaging, which give a product important promotional value. They are mostly the result of extensive marketing campaigns and other efforts that are made to promote and sell products or services[51].

45. They are intangible assets, that may or may not enjoy legal protection, that are the product of a company's market research or sales activities and that are generally applicable to more than one product that is offered by the company in question.

[49] Commentary on the OECD Model Convention, article 12, para. 11.

[50] A. Smits, *Het belang van intangibles als key value driver*, Fiscaal Praktijkboek Directe Belastingen, 1999-2000, 302.

[51] OECD Report, para. 6.3.

46. Among the factors for determining the value of such asset items, the OECD emphasises in particular: the reputation and credibility of the trade name or the trade mark on the basis of sales in the past, the degree of quality control and ongoing research and development, the availability of the goods or services and the extent and success of the promotional expenditures and the distribution network[52].

47. An example of a marketing intangible is the Coca-Cola trade mark[53]. It is indisputable that the promotional efforts of this drinks giant have an enormous effect on sales of the drink. If the rights to use this brand are transferred, say, to another company, it is obvious that a fee has to be paid for that (depending on the functions of the company – see below).

3. Hybrid intangibles

48. It is sometimes hard to determine whether an intangible is to be regarded as a trade intangible or a marketing intangible. Some intangibles can be both. The reputation of an enterprise, for instance, can be a result of the fact that the firm has already been producing very good products for a number of years. In that case, this reputation is not a marketing intangible but a trade intangible.

49. On the other hand, if a firm's reputation is a result of years of marketing campaigns, then this reputation is indeed a marketing tangible. Let us again take the case of Coca-Cola. It is clear that the marketing campaigns, the developed distribution channels, etc. have created a marketing intangible, whilst the secret formula for the drink constitutes a trade intangible.

50. In the case of software, it is often difficult to determine whether or not one is dealing with an intangible or a product. This issue will be gone into in further detail below. If the software is subsequently to be regarded as an intangible, then we are sooner dealing with a trade intangible.

51. Hence, it can be stated that intellectual property rights such as know-how and trade secrets can be both a trade intangible and a marketing intangible under the OECD Report. They encompass privileged information or knowledge that contributes to the firm's commercial activity but that does not enjoy any protected registration, such as a patent or trade mark.

[52] OECD Report, para. 6.4.

[53] Apart from that, according to an Interbrand survey, the Coca-Cola trade mark has a value of some USD 72.5 billion.

52. Note that this difference that the OECD draws between trade intangibles and marketing intangibles ceases to apply when dealing with the question of determining a fee in line with market standards. Furthermore, the OECD also points out that not all research and development work and marketing activity necessarily results in the creation of a valuable intangible for which a fee should have to be paid. We would cite again the pharmaceutical sector, where years of investments are sometimes made in developing a drug that ultimately never comes onto the market[54].

B. The notion of an 'intangible' according to American standards

1. General

53. The United States was one of the first countries to look into the issue of transfer pricing. It is therefore hardly surprising that its internal law contains far more extensive legislation, which moreover does not always accord with the OECD Report. In the following paragraphs, we shall try and give an overview of the definition of the term 'intangible' according to American law; we shall also mention the similarities and differences between this definition and that under the OECD Report.

54. The most important legislation on transfer pricing is to be found in section 482 of the Internal Revenue Code. This provision gives the American tax authorities (the IRS) power to re-apportion income from intra-group transactions if it seems that they do not meet the arm's length principle. By applying this provision, the IRS can, for instance, adjust the fee for the transfer of an intangible from one group company to another if it is of the opinion that the fee paid is too low or too high.

55. According to section 482, the term 'intangible' refers to all items that that are referred to in any of the following six categories, provided that the item has substantial value independent of the services of any individual:

- patents, inventions, formulas, processes, designs, patterns or know-how;
- copyright, literary, musical, or artistic compositions;
- trade marks, trade names or brand names;

[54] A typical successful drug entails an average of 15 years and USD 500 million of investment before being brought onto the market. On this point, see: D. Champion *Mastering the Value Chain. An interview with Mark Levin of Millennium Pharmaceuticals*, Harvard Business Review, June 2001, 110.

- franchises, licences or contracts;
- methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data;
- any other item whose value is derived from intellectual content rather than physical qualities[55].

56. We can state that this description for the most part coincides with that in the OECD Report.

2. Commercially transferable interests

57. In the United States, there has long been controversy as to whether or not there has to be a commercially transferable interest before it can be said that there are intangibles in the context of transfer pricing.

58. The temporary provisions of section 482, which preceded the final regulations, had included this requirement in order to avoid difficulties arising within multinational groups in the case of common use of 'organisational procedures or processes that are based on experiences within the group', the reason being that it would be difficult to determine an arm's length transfer price given that it is highly unlikely that this knowledge would ever be transferred to third parties. If, furthermore, this knowledge should already have been transferred to a third party, then it would probably be of no value to that third party unless the whole group were transferred[56].

59. The IRS has always fiercely resisted the inclusion of this requirement of a commercially transferable interest and has repeatedly defended its stance before a variety of legal fora.

60. Thus, in Merck & Co. Inc. v. U.S., it tried to re-allocate income even though there was no question of any commercially transferable interest. Merck was the American parent of a multinational group that transferred patents on products and know-how with regard to certain production techniques to its subsidiary in Puerto Rico. The subsidiary would then be able to manufacture the products and sell them to the other members of the group. There was never any question but that the intangibles had been transferred.

[55] US guidelines, section 1.482 – 4(b) and section 1.482 – 4T(b).

[56] J. Mogle, *Intercompany Transfer Pricing for Intangible Property, Tax Management Transfer Pricing – Special Report*, 1997, 5; James ('Jim') Mogle is a former IRS official who assisted in drafting the American transfer pricing regulations and until recently was a Transfer Pricing Partner with PricewaterhouseCoopers in New York. For an extensive commentary, reference is made to *Tax Management Transfer Pricing – Special Report – Intercompany Transfer Pricing for Intangible Property*, Report no. 25, Vol. 6, no. 2, 21 May 1997, pp. 36-38.

However, the IRS attempted to attribute certain income from the sale of the products by the subsidiary in Puerto Rico to the American parent company since there was a transfer of other intangibles, namely (i) the existence of an associated group structure, (ii) an intra-group pricing mechanism and (iii) a planning process for the entire group.

61. The court did not, however, accept the IRS's arguments, since an intangible under section 482 must have a substantial value as an individual object. The court ordered that benefits from an organisational structure, control mechanisms, etc. are not the type of property for which an arm's length licence agreement is necessary. It concluded that such organisational processes that are based on experience within the group are not commercially transferable interests that are capable of being of value to a third party, unless that third party were to take over the whole group[57].

62. In the case of Hospital Corp. of America (HCA), the discussion concerned another type of intangible. HCA, whose business was owning and running a number of hospitals, had entered into a management service agreement with one of its overseas subsidiaries for the transfer of its Hospital Management System, a system that covered medical, financial and administrative know-how, which was based on the many years of experience that HCA had in running hospitals. Here, the court did order that there was a transfer of an intangible for which a fee required to be paid. The reasoning was that the system was the most important instrument for generating income and was capable of being transferred to an independent third party. Furthermore, the system was only transferred to the overseas subsidiary in order to be then sold to an independent owner of a hospital in Saudi Arabia. Thus the case did indeed concern a commercially transferable interest[58].

63. Despite confirmation by the courts of the requirement for a commercially transferable interest, Congress eventually succumbed to the wishes of the tax authorities and the requirement was scrapped from the final wording of section 482.

64. It was argued that the requirement was superfluous, since in the cases in which a transfer to a third party was highly unlikely, a transfer within the group would probably also be possible. This stance has been criticised by American legal writers. Thus, as Mogle rightly says, it is hardly unusual for certain transactions that are not customary between independent parties nevertheless to be entered into between group companies[59].

[57] Merck & Co. Inc. v. U.S., 24 Cl. Ct. 74 (1991).

[58] Hospital Corp. of America, T.C. 520 (1983).

[59] J. Mogle, *op. cit.*, p. 5.

65. This qualification is not contained in the OECD Report. The OECD has limited its commentary to intangibles that are used for commercial activities, so that the issue surrounding the use of 'organisational procedures or processes that are based on experiences within the group' does not arise[60].

3. Scientific personnel

66. In this context, there also arises the question of whether the knowledge of (scientific) employees can be labelled as an intangible, since it is possible that, within a multinational group, a considerable amount of tax is saved by the parent company's 'lending' its employees (together with their knowledge) to a subsidiary in a tax haven instead of moving the intangibles there.

67. In the United States, it is assumed that an individual, however talented, cannot be sold, leased or licensed, and therefore cannot constitute an intangible. What nonetheless can be designated as a transfer of an intangible is the transfer of an employment contract. Thus, the employer has no right to the employee's knowledge itself, but does vis-à-vis his employment contract, so that transferring it to another group company may possibly be viewed as the transfer of an intangible. However, this strikes us more as an exception than a rule, since an employer can in principle hire employees in the country in which the business is carried on[61].

68. Indeed, in practice, it will often be the case with independent parties that an employee with a given expertise is taken on at a standard market salary, and there cannot therefore be any question of a royalty. Thus, it seems to us arguable that the company providing the employee should receive a service fee as payment for the provision of this service.

69. In the temporary wording of section 482, alongside the distinction based on commercially transferable interests, a difference was also drawn between 'routine intangibles' and 'non-routine intangibles'. This difference was mostly of importance within the context of the transfer pricing method that has to be used in determining the arm's length price.

[60] A. Smits, *op. cit.*, p. 305; J. Mogle, *op. cit.*, p. 4.

[61] PricewaterhouseCoopers, *International Transfer Pricing 2001*, PricewaterhouseCoopers, London, 2001, para. 213.

C. 'Super intangibles'

70. Sometimes, an intangible can play a key role for a multinational group in ascertaining and maintaining its market position. Where the profitability of an enterprise is sustained for longer in a given market than in normal circumstances (i.e. without this valuable intangible) and there is therefore a hurdle that competitors must breach in order to penetrate that market, we talk about super intangibles[62].

71. An example of a super intangible that has erected a significant barrier to entry in the Coca-Cola brand. The most valuable trade mark in the world has never been challenged by any serious competitor over the years, except Pepsi, which is worth about 15 times less. However, it is to be noted that PepsiCo has logged 4.5%-a-year US volume sales growth (compared to 3.9% since 1995 for Coke) because it has been more aggressive in moving into noncarbonated beverages – a faster-growing sector than traditional fizzy drinks[63]. Richard Branson, with his Virgin Cola, also mounted the challenge, but his brand was only able to steal a very limited measure of the big names' market share.

72. Another example is Reuters, which provides financial information. Traders in financial products have to be able to place great trust in the available financial information that is provided to them. After many years, Reuters has managed to engender this trust, but a newcomer to this market will not find it easy to compete with the strong name of 'Reuters'.

73. In general, it is accepted that in principle such intangibles may only be transferred within a group. It is obvious that, in such cases, it is very difficult to determine an arm's length benchmark[64].

§ 2. The term 'royalty'

A. General

74. When we talk of intellectual property rights in this book, we shall also frequently mention the provision of such rights in exchange for a royalty. Thus it is not an unimportant matter to know what exactly should be understood by a royalty. Moreover, in practice it is no longer always so

[62] PricewaterhouseCoopers, *op. cit.*, para. 206.

[63] D. Foust and G. Khermouch, *Shaking up the Coke Bottle*, Business Week, 3 December 2001, p. 4.

[64] J. Mogle, *op. cit.*, p. 7.

clear when we should talk of a royalty and not of ordinary business profit. Think, for instance, of the downloading of digitised products via the internet (software, music, images, etc.).

75. The difference is important, for royalties are usually treated differently to regular business profits. They might be liable to withholding tax and both their deductibility (in the hands of the payer) and their taxation (in the hands of the recipient) are often subject to special rules.

76. Indeed, royalties are liable to withholdings in a great many countries. Whether or not a particular country is empowered to levy a withholding will often depend on how the transaction is classified under double taxation treaties (where one has been signed).

In the case of a supply of goods or services, then, for the levying of taxation, reference will be made in a treaty situation to the business profits article (see article 7 of the OECD Model Convention), under which there has to be a place of residence or a permanent establishment before tax can be levied in the state of residence or source state.

However, in the case of a royalty, then it is not ruled out that the source state, which is where the payer is established, may have power to levy tax under the treaty. Whether there is a retention at source and at what rate is again dependent on the internal tax laws of that country. A maximum rate can always be imposed in the applicable double taxation treaty. Many treaties incidentally also impose a full exemption[65].

77. Since this issue predominantly arises in transactions involving digital goods, it is not surprising that one of the OECD's work groups ('Technical Advisory Groups' or 'TAGs') has dealt with this area.

78. These TAG's have been set up in the context of the activities undertaken by the OECD regarding fiscal issues arising in an e-business environment. The work group that looked at the issue of the classification of income from e-business activities issued its final report on 1 February 2001 with a view to adjusting the commentaries on article 12 of the OECD Model Convention. In its report, the TAG distinguished amongst 28 different types of transactions, and positions were formulated regarding the classification of income from each of them.

[65] G. Gemis and F. Peeters, *Zakelijk internet*, January 2001, p. 16.

79. In the following, we shall define the term 'royalty' on the basis of international tax law. In so doing, we shall briefly analyse the most important elements of the definition. We shall also deal briefly with the analyse done by the TAG in order to clarify the distinction between business profits and royalties.

B. The term 'royalty' according to the OECD

1. General

80. Article 12 of the OECD Model Convention defines royalties as 'payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographical films, any patent, trade mark, design or model, plan secret formula or process, or for information concerning industrial, commercial or scientific experience'[66]. This definition encompasses both payments under a licence agreement and compensation for infringement of rights or breach of an agreement[67].

81. In most of the double taxation treaties entered into by e.g. Belgium, this definition is incorporated wholesale, although a number of double taxation treaties contain additional or derogatory provisions. Thus, for instance, in certain treaties the definition of a royalty also covers payments for the use of industrial, trade or scientific equipment.

82. In the following, we shall look more closely at the components of the definition that are relevant for this discussion.

2. The transfer of copyright

83. If copyright is transferred from one company to another, this income qualifies as a royalty.

3. The transfer of know-how

84. We would already state that know-how falls under the definition of an intangible given by the OECD and, accordingly, it is obvious that the payment that is made for the transfer of such know-how requires to be classified as a royalty.

[66] Article 12(2) OECD Model Convention 1995.

[67] Comm. OECD Model Convention, article 12(8), C(12)-2; Comm. Ov. 12/316.

85. Note that providing know-how in certain cases is hard to distinguish from the provision of services, income from which is regarded as business profits. In providing know-how, a product that has already been created or that already exists is made available to the buyer. Moreover, ownership of the product remains in the hands of the seller except where it can be said there is a transfer of property in which the seller entirely divests himself of any future interest in the product.

86. On the other side, in the provision of a service, the contractor undertakes to perform services that will result in the creation, development or the bringing into existence of a product, thus making use of already existing knowledge, skills or expertise[68]. In this connection, the result of the work done will be the property of the holder of the right.

87. According to the TAG on the characterisation of income, the most important difference between the provision of know-how and the provision of services lies in the fact that the know-how is already present at the time of the transfer and does not still have to be created under the terms of a given agreement[69].

4. The transfer of software

88. A further question that arises in this context is whether the payments received for the transfer of software are to be characterised as royalties.

89. According to the commentaries on article 12 of the OECD Model Convention, software can be defined as a program or a series of programs that contain instructions that a computer needs for the operational processes inside the computer itself (system software) or for carrying out other tasks (application software).

90. In 1998, a number of countries, including the United States, stirred up the software issue so that the tax rules applying in this field should connect more to economic reality. Under the American Treasury Regulations, a transfer of software where the recipient is not given the right to copy the software and distribute it publicly is to be regarded as a sale. By contrast, payments for the right to copy and publicly distribute software and the right to make derivative programs on the basis of the copyright conferred over a computer program are regarded as royalties[70].

[68] J. Owens, 'OECD TAG – Treaty Characterisation of E-commerce Payments', *Tax Planning International E-commerce*, 2000, no. 9, 5.

[69] G. Gemis and N. De Kinder, *Royalty's or not, that's the question: het kwalificatievraagstuk in een e-business-wereld*, AFT, March 2001, p. 106.

[70] Treasury Reg. §1.861-18, Classifications of transactions involving computer programs.

91. The recently adjusted commentaries on article 12 of the OECD Model Convention are in line with this. Above all, the adjustment is directed towards the distinction between 'the copyright in the program' and 'software which incorporates a copy of the incorporated program'.

92. Furthermore, the adjustment provides that payments that are made to acquire component parts of the copyright, without any right of ownership being transferred, are classified as royalties where the payment is intended to remunerate the grant of a right of use over the program such that, without the grant of a licence, this would cause an infringement of the copyright. In judging whether or not a copyright is used lawfully, reference is therefore made to the national laws of the Member State[71].

[71] G. Gemis and N. De Kinder, *op. cit.*, p. 109.

CHAPTER III

THE DEVELOPMENT OF INTANGIBLES (THE BUILD-UP PHASE)

93. As stated in the introduction, for multinational companies, the development of intangibles is becoming more important, since intangibles are more and more frequently one of the most valuable assets that a business owns. From a list published annually by Interbrand with the 75 most valuable trade marks in the world[72], it can be seen that, the case of a good many undertakings, the value of the trade mark constitutes a major portion of their stock market capitalisation. In the development of such intangibles, therefore, it is recommended that the tax implications of the various development methods should be taken into account, since, once the intangible has assumed a certain value, it is often too late then to do any tax planning.

94. However, taxation is usually not a motive for building up a brand. In earlier times, it often was not so much the intention to build up a strong brand (contrary to what is increasingly observed nowadays). Thus, in 1806, William Colgate certainly spared no thoughts for taxation when he started up his candle and soap business in Dutch Street, New York. Nonetheless, the company, which merged with Palmolive in 1928, has over the years built up a whole range of valuable brands (like Colgate, Palmolive, Ajax, Tahiti, etc.)[73]. According to Interbrand, the company even takes 5th place in the list of groups with valuable brand portfolios[74].

95. In this part of the book, we will be dealing with the various ways in which intellectual property rights can be constituted. In this regard, it is of importance which company will possess legal and/or economic property in the intangible, since it is this company that will also later be entitled to the income generated by the intangible.

96. But, first, we look at the possibilities of providing legal protection for the intellectual property rights discussed here.

[72] Interbrand, *loc. cit.*

[73] M. Grauls, *op. cit.*, p. 39.

[74] Interbrand, *loc. cit.*

Section 1

OBTAINING LEGAL PROTECTION

§ 1. Copyright

97. Copyright arises from the simple fact of exteriorising a creation.

98. Article 5(2) of the Berne Convention states that the enjoyment and exercise of these rights shall not be subject to any formality. However, article 3(1) of the Universal Copyright Convention, signed in Geneva on 6 September 1952, states that *[a]ny Contracting State which, under its domestic law, requires as a condition of copyright, compliance with formalities... shall regard these requirements as satisfied with respect to all works protected in accordance with this Convention and first published outside its territory and the author of which is not one of its nationals, if from the time of the first publication all the copies of the work published with the authority of the author or other copyright proprietor bear the symbol © accompanied by the name of the copyright proprietor and the year of first publication*. The © symbol, the name and the year must furthermore be placed in such a manner and location as to give clear notice of the claim to copyright.

99. Thus, no formality whatsoever is required; in order to obtain a copyright, no application has to be lodged (as in principle is the case in patent and trade mark law).

§ 2. Industrial property rights

100. For most intellectual property rights that form part of industrial property rights, such as trade marks, patents, designs and models, obtaining exclusivity rights is in principle dependent on registration of the intellectual work and payment of certain levies.

101. We shall only deal here with the procedure for obtaining a European patent in accordance with the procedures under the European Patent Convention.

1. Entitled persons

102. According to article 58 EPC, any natural or legal person, or any body equivalent to a legal person by virtue of the law governing it may apply for a European patent.

103. Co-ownership of a patent is also possible. Under article 59 EPC, a European patent application may also be filed by joint applicants or by two or more applicants designating different Contracting States (viz. the signatory states to the EPC) in their application. Thus, this provision can be of importance to multinational undertakings that wish to conduct a clear patents policy within Europe from the outset.

104. The right to a European patent inures to the inventor or his successor in title (art. 60 EPC); indeed, the inventor (a natural person) has a right against the applicant or holder of a European patent to be registered as such at the European Patent Office.

2. Procedure

105. The procedure for obtaining a (European) patent is very cumbersome and formalistic.

106. A European patent application can be filed either with the European Patent Office in Munich or its branch in The Hague, or with the national authority dealing with industrial property.

107. This application must contain at least the following information: (a) a request for the grant of a European patent, (b) a description of the invention[75], (c) one or more claims[76], (d) any drawings referred to in the description or the claims, and (e) an abstract[77] (art. 78 EPC); the application also has to satisfy the provisions laid down by the Implementing Regulations.

[75] Under article 83 EPC, the invention has to be described in the European patent application clearly and fully enough to be capable of being carried out by a person skilled in the art (cf. art. 56 EPC).

[76] The claims describe the item for which protection is sought; they have to be clear and concise and be supported by the description (art. 84 EPC).

[77] The abstract is only intended to serve for use as technical information (art. 85 EPC).

Within a month of filing the application, filing fees have to be paid. In the application for the grant of a European patent, the Contracting States have to be designated in which protection is sought for the invention, and a designation fee has to be paid at the same time.

108. Upon the application being filed, the Receiving Section of the European Patent Office examines whether the application satisfies the requirements for a filing date to be allocated, whether the necessary fees have been paid and whether the necessary translations have been submitted. At the same time, an examination is commenced into any formal deficiencies.

109. Subsequently, in the event that a filing date is allocated to the application, and the application therefore is not withdrawn, the European Patent Office proceeds with drawing up the report of the European novelty examination. Within a period of six months after receiving the results of this novelty examination, the applicant in principle has to request the European Patent Office in writing, on pain of the application's lapsing, to examine the European patent application and the invention to which it relates as to whether they are in conformity with the provisions of the EPC. In principle, each European patent application is published as quickly as possible after the expiry of a period of eighteen months after its filing.

110. If the decision to grant the European patent has come into effect before the expiry of this period, this publication is done at the same time as publication of the specification of the European patent. In this publication, the description, the claims, any drawings and – where available – the report of the European novelty investigation and the abstract are included. The whole invention is consequently made public, as a result of which – by contrast with know-how which remains secret as a matter of principle – anyone can gain access to it.

111. It is of no little importance to mention at this juncture that, within a period of nine months after the day on which the notice that the European patent has been granted is published, any party may lodge a statement of opposition with the European Patent Office against the patent granted. If the Opposition Division of the European Patent

Office is of the opinion that the patent does not satisfy certain, defined conditions (including if the subject-matter of the European patent is not patentable, since it does not satisfy the requirements for patentability, or the patent specification is unclear or contains incomplete descriptions for a person skilled in the art to carry out the invention), it can revoke the patent.

3. Procedure under the PCT

112. (Multinational) companies that engage in cross-border trade can, due to the territorial nature of patent rights, rapidly be faced with complex official and legal procedures when they try to obtain protection for their inventions in other countries. For these reasons, on 19 June 1970, a number of states concluded the Patent Cooperation Treaty, or PCT, in Washington. To date, 112 countries have signed up to the PCT.

113. The PCT lays down the basis for cooperation amongst the various contracting states in respect of filing, searching and examination of applications for the protection of inventions and the rendering of special technical services (art. 1(1) PCT).

B. Trade marks

114. As far as Benelux trade marks are concerned, it can clearly be stated that no one can invoke protection at law for a trade mark that is regarded as a trade mark within the meaning of the Benelux Trade Marks Act (BTMA), regardless of the claim filed by him, unless he has duly filed it and, so far as necessary, had its registration renewed[78].

115. Article 6 (means whereby a Community trade mark is obtained) of the ETMR states expressly that a Community trade mark is obtained by registration of the trade mark.

116. A Community trade mark has to be applied for either from the Office for Harmonisation in the Internal Market in Alicante or from the central office for industrial property of any EU Member State or from the Benelux Trade Marks Office. This application in principle has to contain a request for registration, information on the basis

[78] Sec. 12.A BTMA.

of which the applicant can be identified, a statement of the goods or services for which the application is being submitted and a representation of the trade mark.

117. The Office then examines whether the conditions for filing have been satisfied, the capacity of the holder and whether there are any 'absolute grounds', an exhaustive list of which is laid down in the Regulation, on the basis of which registration can be refused. If the applicant has satisfied these conditions and if a date of filing has been obtained, the Office issues a Community search report in which mention is made of earlier (applications for) Community trade marks that have been discovered and that might stand block use of the trade mark applied for.

118. After publication of the trade mark (a minimum of one month after the Office has issued the search report to the applicant), third parties may submit observations or start opposition proceedings if there are grounds therefore[79] [80]. If the applicant satisfies all the conditions laid down in the ETMR, if no opposition procedure is commenced within the statutory deadline or where the opposition has been rejected by a decision that is not liable to appeal, then the trade mark is registered as a Community trade mark provided the necessary fees are paid in due time.

119. *Mutatis mutandis*, the procedure for obtaining a Benelux trade mark is the same. The main difference lies in the fact that the Benelux Trade Marks Act still does not offer third parties the opportunity of filing opposition to the grant of the trade mark after it has been published.

120. The number of cases where an unregistered trade mark can nonetheless be protected is limited. We would in this respect mention the so-called 'well-known marks' under article 6 bis of the Paris Convention, and common law trade marks.

[79] The opposition procedure has to be commenced within a period of three months of the day on which the Community trade mark application is published (art. 42 ETMR).

[80] The Benelux Trade Marks Act still does not provide for the lodging of any such procedure with regard to Benelux trade marks.

Section 2

THE VARIOUS MEANS OF DEVELOPMENT (OECD)

121. The OECD recognises three methods by which a multinational undertaking can structure its research and development activities:

(1) one single entity within the group carries on the activities entirely for its own account and accordingly enters into licence agreements with the other group companies;

(2) the 'developer' carries on the activities on a contract basis on behalf of another group company, which then becomes the 'economic owner' (*'contract R&D'*);

(3) economic ownership of the intangible assets is divided amongst two or more group companies under a cost-sharing agreement.

122. In the following, these three methods will be discussed. Please note that the issue of determining a market-standard remuneration upon the transfer of an intangible does not come up for discussion in this regard. In the part that deals with the valuation of intangibles, however, this will be discussed in detail.

§ 1. Independent development of an intangible

123. A first possibility is for one undertaking in the group to assume responsibility for developing an intangible in its own name and for its own account. That company bears all the costs and risks of the development activity and will consequently also be the legal and economic owner of the intangible[81].

124. The developed intangibles, for instance patents or know-how, are then licensed to the other members of the group. In practice, it often happens that the intangible asset is developed by the parent company, which then grants licences to the various subsidiaries. It is of course

[81] OECD Report, para. 6.3.

possible to arrange things the other way round. In the event that a multinational concern has research and development companies in a variety of countries, it is usual for these companies to license the developed intangible to the parent company and/or other group companies.

125. The other group companies that make use of the developed intangible will require to pay this economic owner a market-standard remuneration. If, for instance, the intangible is created by a company in Bermuda, this can contribute to a lower tax charge. The remuneration that the other ('normally' taxed) group companies pay will in principle be tax-deductible in their countries of residence, whilst the income due to the Bermudan company will be liable to favourable tax rules there.

126. However, note that, in practice, such structures are often difficult to achieve. Development of an intangible by a company in Bermuda will probably be complicated, since they frequently have insufficient scientific personnel, technological apparatus, etc. at their disposal; thus it is not sufficient just to book the costs of the development in the accounts of the Bermudan company. It will have to be demonstrated to the tax authorities that a significant contribution to the development of the intangible was made in Bermuda (see further on this in chapter VI concerning the migration of intangibles).

127. As already mentioned, the company that develops the intangible bears all the risks of the development process. In this regard, it is important to mention that not all expensive research and development activities result in the creation of an intangible. If no intangible ultimately comes into being, this loss will be borne by the development company.

128. The question does of course arise as to where it can be said there is an intangible. Take marketing activities, for instance. These can encompass a broad gamut of activities, such as market research, designing products according to market needs, working out sales strategies, etc. Some of these activities will only have an impact on the results for the year in question and will thus be incorporated in the profit and loss account for the year. In other cases, a valuable intangible can be created that is then booked as an intangible asset in the balance sheet. We would point out that it can sometimes in practice be particularly difficult to examine whether or not there can be deemed to be an intangible[82].

[82] OECD Report, para. 6.6.

129. The advantage of independently developing an intangible is the simplicity of the method. The legal and economic property in the intangible lies with one single company, although it is true it is responsible for all the costs and risks of the development process; but once the intangible is created, it also receives the income from it. A disadvantage of this method is that its use usually results in the payment of royalties, which can entail having to deduct withholding taxes at source.

§ 2. Joint development of an intangible

A. Legal ownership versus economic ownership

130. In practice, it is more and more the case within multinationals that intangibles are developed jointly. The high cost price and the risks independently developing an intangible obviously play a role in this decision.

131. One of the predominant points for attention in the joint development of intangibles is the answer to the question of who will acquire property in the intangible; the reason is that legal and economic ownership do not necessarily have to belong to the same company. In the case of legally protected intangibles, such as patents, there additionally arises the question of whether it is the legal or the economic owner that will be entitled to the income from the intangible.

132. Mogle stated that, where a number of companies within a group work together on developing an intangible (and where what is involved is not a cost-sharing agreement), only one of those companies can in that case be the (probably legal) owner. The other companies involved would thus not acquire any ownership rights but just a market-standard remuneration for their efforts. From an EU perspective, this position can in no way be followed, since the legislation with regard to intellectual property (frequently) explicitly enables joint ownership[83].

133. Whenever we are dealing with 'unprotected' intangibles, such as know-how and trade secrets, the ownership issue arises to only a lesser degree. Both the OECD and the

[83] See *inter alia* art. 59 of the Convention of 5 October 1973 on the Grant of European Patents (Belgian official gazette, 7 October 1977), as amended (European Patent Convention); secs. 4 and 5 of the Copyright and Related Rights Act of 30 June 1994 (Copyright Act).

United States hold the position that it is the company that bears the greatest costs in the development of the intangible that is regarded as its economic owner.

134. With regard to legally protected intangibles (patents, trade marks, etc.), the ownership issue is more complicated. As already stated, the United States generally hold with the view that the legal owner of the intangible is also the party entitled to the income. It is obvious that this gives rise to a whole plethora of tax-planning opportunities. Thus, it can be enough for a multinational group to transfer ownership of an intangible to a low-tax location in order, by so doing, to have all income flow to that place. If the economic cost of developing the intangible is borne by a company taxed at standard rates, it is of course possible to make considerable tax savings. However, note that, in practice, many multinational companies establish their trade marks and names in the name of the (usually American) parent company, and not in the name of a company established in a tax haven, which may not be able to offer the same level of legal protection and may have a less stable existence[84]. This naturally goes some way to explaining the stance of the United States.

135. The OECD (and most OECD countries) take another view in looking at these protected intangibles. In the OECD Report, the emphasis is laid on economic ownership of the intangible. It must always be examined which company has developed the intangible and, consequently, has also borne the costs and risks. If the royalties are not paid to that company, the tax authorities will invoke their transfer pricing provisions in order to re-allocate the income. Suppose, for instance, a Belgian company has developed an intangible, but the royalties are not paid to this Belgian company but to a company established in a tax haven. The Belgian Revenue would then in all probability invoke article 26(2), 2° ITC 92[85] and re-incorporate an abnormal benefit into the tax base of the Belgian company.

136. In practice, it will not always be easy to gain and maintain an accurate picture of this within a large multinational group of undertakings, especially where the group possesses an extensive portfolio of trade marks and patents. Remember the example of Dow Chemical, which, after an entire year-long's audit, discovered that it owned 29,000

[84] A. Smits, *op. cit.*, p. 306.

[85] By virtue of article 26(2), 2°, ITC 92, the Belgian tax authorities may re-incorporate into the tax base any abnormal or gratuitous benefit that is conferred by a Belgian undertaking on a foreign taxpayer that, under the laws of the country where it is established, is not subject to tax there or is subject to tax there under considerably more favourable rules than those to which the undertaking established in Belgium is subject.

patents. Often it is not even known what intangibles are owned, let alone whether the legal and economic property in them is spread and with which group companies this might be the case. Management of a large trade marks portfolio is a complex matter, as can certainly be testified by groups like Unilever, Procter & Gamble and Master Foods.

B. How to jointly develop an intangible

137. The companies in a group of course decide themselves how they wish to bring about the creation of a given intangible. In this connection, they are free to contract as they please (while accepting certain regulatory restrictions).

138. The most common forms in this regard are (i) where one or more group companies undertake contractual research and development activities for one or more other group companies, (ii) where one company in the group carries out marketing activities to aid purchase and sale transactions for goods produced by one or more other members of the group, and (iii) where two or more group companies jointly develop an intangible on the basis of cost-sharing agreements.

1. Research and development on contract basis

139. Research and development on a contract basis (or 'contract R&D') has already existed for many years[86]. The principle is relatively simple. One or more companies in the group carry out all research and development activities, for which they are paid by means of so-called service fees, which are paid by another company, called the 'principal'. The principal in turn bears all the costs and risks with regard to the success or failure of the research work. If the research and development work is successful and results in the creation of an intangible, then the principal holds all intellectual property rights over the research results or developments, and all income from the intangible will be due to it.

140. The 'service-provider company' receives a fee in consideration for the work done on the basis of the costs incurred by it for the research and development, plus a profit

[86] The 1979 OECD Report already recognised this method.

margin that can be somewhat low, depending on the case. In this event, the so-called cost-plus method is used[87]. The often marginal payment can be justified by the fact that the service-provider company bears only limited costs and risks in developing the intangible.

Needless to say, using this contract R&D method can often give rise to disputes, since it also offers a great deal of opportunity for tax planning[88]. Thus, all intellectual property rights can be channelled relatively 'cheaply' to a group company in a low-tax location, whilst the development is done in a country where the other group company (the contract researcher) is subject to 'normal' tax rules, but is perhaps better suited for the job, being able to find trained employees, obtain public subsidies, access natural resources, etc. (see further on this in chapter VI concerning the migration of intangibles).

141. Bearing in mind the OECD Report regarding documenting the transaction, it is accordingly of importance for the taxpayer carrying out the research and development activity to be able to prove to the tax authorities that:

- it has not borne any financial risk in the development of the asset;
- it has been remunerated according to market standards for the services provided. In this connection, it is advisable to draw up a written agreement in which the following factors are incorporated:
- the scope of the services to be provided;
- the principal's intention of bearing all risks and costs with respect to the research and development;
- who will be the owner of the asset;
- the remuneration to which the researcher is entitled.

142. We would point out that, in such constructions, the rule is 'substance is key'. The method will only work if the research and development activities are in actual fact carried out by the service-provider company on the instructions of the principal. Specifically, this means that there also have to be adequate scientific personnel present within the principal's workforce, since the principal is considered to give instructions to

[87] OECD Report, para. 7.41.

[88] J. Mogle, *op. cit.*, p. 12.

the service-provider company as to the manner in which the research and development work has to be carried out. In other words, the 'brains' have to be within the principal (see also further in this regard in chapter VI).

143. A major advantage of this method as compared with the independent development of an intangible is that the financial risks of the development are not borne by the development company. They are fully borne by the principal (in practice, usually the parent company), which is often better suited to bear the costs of such expensive research and development work.

2. The development of marketing intangibles

144. It is obvious that the aforementioned method can also be used for developing a marketing intangible.

145. However, it often happens that a subsidiary will directly or indirectly contribute to developing the parent company's brand name in the country where the subsidiary is established.

146. An example is the scenario where a parent company calls on the services of a subsidiary to distribute merchandise produced by the parent in the subsidiary's country of establishment. It is possible that the brand name of these products is already particularly valuable in a certain sales territory but not yet so in the one where the subsidiary is established, so that the subsidiary has to make significant marketing efforts in order to be able to distribute the products.

147. The question that arises in this regard is whether the subsidiary requires to be compensated by the parent for the higher value that it confers on the already existing marketing intangible[89].

148. The answer will often depend on the amount of the costs incurred by the subsidiary in comparison with comparable costs that are borne by an independent distributor.

[89] J. Mogle, *op. cit.*, p. 13.

149. This issue will be dealt with in further detail in the section on transfers of intangibles.

3. Cost-sharing arrangements

a) Introduction

150. In recent years, more and more use has been made of cost-sharing arrangements for development and research activities. Hence, in its Transfer Pricing Guidelines, the OECD has devoted a separate chapter to these cost-sharing arrangements. Note that the OECD talks of 'cost-contribution agreements', whilst in the American legislation the term 'cost-sharing arrangements' is used. Both terms probably mean the same sort of agreements.

151. The OECD has defined a cost-contribution agreement (CCA's) as a 'framework agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights'[90].

152. The definition in the American legislation is similar but not identical: 'a cost-sharing agreement is an agreement under which the parties agree to share the costs of development of one or more intangibles in proportion of their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement'[91].

153. The most important difference between the two descriptions is that the use of cost-sharing agreements in the United States is limited to the development of intangibles, whilst the OECD allows such arrangements for far more purposes[92].

154. In this book, however, we concentrate on cost-sharing arrangements for the research and development of intangibles. In so doing, we shall analyse the OECD's point of view, and the American approach will be looked at where it deviates from the OECD Report.

[90] OECD Report, para. 8.3.

[91] Treas. Reg. Sec. 1.482-7(a)(1).

[92] B. Helmut, *Commentary on Chapter 8 of the OECD Transfer Pricing Guidelines: Cost Contribution Arrangements*, International Transfer Pricing Journal, March-April 1998, p. 62.

b) What is a cost-sharing arrangement?

A cost-sharing arrangement can best be described as a contract under which the various parties decide jointly to develop an intangible. The agreement will therefore set down how the intangible is to be researched and developed, and how the costs are to be divided amongst the participants; it is thus a contractual arrangement rather than necessarily a distinct legal entity or permanent establishment of all the participants[93]. According to the OECD, each company's share in the costs has to be in proportion to its anticipated profit from the creation of the intangible.

155. The results of the developed intangible are regarded as though the participating company had carried out the research and development work itself. The developed intangible is in other words regarded as the result of its own, but outsourced, research and development work.

156. The issue surrounding proving that a certain participant has derived a real benefit from the creation of the intangible will consequently not be relevant in the case of cost-sharing arrangements, provided the arrangement itself has been concluded under arm's length conditions. Indeed, some types of CCA will produce benefits in the short term, while others have a longer time frame or may not be successful at all. The treatment of the relevant expenses in the accounts of the various participants will depend on their local national legislation. Some countries may require an entry in the balance sheet, whereas other countries may require immediate expensing. In general, these costs will be tax-deductible if the relevant conditions regarding the tax-deductibility of business expenses are satisfied.

157. If a participating company is established in Belgium, this means specifically that the costs are only deductible if the participating company has incurred or borne the costs in the taxable period for the purpose of obtaining or retaining taxable income. Furthermore, the taxpayer has to evidence that the amount of these costs is authentic[94], which specifically means that the cost-sharing arrangement has to be submitted to the tax authorities.

[93] OECD Report, para. 8.3.

[94] Article 49 ITC 92.

158. As already mentioned, the costs that each participant bears have to be in proportion to the income that that participant receives or expects to receive from the developed intangible. In the event that, in this respect, the costs that one or more participants bear are too high in relation to the costs borne by the other participants, the tax authorities will invoke their transfer pricing provisions in order to re-allocate this cost flow.

159. One important principle under the OECD Report says that each contract party will exercise his rights vis-à-vis the developed intangible individually, either together or in consultation with the others. Accordingly, with the cost-sharing arrangement there will be no question of any sale or transfer of an intangible from one participating company to another participating company.

160. An important consequence of this is that no royalty flows are set up that might potentially give rise to deductions of withholding tax.

161. A complexity of cost-sharing arrangements comes to the fore when a new company wants to accede to the arrangement or a company wishes to terminate the arrangement. In these cases, a valuation will always have to be done of the research and development work already done. On the basis of this valuation, it will be determined whether the exiting company has to receive payment for work already done and what it will be, and what payment the acceding company has to make for the activities that the other participants have already carried out. This will be gone into in further detail in the part dealing with transfers of intangibles[95].

c) Legal versus economic ownership

162. The question that always arises in using cost-sharing arrangements is of course who will ultimately acquire legal and/or economic ownership of the intangible. It is possible for all the companies participating in the cost-sharing arrangement to acquire (part) legal ownership, but it is likewise possible for only one company to acquire legal ownership and for the other companies to be economic owners[96].

[95] Helmut, *op. cit.*, p. 66.

[96] OECD Report, para. 8.6.

163. The OECD again also draws the characteristic distinction here between legal ownership and economic ownership with regard to the developed asset item:

'The separate rights obtained may constitute actual legal ownership; alternatively, it may be that only one of the participants is the legal owner of the property, but economically all the participants are co-owners'[97].

164. The OECD is clearly of the view in this connection that economic ownership should prevail over legal ownership:

'In cases where a participant has an effective ownership interest in any property 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 property consistent with the interest that the participant has acquired'[98].

165. The OECD's approach can be called misleading to a certain extent, since, in dealing with cost-sharing arrangements, the intellectual property rights in the primary stage appear to be disregarded.

166. It should, indeed, be pointed out that the actual 'developers' (natural persons) of the asset item – the 'inventors' or 'authors' – are to a large extent protected by the intellectual property legislation[99].

167. Undertakings that carry on business in the domain of research and development, marketing, design, etc. thus in the first instance have to acquire the intellectual property rights of their personnel before mutual arrangements concerning these rights can be made between the undertakings.

[97] *Idem.*

[98] *Idem.*

[99] See *inter alia* as regards copyright sec. 3, in particular sub-section 3, of the Copyright and Related Rights Act of 30 June 1994, official gazette 27 July 1994, 19297, as corrected and amended, in which it is stated that *where an author creates works in performance of an employment contract or official appointment, the property rights can be transferred to the employer in so far as express provision is made for the transfer of rights and in so far as creation of the work falls within the scope of the contract or appointment*. However, an exception is made in this connection for the 'authors' of software who work under an employment contract, where the rights of exploitation relating to the software are transferred automatically to the undertaking for which the programmers work (sec. 3 of the Legal Protection of Computer Programmes (Transposition into Belgian Law of the Community Directive of 14 May 1991) Act of 30 June 1994, official gazette 27 July 1994, corrected official gazette 5 November 1994, 27467).

168. The American guidelines are clearly – and rightly so, in our view – of the opinion that the legal owner of the intellectual property rights is entitled to the income flowing from the licences[100]. The notion of 'economic ownership' that the OECD uses therefore, from a legal viewpoint, has to be called a fiction in the domain of intellectual property rights. Note, notwithstanding, that these varying approaches can, as stated above, give rise to a double taxation problem.

169. From a legal point of view, it is therefore clear that cost-sharing arrangements must lay down clear provisions with regard to the intellectual property rights over the developed asset item, which is moreover also advisable from a tax viewpoint in setting up and defending a transfer pricing policy[101]. A cogent policy on intellectual property rights always requires assignments and licences to be set down in writing[102].

[100] US guidelines, § 1.482-4(f)(3)(ii)(A).

[101] The so-called 'documentation obligation', which is explained in full in Chapter V of the OECD Report.

[102] In most cases, these is even a legal requirement. See *inter alia* sec. 11.A BTMA, in which it is even stated that a lifetime transfer that is not in writing is void.

Section 3

TAX PLANNING IN THE START-UP PHASE

170. If we follow our position that intangibles are becoming increasingly important in business processes through to its logical conclusion, then this also means that they will also attract ever more fiscal value. Good tax planning will therefore also be of importance from the start in order to achieve the best possible result; this begins in examining the tax treatment of the costs incurred (booking to fixed assets, investment deduction), but can also go much further, if one is prepared to set up a modified company structure in order to optimise the various elements.

§ 1. Long-term asset v. direct costing

171. The tax treatment of research and development costs will depend on whether or not these costs are booked as long-term assets.

172. If they are booked as long-term assets, it is obvious that the costs will be included in the profit and loss account on a *pro rata temporis* basis by means of depreciation. Often, intangible fixed assets have to be depreciated over a maximum of five years from an accounting point of view. Deviations from this rule then need to be justified in the notes to the annual accounts. For instance, Belgian tax law does not lay down a *maximum* period for depreciating intangible fixed assets, but does lay down a *minimum* period of three years (for research and development) to five years.

173. If the costs are charged directly to the result, their tax-deductibility will depend on the appropriate rules that apply to the deductibility of business expenses in each country.

174. As stated earlier, the costs will only be deductible as business expenses in Belgium if the terms of article 49 ITC 92 are fulfilled.

Specifically, this means that:

- the costs must relate to the business activity of the taxpayer;
- the costs must have been incurred or borne in the taxable period;
- the costs must have been incurred in order to acquire or retain taxable income;
- the taxpayer must be able to demonstrate the authenticity and amount of these costs.

175. Note that, in Belgium, there are no specific rules that apply to the deductibility of costs for the research and development of intangibles. The general principles apply. This means, amongst other things, that certain costs will only be accepted as business costs if they are vouched by individual slips and a summary statement presented in the form and within the deadline laid down by order of the King. This concerns *inter alia* fees, commissions and salaries paid out that constitute earned income in the hands of the recipient[103]. If these formalities are not gone through, these costs can be subject to taxation as secret commissions at a rate of 309%[104].

§ 2. Tax and other incentives

176. During the development of intellectual property rights, it is equally important to look into the possibilities of obtaining tax and other incentives. Indeed, alongside more complex tax planning, this can be a very effective way of subsidizing the development cost for the company (or group of companies).

177. Tax incentives differ from country to country, and in Belgium there is e.g. the system of investment deduction, where the taxpayer can obtain a tax deduction on the amount of the investment booked in the balance sheet. In its most optimal form, this can generate a tax deduction of up to 21.5% over the depreciation period (assessment year 2002).

178. Other incentives, such as government grants, can equally play an important role. Given the specific subject matter of research and development, it is not at all surprising that such grants can be obtained.

[103] Article 57 ITC 92.

[104] Article 219 ITC 92.

179. These grants will also undergo some form or another of tax treatment, but more important is to consider the requirements of the grant, and their impact on the tax structure that is in place. In fact, one of the conditions of grants, which seems to be applied quite frequently, is that the results of the R&D work later on have to be economically exploited by the company that obtained the grant.

180. In practice, this may seem straightforward, but in the case of contract R&D it is not. In fact, when a company performing contract R&D obtains such a grant, this condition will not be satisfied, because it will not retain any rights to further exploit the fruits of its work, as they will all be transferred to the principal in the transaction. As a consequence the grant may need to be repaid in full, including interest. We have seen in more than one case, that this requirement was not taken into consideration, leading to significant exposure for the contract R&D entity (which would have to be on-charged to the principal).

§ 3. A tax-friendly structure

181. In addition to looking at whether or not to book the costs for creating intangibles as long-term assets and the possible application of the tax incentives, much more can be done in tax-optimising these valuable assets. For this, however, it is required that all the tax, legal and economic consequences are logically accepted and applied.

182. The aim of a tax-friendly structure is that income should attract a low tax charge within the recipient undertaking, whilst the group companies that pay (via royalties) generate a deductible cost. For this to work well in practice, it is *inter alia* required that it be introduced in good time.

183. However, in practice, it is all too often discovered that the tax impact of intangibles is only thought about at too late a stage. Young enterprises often end up in a loss-making position in the first few years and assume that tax planning is only relevant once they are generating profits. However, nothing could be less true, since an undertaking can already build up a valuable intangible (certainly in the current internet economy) during

the first (usually loss-making) years of its existence. When the undertaking then makes a profit, the intangible often has acquired such a large value that moving it to a low-tax jurisdiction is no longer financially worthwhile[105]. Take, for instance, the 'Yahoo!' trade mark, which, in 2000, after little more than five years in business without any profit worthy of mention, had accumulated a value of some USD 6.3 billion[106]. If there had at that time, hypothetically, been a desire to move that intangible from the United States to a low-tax jurisdiction, the IRS would have charged American corporation tax (at a rate of approx. 35%) on the capital gain realised in the United States. The tax due on the often considerable capital gain usually renders migrating the intangible devoid of interest in such cases.

184. In chapter VI on the migration of intangibles, we shall look in further detail at the tax planning that is possible in this connection. For the time being, it is sufficient to point out that tax planning must be taken into consideration in the start-up phase, given the considerable tax-savings that can thus be achieved in the long run.

[105] A. Smits, *op. cit.*, p. 299.

[106] Interbrand, *loc. cit.*

CHAPTER IV

APPLYING INTELLECTUAL PROPERTY RIGHTS

185. In practice, it is not always possible to draw a clear line between the use phase and the development phase. For instance, take the case of the pharmaceutical industry, where the development of new drugs can be divided into a period of research and a period of development. In switching from one period to the other, the developer will already file his formula[107], whilst during the development phase it will still undergo numerous clinical trials. It is only after that phase that the government department in charge of national health matters may be able to grant a permit allowing a start to be made on marketing the drug. In principle, it is only as from that time that it can be said that the intangible is truly being exploited. Nevertheless, it is very possible in the pharmaceutical sector that the filed formula will already be licensed to one or more affiliated companies before it is marketed. This can be the case where the holder of the right of property wants to market the product in various countries in which different legislation applies. In such a case, it can be worthwhile having the subsidiary work the formula out itself, which again entails a number of tax consequences.

In the rest of this chapter, in order to avoid confusion, we shall only talk about the application of intellectual property rights where the development phase has been fully completed.

186. Once an intangible has thus been developed and can be exploited, there are various ways to do this: the intangible can be applied for a firm's own business, or use of the intangible can be given in exchange for a fee, or the intangible can be alienated, in exchange for a one-shot payment.

[107] It is possible for only one person to file the formula. By contrast, it often happens that an intangible is jointly owned.

Section 1

OWN USE

§ 1. Legal aspects

A. Exploiting the rights

187. The predominant consequence of granting an intellectual property right is that its holder is given the exclusive right to exploit his invention, his trade mark, his copyrighted work, etc.[108].

1. Copyright

188. According to section 1(1), first and last paragraphs of the Copyright Act (CA), as regards copyright, this means that the author of a literary or artistic work is entitled to reproduce that work in any manner and in any form (or to have it reproduced), encompassing the right to grant permission to adapt, translate, hire or lend the work, and to communicate it to the public according to any process whatsoever.

2. Patent

189. Exploitation of a patent means that the holder is entitled *inter alia* to produce, offer for sale, put on the market, import or, for those purposes, hold stocks of the patented products, working methods, new applications and new combinations of already known technical mean[109].

3. Trade marks

190. As regards trade marks, it can be stated that the holder is in principle exclusively entitled to affix the sign to the goods for which it is registered or to the packaging thereof, to offer the goods, put them on the market or stock them for these purposes, or

[108] See *inter alia* article 9(1), first sentence of the ETMR.

[109] M. Buydens, *op. cit.*, p. 137, 270.

offer or supply services under the sign, import or export goods under the sign or use the sign on business papers and in advertising[110].

B. The right to prohibit third parties from exploiting intellectual property rights

191. Holding an exclusive right also in principle means that the holder is entitled to take action against third parties that commit infringements against that exclusive right. This 'right of prohibition' is not absolute, however; thus, the holder can only take action against 'infringers' in cases provided for by treaty, order or statute.

1. Trade marks

192. In principle, a trade mark holder can take action against any third party that has not obtained the relevant permission, and prohibit use of a sign in economic dealings:

- where it is identical to the holder's trade mark and is used for the same goods or services as those for which the trade mark is registered[111];

- where it is identical to or corresponds to the trade mark and is used for similar goods or services if, as a result, confusion may arise amongst the general public[112] [113];

- where it is identical to or corresponds to the trade mark and is used for goods or services that are not similar to those for which the trade mark is registered if what is involved is a trade mark that is known within the territory for which the trade mark is registered and if, by using the sign without valid reasons, an unjustified benefit is derived or harm is done to the distinctive qualities or reputation of the older trade mark[114];

- where any use is made of a trade mark or a corresponding sign without valid reasons in economic dealings other than to distinguish amongst goods, if as a result of such use any unjustified benefit can be derived from or harm can be occasioned to the distinctive qualities or the reputation of the trade mark[115].

[110] Article 9(2) ETMR.

[111] See article 9(2)(a) ETMR; 13.A(1)(a) BTMA.

[112] See article 9(2)(b) ETMR; 13.A(1)(b) BTMA.

[113] See also article 16(1) TRIPs.

[114] Article 9(1)(c) ETMR; section 13.A(1)(c) BTMA.

[115] Section 13.A(1)(d) BTMA – this possibility is not incorporated in the ETMR.

193. If the infringer has acted with wilful intent, the trade mark holder may either lay claim to any moveable property used to commit the infringement of his rights or that have been used in production of the items, or demand that they be destroyed or rendered unusable. He can also lay claim to such sums of money as can be assumed to have been received as a consequence of the infringement of his trade mark rights[116].

194. On top of that, the trade mark holder has the right to claim damages from the infringer[117].

195. However, the trade mark holder does not have the right to take action against use by a third party for making use in economic dealings of his name or address, indications as to type, quality, quantity, intended use, value, place of origin, time of production of the goods or provision of the service or other features of the goods or service. Nor can the trade mark holder take action against use by a third party of the trade mark itself in economic dealings, where that is necessary in order to indicate the intended use of a good or service, viz. as an accessory or component, in so far as such use is in line with fair trade practices[118].

196. To the extent allowed by the ETMR and the BTMA, the holder of the trade mark can also file a claim to have another registration declared void.

2. Patents

197. A patent gives the patent owner the right to prohibit any third party that has not been given his permission to do so from:

- producing, offering, putting on the market or using any product to which the patent relates or importing or stocking same for those purposes;
- applying a working method to which the patent relates or, where the third party is aware, or, in the circumstances, it is clear, that the working method is forbidden without the permission of the patent owner, offering it for application on Belgian territory;
- offering, putting on the market or using a product that is obtained directly according to the working method to which the patent relates or importing or stocking same for those purposes[119].

[116] Section 13 *bis* (1) BTMA.

[117] Section 13.A(1), introduction, BTMA.

[118] Article 12 ETMR.

[119] Section 27(1), Belgian Patents Act.

The specific rights granted to the patent owner in order to enable him to counter infringements are dealt with in more detail in national legislations. Since the European Patent Convention only provides a framework in this respect, we will use the Belgian Patents Act as an example.

198. Any infringement of one or more of the patentholder's aforementioned rights is regarded as an infringement for which the infringer is held liable regardless of whether he acted in good faith[120]. The owner of the patent and, unless otherwise provided, an exclusive licensee are therefore entitled to raise proceedings claiming damages for infringement[121]. In addition, any licensee may intervene in such proceedings with a view to claiming damages[122].

199. In the event that a wilful infringement is committed, the court may order confiscation in favour of the plaintiff of the items that have been produced in infringement of the patent and of instruments or means that were specially intended for such production, or award compensation in a sum equal to the price of the goods sold[123]. If the infringer did not act wilfully, then the court orders the infringer to cease the infringement and may in some cases order a payment of damages to the disadvantaged party[124].

200. Apart from any exceptional cases provided for by statute, a patent also gives the patentholder the right to prohibit any third party that has not been given the relevant permission therefor from applying the invention on the territory of Belgian to anyone other than someone who is entitled, offering or supplying such persons means concerning a significant component of the invention for application of the patented invention in the territory, in the event that the third party knows, or, in the circumstances, it is clear, that these means are suited and intended for such application[125].

201. However, in some cases identified by statute, the patentholder is not able to take action against infringements against his, in principle exclusive, right. These concern *inter alia*:

- acts in a purely private-use context, carried out for non-commercial purposes;
- tests involving the subject-matter of the patented invention;
- preparation of drugs by chemists for direct use for the benefit of individual cases on a medical prescription, or dealings involving the drugs thus prepared[126].

[120] Section 52(1), first paragraph, Belgian Patents Act.

[121] Section 52(2), first and third paragraphs, Belgian Patents Act.

[122] Section 52(2), last paragraph, Belgian Patents Act.

[123] Section 53, Belgian Patents Act.

[124] Section 52(4), first paragraph, Belgian Patents Act.

[125] Section 27(2), Belgian Patents Act.

[126] Section 28(1), Belgian Patents Act.

3. Copyright

202. As has already earlier been stipulated, it is only the author of a literary or artistic work that possesses the right to reproduce the work or to have it reproduced in any manner or in any form (right of reproduction) and to communicate it to the general public via any process whatsoever (right of public communication)[127]. In addition to reproduction in any sense, the right of reproduction also embraces the exclusive right to give permission for adaptation or translation of the work, and renting or lending it[128].

In some cases, however, the law lays down exceptions to these, in principle exclusive, rights on the part of the author. Amongst other things, the following do not constitute an infringement of copyright:

- short citations from a work that has been made public in a permissible manner, for the purposes of criticism, polemic or education or in the context of scientific activities, in so far as this occurs in accordance with fair professional usage and the goal aimed at warrants same (right of quotation);
- reproduction and public communication for the purposes of information of short fragments from works or entire works of artistic expression in a report that is issued concerning actual events;
- free private communication in family circles;
- the partial or entire reproduction of articles of works of artistic expression or of short fragments from works that are established on a graphic or similar carrier, where such reproduction is exclusively intended for private use or for teaching purposes and does not prejudice the issue of the original work;
- reproduction of sound works and audio-visual works within family circles that is intended for them alone[129].

4. Exhaustion

203. The Community law principle regarding the internal market has an important impact on the exclusive rights of the holders of intellectual property rights. Although

[127] Section 1(1) first and last paragraphs CA.

[128] Section 1(1) second and third paragraphs CA.

[129] See *inter alia* art. 13 TRIPs; art. 2 bis Berne Convention; sections 21 and 22 CA.

their rights are in a number of cases determined nationally (*inter alia* in the case of patents, copyright and 'national' trade marks), under the aforementioned principle they cannot challenge use of their exclusive rights for goods that are brought onto the market within the European Union by them themselves or with their express permission[130] [131].

204. Their exclusive rights will nonetheless 'revive' if there are justified reasons that run counter to further trading in the goods, i.e. where the state of the goods has changed or deteriorated after they have been brought onto the market[132].

C. Obligations

205. The holder of an intellectual property right also has a number of obligations to fulfil in order to retain his exclusive right over the entire period of protection.

206. In the first instance, the holder is obliged to pay certain fees[133]. In addition, the holder of the exclusive right is in principle obliged to exploit the right, otherwise he runs the risk of losing either exclusivity or the right itself (see below, paragraphs numbers 531 *et seq.*).

§ 2. *Tax aspects*

207. Where the intangibles are applied by the undertaking itself in its own business activities, there are few points of note in a transfer pricing context. Where the undertaking operates within a group, then account will have to be taken within the context of the functional analysis of the fact that the undertaking is one that possesses intangibles, which will have an effect on the payments to which it is entitled. Naturally, this will have to be looked at together with the functions the undertaking fulfils and the risks it bears, and this will be dependent on the value that the intangible has (on this, see chapter V on valuation).

[130] It is in this sense that one should read section 28(2) Belgian Patents Act, which states that 'the rights flowing from a patent do not extend to dealings concerning a product protected by that patent that are effected on Belgian territory after that product has been brought onto the market in Belgium by the patentholder or with his express permission'.

[131] See *inter alia* section 13.A(8) BTMA and article 13(1) ETMR.

[132] Last part of section 13.A(8) BTMA and article 13(2) ETMR.

[133] Last part of article 47(1) ETMR, section 10, 3rd paragraph BTMA, article 86 EPC.

Section 2

LICENCE AND ASSIGNMENT

§ 1. Legal approach

208. Intellectual property rights are capable of being assigned and the holders can grant third parties the right, exclusively or otherwise, to apply or use this intellectual property within all or any number of the countries for which the right has been granted and in accordance with the statutory provisions, and/or can grant such third parties the right to confer the right to do so on others.

A. Trade Marks

209. As regards trade marks, account has to be taken of a number of grounds for declaring such transfers or licences void. Under articles 17(1) and 22(1) ETMR and section 11.A BTMA, Community trade marks and Benelux trade marks, respectively, can be assigned or licensed independently from the business for all or a part of the goods or services for which it is registered.

210. The specification of 'independently from the business' is not unimportant in this regard. Indeed, article 21 TRIPs states that the '*Members may determine conditions on the licensing and assignment of trademarks, it being understood that... the owner of a registered trademark shall have the right to assign the trademark with or without the transfer of the business to which the trademark belongs*'. This provision can present a risk for multinational undertakings that, for either operational or tax reasons, assign trade marks to one or more group companies that, preferably, operate under a tax-friendly climate.

211. In order to be valid, the assignment of a Community or Benelux trade mark has to be effected in *writing, in a deed signed by the parties to the contract* (art. 17(3) ETMR, sec. 11.A, second paragraph, sub-paragraph 1, BTMA).

212. A trade mark can also be the subject of a licence for all or part of the goods or services for which it is *registered* and for all or part of the Member States of the European Union, or of the Benelux countries, respectively. A licence may or may not be exclusive[134].

213. An assignment or other transfer or a licence cannot be enforced as against third parties unless an extract from the deed evidencing the assignment or licence or a statement signed by the parties involved is filed and registered. This filing is subject to certain formal requirements and requires the payment of certain fees[135].

214. Unless otherwise provided in the licence agreement, in principle the licensee may only raise proceedings for infringement of trade mark with the consent of the trade mark holder.

215. However, if the licence agreement for a Community trade mark is exclusive – meaning that the licensee may exercise all or some of the licensor's rights, even under exclusion of the holder of the right of property – the licensee can raise such proceedings himself. For this, nonetheless, it is required for the licensee to have requested the owner to take action against the alleged infringer but for this request not to have been heeded within a reasonable period[136].

216. Nevertheless, a party that has been granted a licence over a Benelux trade mark can intervene in proceedings for trade mark infringement in order to seek compensation for the loss suffered by him or to have a commensurate part of the profit gained by the defendant awarded to him.

B. Patent

217. Patents are also capable of assignment or can be subject to contractual licences, which have to be constituted by a written deed signed by the parties to the contract[137], that comply with the requisite formal provisions, failing which they are void[138].

[134] Article 22(1) ETMR; section 11.A BTMA.

[135] Section 11.C BTMA, see also article 23 ETMR.

[136] Article 22(3) ETMR. Articles 72 and 73 EPC; sections 44 and 45 Belgian Patents Act.

[137] Sections 44(2)-(6) and 45(2)-(6) Belgian Patents Act.

[138] Sections 44(2)-(6) and 45(2)-(6) Belgian Patents Act.

C. Copyright

218. The same principles apply to the property rights of an author, being the right of reproduction (including the exclusive right to adapt, translate, rent or lend the work)[139] and the *right of communication to the general public*[140]. Under section 3(1) Belgian Patents Act, these property rights fall under moveable rights, which are capable of assignment in whole or in part, and they can also be licensed under ordinary or exclusive licence agreements (section 3(1) CA).

219. Moral rights in general cannot be transferred[141]. Furthermore, it should be pointed out that the transfer of rights for as yet unknown forms of exploitation is void under Belgian law, even if otherwise contractually provided for[142].

220. In the case of copyright, as well, there applies the principle that assignments and licences have to be drawn up in writing, if they are to serve as valid evidence. On this score, however, they are not deemed to be void if there is no written instrument.

§ 2. Tax aspects

221. In actual fact, the tax consequences of an assignment will for the most part be determined by what has happened in the development phase: whether one group company has itself done the development, or if the work has been done under an R&D contract, or if the work has been done under a cost-sharing arrangement.

222. Thus, granting a licence in exchange for royalty payments will generally not be possible where the company receiving the licence has made a proportional contribution to developing the said intangible. In the following, we therefore assume that we are not dealing with intangibles that have been developed under a cost-sharing arrangement. In other words, we shall assume that the intangible has been developed or acquired by the undertaking that is granting the licence itself, or that the intangible has been developed in its name and for its account.

[139] Section 1(1), second and third paragraphs CA.

[140] Section 1(1), fourth paragraph CA.

[141] Section 1(2) CA.

[142] Section 3(1), last paragraph CA; see also sec. 3(3), fourth paragraph CA, regarding such provisions in employment contracts or for appointments under a civil service office.

A. Forms

223. Intellectual property rights can in general be attributed from one undertaking to another (associated) undertaking in four ways: by contribution in kind, by sale (the actual 'transfer'), a de iure transfer or by granting a right of use ('licence'). The consideration that is agreed can in any of these cases comprise a one-shot payment or a periodic payment, or royalty.

224. Please note that the OECD Report is directed only to the use and not the sale of rights attaching to intangible assets. Despite this, we are of the opinion that all factors mentioned below likewise require to be taken account of in determining the sale value of an intangible.

B. Licences

225. In addition to use for one's own business activities, licensing intangibles in exchange for the periodic payment of royalties is probably the most common may of exploiting intangibles. An example is a drug protected by patent, for which a licence is granted to a manufacturer, or the case where group companies are granted licences to use trade marks.

226. Once an intangible is created, its use will thus be granted to the other members of the group by way of licences. Note that the payments made by the group members under the licence agreements will only be tax-deductible where a true benefit has been derived from the licence or it was to be reasonably expected that such a benefit would be received at the time the agreement was entered into. In order to avoid disagreements with the tax authorities, we advise always ensuring there is a written agreement that describes the nature of the relevant intangible fixed asset as clearly as possible and thereby constitutes a basis for valuing the benefit derived. In addition, the taxpayer has to provide all the evidence that the tax authorities need to be able to verify whether, in a particular case, the licensee has received a true benefit[143].

[143] OECD Report, para. 6.14.

227. Most European tax authorities will proceed in making a judgement on the basis of economic reality far sooner than the mere legal framework.

228. However, it is important to mention that the discussion regarding whether or not there is a true benefit is separate from the calculation of the remuneration paid. This latter issue is quite distinct and will be discussed later on in this book (see chapter V on valuation).

229. The contractual arrangements for entering into licences will in practice be affected by a number of factors. For instance, the true benefit of the licence for the production of a drug can for the most part disappear if a competitor brings a better drug onto the market. In this situation, independent parties should incorporate a provision that leaves room for reviewing the licence where significant unforeseen circumstances arise[144].

230. In practice, licences are extremely common in the software sector. In this regard, it used not always to be equally easy to state whether or not what was involved was a licence, since the provisions regarding software and royalties in practice resulted in difficulties. The adjustments to paragraphs 12 and 17 of the Commentary to the OECD Model Convention offer some solace. Since 1992, software that has been purchased for own use only has been regarded as a sale, and thus qualified as a business profit[145].

In 1998, a further adjustment was introduced to the Commentary on article 12 of the OECD Model Convention. This adjustment was directed in particular at the difference between the copyright over the program and the product software that contains a copy of the copyright-protected program (see above)[146].

231. When charging royalties, sufficient attention should not only be paid to withholding taxes, but equally to customs duties. In fact, it might be tempting to think that, when importing goods from outside the EU for 1,000, it might be beneficial to import them for 600 and pay a royalty of 400, thus saving on the customs duties. It is important to note here that the royalty charge will usually be added to the basis on which the customs duties are calculated.

[144] OECD Report, para. 6.30.

[145] Comm. OECD Model Convention, art. 12(14).

[146] G. Gemis and N. De Kinder, *op. cit.*, p. 109.

1. Licensing trade names, brand names, etc.

232. In practice, it frequently happens that the headquarters of a group of companies wish to charge their (foreign) subsidiaries for making use of the group's 'brand'. In practice, this does, however, give rise to tax problems, since from a legal point of view there is no such thing as a 'brand'; legally considered, a difference is drawn between the trade mark, trade names and the company name. It is probably worthwhile first dwelling a while on these legal terms.

a) Legal definitions

1) Company name

233. The *company name* is the name under which a legal entity is incorporated (which is given in the deed of incorporation), as it may be amended by the shareholders in general meeting in accordance with the applicable legal procedures (by an amendment to the memorandum and articles of association). The aim of the company name is to be able to identify the legal entity by distinguishing one company from another (e.g. Philips NV, Sony Ltd., Fortis NV, etc.). In most jurisdictions, the company name must be unique within that jurisdiction: if the name is identical to another company name or so similar that confusion may arise, any party having an interest may have it changed and, if cause is shown, claim damages[147].

2) Trade name

234. A *trade name* is the *distinctive name* under which an undertaking (that is managed by a natural person or a legal entity) is generally known. Generally this is the name under which a firm does business. This name has an *advertising function*. Consequently, the trade name must be *distinctive in nature*: by using a separate name, one business can be distinguished from another (e.g. *McDonald's* as against *Burger King*). The holder of a trade name can go against any third party that uses a similar name, albeit only before the courts, where there is a *chance of confusion* between the two entities and a risk in

[147] See: art. 65, first and second paragraphs, of the Companies Code; G. Bogaert, *De juridische bescherming van de handelsnaam in het licht van de recente rechtspraak*, T.B.H. 1984, pp. 20-22; G. Bogaert and P. Mayaert, *Handelsnaam – Vennootschapsnaam – Merk – Bescherming en onderlinge conflicten, Rechtspraak (1990-1997),* T.B.H. 1999, pp. 72-96. The founders or, in the case of a later change of name, the members of the management organ of the company are jointly and severally liable to those having an interest for payment of this compensation (art. 65, third paragraph, of the Companies Code).

that connection of losing customers or orders, taking into consideration the trade names *as such*, the businesses of the companies and their geographical situation. Sometimes, it is improbable that two identical trade names could be confused with one another (e.g. because one of the firms is situated in Maastricht and the other in Seville). By contrast, there can indeed be a chance of confusion where two non-identical (but similar) trade names are used within a certain area and for carrying on the same activities (this is assessed on a case-by-case basis).

A trade name is protected by international treaties on intellectual (industrial) property rights[148] and by national legislation. According to these international treaties, a trade name is protected as of its first use within a given territory; no registration formalities have to be gone through. Since legal protection of the name is not formally delimited, this can mean that this protection is not necessarily restricted to national borders[149].

3) Trade mark

235. We refer to the discussion under paras. 17 *et seq.* for a definition of this term.

4) Interaction between the company name and the trade name

236. In most jurisdictions, given the identification function of the company name, a legal entity is obliged to mention it on its 'official' documents, such as invoices, official public notices (e.g. notices of general meetings of shareholders), share certificates, other certificates, etc. Where a business decides to use its company name for a publicity campaign or advertising for the company, the company name becomes a trade name.

237. On the other hand, it is not compulsory to use the same name as both a company name and a trade name. A good example of this is to be found in the principle of franchising, whereby various companies share the same trade name (McDonald's, Pizza Hut, H&M, Esso, etc.), albeit the various franchisees must necessarily have different company names.

[148] Article 8 of the Paris Convention; Agreement on the Trade-Related Aspects of Intellectual Property and the Trade in Counterfeit Goods (the TRIPs Agreement), Annex 1C to the Marrakesh Agreement Establishing the World Trade Organisation.

[149] Moreover, this can also be the case with identical or similar company names, provided that confusion can be proved to exist in Belgium; see Brussels Commercial Court, 11 March 1975, *Rev. Prat. Soc.*, 1975, p. 230, note by F. Bauduin.

5) Interaction between the company name and a trade mark

238. A company is entitled to have a whole string of trade marks registered. The Nike Corporation has filed various trade marks, including the word 'Nike', the Nike 'swoosh' and the words 'Just do it'. Whenever a company files a trade mark in one given territory, this will necessarily have the consequence that it automatically enjoys worldwide protection for the trade mark for all goods and services. The following preliminary remarks are worthy of attention:

a. the protection of trade marks is territorially limited: an undertaking can choose to have a trade mark registered in one or more jurisdictions. If a trade mark has been filed in a given jurisdiction[150], the company is given a monopoly for using the trade mark in that given jurisdiction.

b. In principle, the party filing the trade mark is only given protection for the trade mark for the categories of goods and services for which he has filed an application. For example: by filing the word trade mark 'Iceberg' for clothing, the owner of the trade mark normally does not acquire the right to prevent a third party from using the word 'Iceberg' for cars.

Bearing in mind the foregoing, it is possible for a company to use the same word as a company name, trade name and trade mark (such as is done by Nike, Philips, Sony and other groups).

However, a clear distinction does have to be drawn between use of the respective company name, trade name and trade mark. Where a company decides to use its company name 'as a trade mark' (in order to distinguish its goods/services from those of another undertaking), it is also possible that they might thereby infringe the exclusive (trade mark) rights of another party that has already filed the same (or a similar) name earlier as a trade mark in the corresponding category of goods or services in the same jurisdiction.

[150] A jurisdiction can be a given country (like France) or a union of (Member) States (the Benelux or the European Union). International treaties (like the Madrid Convention or the Madrid Protocol) offer parties the possibility of applying for simple registration of their trade marks in various member States that have signed the relevant treaty.

2. The transfer pricing question

239. The relevance of the distinction that we have explained above is that a number of countries still have difficulty in accepting the deduction of royalties that are paid to remunerate a trade mark or trade name where this trade mark or name corresponds to the company or group name.

240. Thus, in Belgium in the 1970s, there was a case in which the tax office took the view that a Belgian company was artificially shifting profit to its French parent by paying royalties for use of the parent company's name. The tax office thought that the French shareholder had free disposal over the name by means of its dominant position; moreover, matters were only set down on paper some seven months after the Belgian subsidiary was incorporated. The Brussels Court of Appeal confirmed the tax office's position in the case[151].

241. In Germany as well, the courts have looked repeatedly at this issue. Thus, in December 1999, a German regional court (in Rhineland-Pfalz) handed down a decision in this regard[152].

242. The case concerned a German company that produced brakes and brake components. The German company belonged to an international group of companies that all used intangibles (in particular the name and logo/trade mark of the parent company) that were all the property of the foreign parent company, which did not however have any worldwide legal protection for them. The German company had already used these intangibles since 1985 without paying any remuneration.

243. In 1991, the German group company suddenly started paying a royalty of 1.5% of its turnover to the foreign parent company for use of the group name and the logo/trade mark. The German tax authorities rejected the deduction of these royalties and treated the payment as a hidden dividend payment.

This treatment was confirmed by the regional court in Rhineland-Pfalz, which was of the view that, although a subsidiary can pay a royalty for the use of an intangible, this must

[151] Brussels Court of Appeal, 4 October 1972, *in causa* Veritas, JPDF 1972, p. 311.

[152] See Tax Management Transfer Pricing Report, 24 November 1999, p. 654.

be judged restrictively where the group name and the logo/trade mark are the same. In the latter case, the deduction could only be accepted if the group name was less important in the market than the logo/trade mark. Here, the court opined, the logo/trade mark was certainly not dominant.

The regional court was also of the opinion that use of the logo/trade mark had not given rise to any increased turnover. It is certainly true that the turnover of the German subsidiary had risen from DEM 290 million in 1985 to DEM 584 million in 1992 (an increase of some 107%) and the firm's market share had increased from 9% to 17%, but against this was the fact that the automobile sector in general had seen growth of 136% over that period, so that the court concluded that the firm had merely profited along with the pace of market growth.

244. The taxpayer was not satisfied with this decision, however, and appealed to the highest court of appeal in Germany. The court came to another conclusion to that of its colleagues in the regional court[153]. The court stated that it is indeed so that the right to use the group name or the logo comprises a part of the support that the parent company can be regarded as providing to its subsidiaries without any fee being due for that. But, the court said, if the group name also enjoys legal protection as a trade mark or trade name, then a royalty can be charged, because the group name is adequately distinguished from the trade mark or trade name. The court went on to explain, as we have stated above, that the company name identifies the undertaking, whilst the trade mark identifies a product that is sold in the market.

The court concluded that, where the trade mark or trade name, on the one hand, and the company name, on the other, are identical, the latter is at least to an extent superseded by the first two and the shareholder is entitled to license the trade mark in exchange for a royalty. Moreover, the court also disagreed with the dictum by the regional court that the trade name had no value-added; the court considered that the value of a trade mark is not necessarily determined by the creation of a higher turnover; it is sufficient that the trade mark promotes the products on the market.

[153] See Tax Management Transfer Pricing Report, 24 November 1999, p. 637.

In this regard, five factors have to be looked at:

- the popularity of the trade mark;
- the export quantity on the part of the licensee;
- the worldwide or regional presence of the trade mark;
- who created the trade mark;
- who has borne the costs of its development, maintenance and protection.

245. This case illustrates very nicely the interaction between the legal and tax rules and shows that a proper picture of the legal position in which an undertaking or group finds itself is a prerequisite before a tax position can be assumed. Seen fiscally, it will be of crucial importance that the royalty is clearly paid for use of the trade mark.

246. Fiscally, it will also be of great importance to determine the value of the intangible, an item into which we go in further detail in the next chapter.

247. However, one remark that we should still like to make here is that, regardless of the situation, it has to be ensured that consistency is the watchword. The German case also goes to show that, where a system has been applied for years and then is suddenly changed, the tax office may (rightly) pose questions. This is also shown by a fairly old decision by the Brussels Court of Appeal[154], in which a group company had paid a royalty of 10% for years and, at a given moment, adjusted the rate of the royalty to 5%. the tax authorities did not have any problem with this as regards the future, but successfully challenged the reasoning for paying 10% in the past.

C. Assignment in exchange for a one-shot fee

248. It is also possible to alienate intangibles in exchange for a one-shot fee. This fee will then be determined on the basis of the expected flow of royalties spread over the period of the assignment or the lifetime of the intangible.

249. It is useful here to refer to the American rules in this regard[155]. The ‘commensurate with income’ rule (see below), which requires a periodic check to see whether the expected royalty

[154] Brussels Court of Appeal, 12 June 1958, *La Revue Fiscale* 1959, p. 118.

[155] US Guidelines, § 1.482-4(f)(5).

income in reality tallies with the actual income from the intangible, means immediately that an assignment in exchange for a one-shot fee is not possible there, because the one-shot fee can be subjected to periodic adjustments, just as actual royalty payments can be.

D. Unconscious transfer

250. Closely linked to the subject of ownership is the issue of when a transfer of intangibles actually takes place.

There are cases in which, instead of a conscious transfer (by sale, grant of a licence, etc.), one can be faced with an unconscious or probably also an undesired transfer.

251. The lack of clear provisions regarding whether or not there is a transfer has led to a number of disputes between the Revenue and taxpayers.

252. Within this context, there are two types of transactions that are problematic, namely those in which 'embedded intangibles' are involved and, the 'round-trip' buyer/seller transaction. In the first case, the situation is one in which a transaction involving physical goods is effected between group companies and, without dwelling on the matter, an intangible is also to be transferred. These are marketing intangibles, such as the brand name, the group image, the logo, etc. Another type of transaction concerns the situation where a parent undertaking provides its subsidiary undertaking with intangible assets that are necessary to produce the physical goods, which are subsequently sold back to the parent company.

253. In the case of an embedded intangible, the American guidelines[156] provide that there will no question of any transfer where the purchaser within the group does not acquire the rights to exploit the intangible with the exception of the right of resale under normal commercial circumstances.

254. However, practice is not always so clear. Often, distributors undertake marketing activities regardless of whether or not they possess the trade names or trade marks.

[156] US Guidelines, § 1.482-3(f).

255. Suppose, for instance, a European group with a strong brand name and reputation wishes to start developing business activities in the United States, where the group is still utterly unknown. The American subsidiary, which acts as the distributor, will therefore have to make efforts to build up the brand name and reputation of the group in the United States. The question arises whether a transfer has actually taken place and the American subsidiary has acquired the rights over the brand name and reputation of the group.

256. In the United States, the Internal Revenue Service (IRS) has long-since tried to defend the position that this was indeed the case and that the American distributor was entitled to a proportional share of the income from that intangible. In an outbound situation (American company with foreign distributors), the IRS is far less inclined to assume this stance and the position is usually defended that the foreign group company is just a distributor, whereby the American parent company retains all the rights over the intangibles[157].

257. However, the question in all of this is whether this can be gone along with from a European point of view. Suppose an American manufacturer of sports shoes comes to Europe and sets up a distribution network via subsidiary companies by licensing the trade marks/trade names. Where the subsidiaries have to make sales efforts (with their own funds) in order to get their name known in the local markets, then the question is very much whether rights have been built up by the subsidiaries in Europe vis-à-vis the trade marks/names. On the one hand is the question of whether it can be regarded as in conformity with the market that the European subsidiaries have to bear these market penetration costs in full. On the other, if this should be the case, it seems hardly defensible that, in this situation, royalties would be charged by the American parent for use of the trade marks/trade names.

258. The OECD Report[158] extensively covers the distribution of brand-name products; above all the aforementioned situation whereby an associated distributor is involved in significant marketing activities, but does not have any share in the ownership of the trade mark or trade name associated with the product.

[157] J. Mogle, *op. cit.*, p. 14.

[158] OECD Report, paras. 6.36-6.39.

259. Where the owner of intangible marketing assets reimburses the promotional outlays incurred by the distributor, then the latter will only be entitled to a fee that is appropriate for its activities as a representative[159].

260. Where, on the other hand, the distributor bears the costs of its marketing activities itself, then, according to para. 6.38 of the OECD Report, there arises the question of the extent to which the distributor can share in the potential profit from those activities. According to the OECD, this will generally depend on the nature of the rights of that party. Thus, a comparison has to be made here with an independent distributor in similar circumstances.

261. Finally, there arises the question of the extent to which the outlays have contributed to the success of a product. The OECD Report[160] state here that in a large measure, account must be taken with the actual behaviour of the parties over a number of years.

262. Another point for discussion is so-called round-trip transactions. In a typical round-trip transactions, say, an American parent company makes a number of intangibles available to its foreign subsidiary, for the purpose of producing goods that will subsequently be sold back to the American parent. It should be possible to state here that the American parent has transferred intangibles to the foreign subsidiary, with the consequence that that subsidiary should be entitled to a considerable portion of the profit that is realised on the goods produced by it. The IRS has always argued that the American parent would never permit a transfer of intangibles in a transaction with a third party. Whereas the IRS initially had difficulty in seeing the whole picture and therefore could not recognise any separate transfer of intangibles, the final American guidelines[161] expressly reject the combination of 'tangible' and 'intangible' transactions. Since then, the IRS has indeed had to analyse whether there had been a transfer of intangibles. In practice this will depend on the result of the functional analysis.

E. The American commensurate with income standard

263. From 1986, American taxpayers were obliged not only to deploy an arm's length transfer price in intra-group transfers of intellectual property rights[162]; the IRS additionally required that the taxpayer stipulate that this transfer price is commensurate with the

[159] OECD Report, para. 6.37.

[160] OECD Report, para. 6.39.

[161] US Guidelines, § 1.482-1(b)(2)(ii).

[162] In which use can be made of the aforementioned transfer pricing methods.

income that is to be attributed to the intellectual property right[163]. The aim of this reform was to ensure that the allocation of the income between associated undertakings reasonably reflected the respective economic activities of each undertaking[164].

264. Immediately, this commensurate with income standard caused great confusion and uncertainty amongst American taxpayers, since the IRS was suddenly able to assess after the fact whether or not the initial transfer price did in fact satisfy the arm's length criterion. However, taxpayers take the view that unassociated parties would also fix the royalties beforehand in an agreement, as a result which of no possibility of carrying out corrections would be incorporated.

265. Following great criticism that was expressed against the new regulations, the IRS adjusted its guidelines. The new guidelines only seek an answer to the question of whether the analysis of the facts and circumstances at the time the *intra*-group transaction came into being would have been the same had the transaction in question then been brought about by unassociated undertakings. If the IRS later considered that the taxpayer *at the time the given transaction came about* carried out an unreasonable analysis, then they are empowered to effect a retrospective adjustment[165].

266. In the context, three factors are of importance, first, the guidelines require that the initial royalty be fixed in the year in which the right of use is granted at arm's length. It is assumed that in a certain measure this provision is dependent on the anticipated income (or cost-savings) from use of the asset item. Second, the assumption is that the acceptability of the transfer price initially fixed at arm's length is significantly dependent on the reliability of the income forecast.

267. And finally, the guidelines proceed on the basis of a so-called safe-harbour assumption that the initial quantification of the anticipated income was sufficiently reliable as regards the determination of the initial arm's length transfer price if the budgeted income is not less that 80% of the income actually received and not more than 120% of the income actually received in the hands of the licensee as a consequence of its use of the asset item. If it seems that the safe harbour principle is not satisfied, the IRS

[163] Section 1231(e)(1) of the Tax Reform Act of 1986 requires that '*the transfer price paid or received in connection with the transfer of an intangible be commensurate with the income attributable to the intangible*'.

[164] See J. Mogle, *op. cit.*, p. 43 and the references therein.

[165] *Ibid.*

can adjust the royalty within a certain time frame until it satisfies the arm's length standard, taking into account the specific circumstances of the case[166].

268. It must be emphasised, however, that the IRS can only carry out adjustments if and only if it can demonstrate that adjustment of the royalty would have been necessary at the time of the initial transaction by unassociated undertakings, taking account of the normal (arm's length) trading terms, a condition that in practice seems to be by far the greatest hurdle[167] [168]. However, the taxpayer is given the possibility of demonstrating that the transfer price did indeed satisfy the arm's length criterion[169].

269. In no event should the IRS be able to invoke circumstances that have altered after the signing of the contract in question.

THE POSITION OF THE OECD

270. There is not much distance between the positions of both the IRS and the OECD as regards periodic adjustment, apart from the fact that the OECD would above all limit the application of this standard to cases in which the Revenue encountered unwillingness on the part of the taxpayer to cooperate.

271. Another position taken by the OECD is its proposal that associated undertakings should only enter into short-term contracts, thus making it possible, after the expiry of the contract, to negotiate other terms, which should indeed go some way to meeting the arm's length criterion[170].

272. In practice, however, it appears that long-term contracts almost always make provision for periodic adjustments, in which account is even taken of circumstances that might change after signature of the agreement. This practice goes much further that the stance of the IRS and the American case law on the commensurate with income standard, which does not take any account of such circumstances (see below).

[166] J. Mogle, *op. cit.*, p. 44.

[167] *Ibid.*

[168] See also OECD Report, para. 6.29.

[169] J. Mogle, *op. cit.*, p. 48.

[170] OECD Report, para. 6.30.

CHAPTER V

VALUATION OF MARKETING-RELATED INTANGIBLE ASSETS – TRANSFER PRICING ASPECTS

Section 1

INTRODUCTION

273. The value of a brand is determined by the potential for increasing the price, at least consolidating the customer base and achieving such a dominant character that any competitors will not gain any fixed foothold in the market. The last of these is called 'barriers to entry'. A strong brand has the hallmarks of a 'promise' that the company will at all times honour vis-à-vis its customers, in order to ensure trust on the part of buyers[171]. Keller[172] states that a brand is something that resides in the minds of consumers. He describes it as a perceptual entity, rooted in reality, but also reflecting the perceptions and perhaps even the idiosyncrasies of consumers.

274. Multiple examples exist of how precious and volatile value can be. For instance, we could quote American Express's CEO, Kenneth I. Chevault, who said that 'even the company's most valuable assets – its brand name and global scope – can be viewed as severe liabilities in the current climate when anything American can invite an irrational attack'[173].

In that same context, one might refer to the challenges faced by global brands such as e.g. KFC and Pizza Hut, both owned by Tricon (a 1997 spin off from PepsiCo), in order to push globally as the main driver of their growth. Knowledge that they may represent 'the face of American business' in consumers' minds, could adversely affect the latters' buying patterns[174].

Even though this book does not at all aim to enter into any ethical debate surrounding the anti-globalisation movement, it cannot simply be ignored that valuation exercises of, say brands, can be troubled when they are depicted as having come to represent 'a fascist state where we all salute the logo and have little opportunity for criticism because

[171] M. Peterkin, *Build an Effective Brand*, Worldlaw Business, September 2000, p. 35.

[172] K.L. Keller, *Strategic Brand Management*, Prentice Hall, Upper Saddle River, New Jersey 07458, p. 10.

[173] J.A. Byrne and H. Timmons, *Tough Times For a New CEO*, Business Week, 29 October 2001, p. 50.

[174] B. O'Keefe, *What do KFC and Pizza Hut conjure up abroad? Are they American symbols? Or have they become global brands?*, Fortune, 26 November 2001, pp. 42-48.

our newspapers, television stations, Internet servers, streets and retail spaces are all controlled by multinational corporate interest'. This is how Naomi Klein describes brands and their impact in her book, which is seen by many as the anti-globalist bible[175]. Keller acknowledges that certain brands reflect different values or traits. Consuming such products is a means by which consumers can communicate to others – or even to themselves – the type of person they are or would like to be. He refers to Harvard's Susan Fournier who notes that 'relationships with mass brands can soothe the 'empty selves' left behind society's abandonment of tradition and community and provide stable anchors in an otherwise changing world. The formation and maintenance of brand-product relationships serve many culturally-supported roles within postmodern society'[176]. Increasingly, consumers' perceptions of a company as a whole and its role in society affect a brand's strength[177]. We have found the most extreme illustration of the emotional aspects of trade marks in a quote from Kevin Roberts, CEO Worldwide of the Saatchi & Saatchi ad agency, where he says that instead of trade marks we should think of brands as 'lovemarks'[178].

275. Quantifying the value of a brand can hardly be called easy given the 'emotion' that affects a consumer before he will try out a product or service for the first time or make a second purchase. It will not surprise anyone that valuing emotion is not easy, for want of objectively measurable parameters. A brand has a value because it is a promise of future service quality based on past experience[179]. It allows consumers to assign responsibility as to which manufacturer or distributor should be held accountable.

276. When, a few years ago, the first shy attempts were made to seduce consumers to purchase via the internet, the so-called 'business-to-consumer' or 'B2C' sales channel, it was thought for a while that the importance of brand value would rapidly decrease. Indeed, the internet suddenly cast question on a number of constant maxims of

[175] N. Klein, *op. cit.*, p. 187; for critical comments see The Economist, *The case for brands, pro logo*, 8 September 2001, p. 9 and Who's wearing the trousers? pp. 27 – 30.

[176] K.L. Keller, *op. cit.*, p. 8.

[177] K. L. Keller, *The Brand Report Card*, Harvard Business Review, January - February 2000, p. 6.

[178] G. Colving, *What's love got to do with it?*, Fortune, 12 November 2001, p. 24.

[179] J. Henshall, *Failure to Examine Intellectual Property can Lead to 'Horror Stories'*, Tax Management Transfer Pricing Report, 24 January 2001, pp. 639-640; T. Levitt, *Marketing Intangible ¨Products and Product Intangibles*, Harvard Business Review, May-June 1981, p. 95; J. Henshall, *Intellectual Property Horror Stories*, Tax Planning International Transfer Pricing, February 2001, pp. 3-6.

economic theory, for is it not so that economic doctrine is directed towards the 'scarcest'? In other words demand and supply result in a price for a product or service that will be higher or lower depending on the market imperfections that are in play. An important cause is the incomplete information that market players have of the demand and supply sides. In essence what it boils down to is that the consumer wishes to satisfy certain needs by purchasing a good or a service. The means for producing these goods or services, however, are limited in relation to the needs and give rise to a welfare shortage.

277. A choice has to be made, priorities have to be set between the needs of the consumer that can be satisfied in given circumstances. Against this, the producer will have to decide what, how and where he will produce and who should benefit from the result of the production[180].

278. The rise of the internet meant that the scarcity of information was suddenly made good. Ever stronger, the consumer suddenly had access to a mass of information that he previously could not have guessed about; but, more than this, he had access to information that might well have been available in a disparate manner but was now suddenly available in such a comprehensive manner that price comparisons were simply reduced to a few 'mouse-clicks'.

279. It is said that this consideration held the big supermarket chains back for a fairly long time from launching product catalogues on the internet, since it can actually be more commercially interesting to keep consumers that want to do price comparisons sweet by making comparisons in the many kinds of advertising leaflets that bulge out of the standard letter box.

280. Authoritative magazines strengthened this expectation in their 'internet surveys'[181], for the internet made it possible for the consumer to look for the lowest price, and for businesses to obtain offers from various suppliers. It also made it possible to reduce transaction costs and barriers to entry. In other words, thanks to the internet, the economy

[180] V. Van Rompuy, P. De Grauwe, T. Peeters, H. Van der Wee and P. Van Rompuy, *Inleiding tot de economie, Universitaire Pers Leuven* (Louvain University Press), fourth revised impression 1981, p. 19.

[181] See, for instance, P. Woodall, *Untangling E-conomics – A Survey on the New Economy*, The Economist, 23 September 2000, p. 44 ; F. Cairncross, *Inside the Machine – A Survey on E-management*, The Economist, 11 November 2000, p. 40; E. Duncan, *Thrills and Spills – A Survey on E-entertainment*, The Economist, 7 October 2000, p. 24.

evolved towards a model of perfect competition, which means that there is sufficient information available and there are also sufficient players operating on the purchase and sales sides without transaction costs and barriers to entry[182]. However, it has not turned into a self-fulfilling prophecy. Quite the contrary: not only has internet trade been vastly over-estimated, but the conclusion has had to be drawn that even the price-sensitive on-line buyer is not really the ‘bargain-hunter’ that drives producers into a constant price war[183].

281. The reality is that internet shoppers are prepared to pay more, a so-called ‘premium’, for a brand and for addresses where they had previously made purchases[184].

282. The prediction that monopolies, as an example of market imperfection, could at most exist only temporarily has been overtaken by reality. This maybe is not necessarily bad news for the consumer, since is it not the case that an important motive for producing lies in the possibility of possessing a temporary monopoly? Indeed, if that were not the case, we would be forced to sell at a marginal cost whilst overheads appeared to be irrecoverable.

283. Hence, with market imperfections investors have an interest in an ‘information economy’ in order to recover their investment and make profit. With information, the fact is that it is extremely difficult to produce but easy to reproduce, in other words, relatively high fixed costs as against the marginal costs. Ultimately, the consumer is offered products and services of superior quality.

284. The valuation of brands will therefore not only increase in importance but more than ever affect business life in the near future, despite – or maybe due to – the rise of new channels of distribution, facilitated by the internet.

285. Financial analysts are asking to receive more, quantified information on brands. References can be made, for instance, to a referendum conducted by Brand Finance

[182] P. Woodall, *op. cit.*, p. 10.

[183] For a critical analysis , see also M. E. Porter, *Strategy and the Internet*, Harvard Business Review, March 2001, pp. 62-78.

[184] E. Brynjolfsson and M. D. Smith, *The Great Equalizer? Consumer Behavior at Internet Shopbots*, http://e-commerce.mit.edu/papers/tge, included in MIT Sloan Management Review Winter 2001, Volume 42, Number 2. The authors assessed the buying behaviour of ‘shopbot’ consumers. A ‘shopbot’ is an intelligent robot that makes lists of certain products, with the cheapest at the top. The brand made 3.1% extra premium possible, whilst purchases on already known addresses even allowed of 6.8% extra premium.

amongst 292 analysts working in the City (of London) in 2000[185]. No less than 73% wanted information on brands in the balance sheet (thus including self-developed brands, and not just those received from third parties).

286. Moreover, the same report states that brands will be ascribed increasing importance in mergers and acquisitions and decisions regarding corporate financing in the next five years. Useful inspiration can also be found in a publication that has shed light on the shortcomings in the current reporting obligations for companies, and arrived at a proposal for 'value reporting'. The aim is to achieve a reporting standard under which the public gains an insight into that which a company exactly does in order to create value.

287. 'Public' means investors, analysts, legislators, accounting firms, in short anyone who is directly or indirectly affected by the parameters of 'shareholder value' and its micro- or macro-economic impact[186]. Intangible assets such as a team of excellent employees, market share, consumer satisfaction and brand trust can have a value that by far exceeds those entered in the balance sheet. Consumer retention, for instance, affects shareholder value directly. A study by McKinsey & Company has demonstrated that a 10% increase in customer retention triggers a positive effect on shareholder value of no less than 9.5%[187].

288. Harvey L. Pitt[188], head of the US Securities & Exchange Commission, is pledging to overhaul the current system of financial reporting and disclosure. His objective: to supplement narrow, background-looking earnings and asset data with far more information on companies' future trends and strengths.
Much controversy revolves around intangible assets. Overlooking them means that investors are misled about the value of companies, according to New York University accounting professor Baruch Lev. His research shows that insiders who buy and sell stocks at research-

[185] D. Haigh, *Make Brands Make Their Mark*, International Tax Review, February 2001, p. 40; S. Arthur, *Mergers & Acquisitions; Royalty Structures; Brand Valuations; Trusts – CIOT European Branch Report*, Tax Planning International Review, The Bureau of National Affairs Inc., 2000, p. 28; D. Haigh, *Brand Valuation – The Need for Tax Planning When Valuing Brands*, International Tax Report, February 1997, pp. 4-8; D. Haigh, *Getting the Best From Brands*, International tax Review, February 1997, pp. 30-34.

[186] R. G. Eccles, R. H. Herz, M. E. Keegan and D. M. H. Phillips, *The Value Reporting Revolution – Moving Beyond the Earnings Game*, PricewaterhouseCoopers, 2001, John Wiley & Sons Inc., vii and 16, possibly also see www.valuereporting.com. See also: K. G. Rivette and D. Kline, *Discovering New Value in Intellectual Property*, Harvard Business Review, January-February 2000, p. 11.

[187] R. G. Eccles [*et al.*], p. 17.

[188] M. Mc Namee, *New Yardsticks for Investors*, Business Week, 5 November 2001, pp. 36-37.

intensive companies earn three times as much profit as their counterparts at other companies because they know more than other investors do about how R&D is paying off.

289. The OECD has looked into this matter in the context of its reports (also called 'guidelines'). In July 1995, the 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' were issued. In March 1996, amongst others, Chapter 6 was published, under the title of 'Special Considerations for Intangible Property'. These guidelines ('the OECD Report') offer a helping hand in order to apply the often (too) theoretical ground rules on transfer pricing in practice.

290. The relevance of Transfer Pricing is undoubtly constantly increasing given the ongoing trend of globalisation. As a recent Economist survey says, 'the affiliates of multinationals trade with each other… Before FDI (Foreign Direct Investment) the companies exported finished goods. After FDI, they ship, let us suppose, a mixture of finished goods and intermediate goods'[189]. The role of intangible property in this trend cannot be underestimated taking into account the current move to a 'knowledge society'. Reference can especially be made to Peter Drucker's vision on 'the next society'[190]. He states that, from a statistical viewpoint, multinational companies play much the same part in the world economy as they did in 1913. At that time they were domestic firms with subsidiaries abroad, each of them self-contained, in charge of a politically defined territory, and highly autonomous. However, now they tend to be organized globally along product or service lines but they are held together and controlled by ownership. By contrast, the multinationals of 2025 are likely to be held together and controlled by strategy. There will still be ownership, of course. But alliances, joint ventures, minority stakes, know-how agreements and contracts will increasingly be the building blocks of a confederation. It is thus not surprising, that we strongly believe that pricing for transfers between the members of such a 'confederation', whereby some form of economic solidarity prevails, might be a hard nut to crack.

291. The aim of the OECD Report is to reduce situations in which there is economic double taxation – whereby various taxpayers are taxed on the same tax base. In the first paragraph of the relevant chapter, the OECD Report already discerns that transactions with intangible property are frequently difficult to evaluate for tax purposes[191].

[189] C. Crook, *Globalisation and its critics, A survey of globalisation*, The Economist, 29 September 2001, p. 9.

[190] P. Drucker, *The Next Society, A survey of the near future*, the Economist, 3 November 2001, p. 5.

[191] OECD Report, para. 6.1.

'Intangible assets' refers to the rights for use of industrial assets such as patents, trade marks, trading names, models or designs.

292. They also encompass literary and artistic property rights and intellectual property, such as know-how and trade secrets. In the chapter on intangible assets, the OECD Report is oriented towards 'commercial rights', which mean 'intangible property associated with commercial activities, including marketing activities'. These intangible assets are assets that may have considerable value even though they may have no book value in the company's balance sheet. There may also be considerable risks associated with them (e.g. contractual or product liability and environmental damages)[192].

293. In this contribution, we restrict ourselves to the valuation of what the OECD Report classifies as 'marketing intangibles'. These are a 'special type of commercial intangible with a somewhat different nature'[193], in the words of the OECD Report. They encompass 'trademarks and tradenames 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'[194].

[192] OECD Report, para. 6.2.

[193] OECD Report, para. 6.3.

[194] OECD Report, para. 6.4.

Section 2

GENERAL CONSIDERATION OF VALUATION METHODS

§ 1. Introduction

294. From the viewpoint of the transfer pricing issue, taxpayers are regarded as being inspired by the aforementioned OECD Report. We see that it is usual for national legislatures and/or tax authorities to take the OECD regulations in this area as an inspiration, or at least to refer to them. In Belgium, for example, officials are given notice that they should seek inspiration in the matter of transfer prices from the OECD Report[195].

295. However, the question is whether the OECD Report can be assessed as being of such practical usefulness as to serve this purpose, since it refers itself to the complexity of the issue when it says that 'the value of marketing intangibles depends upon many factors, including the reputation and credibility of the tradename or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past, the degree of quality control and ongoing R & D, distribution and availability of the goods or services being marketed, the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies), the value of the market to which the marketing intangibles will provide access, and the nature of any right created in the intangible under the law'[196].

296. Hence, the tax practitioner will sooner seek inspiration from valuation methods and techniques that are used generally in the area of financial analysis and economic theory in general and thereafter test these in terms of their 'compatibility' with the approach advanced by the OECD. However, what is involved here are often valuation techniques for businesses in general, a number of whose factors are reduced in importance in order to determine the value of the intangible assets.

[195] See AFZ/98-0003 dated 28 June 1999. Page 4 of this practice note states that it contains 'a general overview of the legal and treaty framework in which this issue is located. Thereafter, it deals with a number of more practical aspects concerning transfer prices, such as functional analysis. Finally, it contains a summary of the guidelines that are included in the new OECD Report'.

[196] OECD Report, para. 6.4.

297. We shall try in this contribution to show why it is that such techniques are not always free from criticism. Nevertheless, we also have to recognise here that the economic theory of the 'scarcest' comes into play. The valuation has to be founded on publicly available information that is at least complete, as we have tried to make clear in the introduction to this chapter. Thus, it so happens that a pragmatic approach, on the basis of already generally accepted valuation techniques, will best serve the tax practitioner[197].

298. Thus, it is not our aim with the following contribution to pretend that we will introduce 'new insights' into the question of tax valuation. We restrict ourselves to making suggestions that try to provide a solution to the practical problems that ensue unavoidably from strictly following the OECD Report in the area of brand valuation.

299. The term 'trade mark' refers to the relevant description in the OECD Report, which states: 'a trademark is a unique name, symbol or picture that the owner or licensee may use to identify special products or services of a particular manufacturer or dealer and, as a corollary, to prohibit their use by other parties for similar purposes under the protection of domestic and international law'[198].

§ 2. Importance of a 'cross-functional perspective'

300. Brand valuation entails more than an estimation by the marketing division of future expenditure. Allocating a marketing budget is historically characterised by a certain subjectivity. The saying 'I know that half of every penny I spend on marketing is wasted, I just don't know which half' is not entirely fanciful[199], although a swing can be detected.

301. Marketing specialists in a business should be able to make profitable use of information on the value of a trade mark as an alternative to or on top of just designing

[197] See also: P. Cauwenbergh, *International Transfer Pricing – De fiscale behandeling van grensoverschrijdende intragroepscontracten*, Antwerp, 1998, Intersentia Rechtwetenschappen, pp. 230 and 235, where it is said that in Belgium there are no precise rules for calculating the normal amount of intangible assets for tax purposes, that the question is a pure question of facts and that no magic formulas are available.

[198] OECD Report, para. 6.8.

[199] M. G. Dekimpe and D. M. Hanssens, *Lange-termijn effecten van marketinguitgaven: onmeetbaar en dus onbestaand, of toch niet? – Effectiviteitsmeting van marketinguitgaven: een historisch perspectief*, Business Inzicht – Een bericht over onderzoek aan het Departement Toegepaste Economische Wetenschappen van de Katholieke Universiteit Leuven, no. 7, March 2001, pp. 2-3.

marketing expenditure in a modular fashion according to the relative market shares of products or services. Market share is merely an expectation of future sales. Although it certainly has merits, it can hardly function as a yardstick for the actual value of future sales, the strength of a trade mark or its profitability as a function of expenditure.

302. In order to make good this shortcoming, it can be useful to involve the finance department. Nonetheless, the internal financial experts or accountants are classically given the job of external reporting, and this is not as a rule designed to facilitate internal decision-making processes.

303. This will particularly be the case in undertakings where intangible assets are developed internally and therefore are not registered in the external reporting, the balance sheet. Ideally, marketers and accountants should have to gear their activities and information collection to one another in order to arrive at a brand valuation that enables the management to judge the effectiveness of marketing expenditure in terms of the impact on the value of the brand[200].

304. Channelling marketing and accounting information towards one and the same goal is not easy, however. Accountancy principles have led to a culture in which only data that are objectively measurable and verifiable are used as a basis for any action.

305. This means that the cost calculation by the accounting department will only incidentally contain information of potential use to the marketing department, since these data are in the first instance intended to find the product cost in order to value stock, and therefore lack any empathy with the consumer's perspective. Moreover, they are founded only on historical information and do not reflect any future expectations. On the other hand, the marketing division looks by definition to the future and relies on projections and estimates that are often to a large extent collected via external sources, and are thus hard to verify or at least to test as to their trustworthiness. All this has the consequence that potential synergies between marketing and finance managers within businesses often are not or are insufficiently explored[201].

[200] K. S. Cravens and C. Guilding, *Strategic Brand Valuation: A Cross-Functional Perspective*, Business Horizons, Indiana University Kelley School of Business, July-August 1999, p. 53.

[201] The same remark is valid in the relationship between R&D and marketing departments according to a study, referred to in MIT Sloan Management Review. Reference is even ironically made to a Dilbert comic expressing that engineers and marketers mix like oil and water; see L. Yu, MIT Sloan Management Review, Fall 2001, p. 13.

§ 3. *'Cross-functional' cost accounting methods*

306. Certain cost calculation methods can, however, be used for the marketing department without deviating from the accountancy principle of prudence. Such methods start from the cost of a product or service, but go on and gear the financial value to the marketing decision-making process.

307. An example of this is the so-called 'Life Cycle Costing[202], in which no account is taken of the classic accountancy reporting periods, i.e. the accounting reference periods, but the basis is taken as the total cost over the lifetime of the product or service on the market.

308. 'Target Costing'[203] is also headed in this direction. Not only is the actual production cost taken into account, but also an estimate of the long-term cost that is necessary in order to remain competitive in the market. If the target cost cannot be achieved, this means that a product cannot be launched at a competitive price that guarantees an adequate margin. The thorny question then remains as to whether the product (or service) can still be launched. The answer is 'no' unless the production processes can be rendered more efficient. Finally, reference can be made to 'Customer Costing'[204], which is used in quantifying the profitability of products and services per consumer segment. In this manner, the management gains a view of which consumers are the most important for the company.

§ 4. *Brand valuation*

309. Brand valuation goes further than the above shy attempts at cross-functional cooperation between marketing and finance managers.

310. It involves measuring brand equity, which is the result of a combination of brand trust, being well-known, quality perception and other specific assets such as the competitive advantage created by a brand[205].

[202] K. S. Cravens and C. Guilding, *op. cit.*, p. 54.

[203] K. S. Cravens and C. Guilding, *op. cit.*, p. 54.

[204] K. S. Cravens and C. Guilding, *op. cit.*, p. 54.

[205] For an extensive explanation, see D. A. Aaker, *Managing Brand Equity*, New York, Free Press, 1991.

311. Determining the value of a brand constitutes not only a basis for the fair allocation of taxable subject-matter over a variety of jurisdictions in order to arrive at a coherent and consistent fiscal transfer pricing policy.

312. Of more importance than the tax dimension in our view is the realisation that the brand value is also useful in determining inter-company prices in order to arrive at a realistic and fair evaluation of the management within the various undertakings that form parts of one and the same multinational group. Procter & Gamble use brand valuation in order to determine a fair price that sometimes no less than fifty group members have to pay for use of a brand or the technology related thereto[206]. This underpins our perception that transfer pricing constitutes part and parcel of strategic planning.

313. Indeed, it ensures that income is correctly matched against expenditure, and, in so doing, that the performance of each component of an undertaking can accurately be measured and comprehended[207]. Keller argues that putting a price tag on a brand's value may be useful for the following reasons:
'1. Mergers and acquisitions: both to evaluate possible purchases as well as to facilitate disposal;
2. Brand licensing: internally for tax reasons and to third parties;
3. Fund raising: as collateral on loans or for sale or leaseback arrangement;
4. Brand management decisions: to allocate resources, develop brand strategy, or prepare financial reports'[208].

314. He adds that accounting firms put forth various arguments why brands should be valued. Examples are to strengthen the presentation of a company's accounts; to record hidden assets so as to show these to the shareholders; to enhance a company's shareholders' funds to improve its gearing ratio's; to provide a realistic basis for management and investors to measure a company's performance and to reveal detailed information on brand strengths so that management could formulate appropriate brand strategies[209].

[206] K. S. Cravens and C. Guilding, *op. cit.*, p. 57.

[207] For an interesting piece on how business regards the importance of transfer pricing, see P. V. Morton, *Transfer Pricing – An Industry View*, Tax Planning International Transfer Pricing, Volume 1, Number 1, September 2000, pp. 8-11; T. Brierley, *Transfer Pricing in a Changing Business Environment*, Tax Planning International Transfer Pricing, volume 1, Number 2, October 2000, pp 10-12.

[208] K.L. Keller, *Strategic Brand Management*, p. 357.

[209] K.L. Keller, *Strategic Brand Management*, p. 358.

§ 5. *Brand valuation methods*

315. Before dealing with specific tax aspects, we consider it worthwhile to offer some explanation of a number of currently used valuation methods[210]. For the sake of completeness, we would point out that not only is the sale of intangible assets dealt with in this contribution, but also the payment of royalties under a licence agreement. The OECD Report states: 'a royalty would ordinarily be a recurrent payment based on the user's output, sales, or in some rare circumstances, profits'[211]. The valuation methods below all attempt to express the incremental earnings expected to arise from the ownership and/or use of brands.

A. Market-based approaches

316. An estimate of the price at which a brand can be sold forms the core of the market-based approaches. Forecast future profits form the basis, and a discount rate is applied in order to take account of the time value of money. In other words, one determines the present value of the future economic benefits to be derived by the owner of the brand. The question is whether there exists such a thing as a 'market' for a brand at all. Indeed, this approach leads to the amount an active market would allow such that the brand asset would be exchanged between a willing buyer and seller. In practice, there is often no option other than to build further on how the financial market assess a brand value.

317. The aim then is, proceeding on the basis of the total value of all tangible and intangible assets under such deductions as are necessary, to arrive at the value of the brand[212]. We shall revert to these methods when discussing the tax aspects, in particular the 'comparable uncontrolled price' and 'market capitalisation' methods, the latter of which can be catalogued under the 'Other Methods' in the OECD Report.

B. Cost-based approaches

318. The most classic valuation method, which is also used as such in accountancy practice, proceeds on the basis of the costs that are incurred in the creation of a brand throughout the

[210] K. S. Cravens and C. Guilding, *op. cit.*, pp. 58-60.

[211] OECD Report, para. 6.16.

[212] Keller refers to a methodology developed by Simon and Sullivan in order to define a brand equity as the incremental cash flows that accrue to branded products over and above the cash flows that would result from the sale of unbranded products; see K.L. Keller, *Strategic Brand Management*, p. 359.

various stages of research and development, market testing, promotion and support during the marketing and product-improvement phases. It is very conservative and contains little or no future-oriented information that supports the process of brand management.

319. An important shortcoming consists in the fact that it is not obvious how to trace all the historical costs. For example, there are costs that cannot be directly allocated to a given brand. An example we might cite is Richard Branson's round-the-world trip in a hot-air balloon.

320. The 'Virgin Global Challenger' project cost $4.9 million in 1998. The brand name of the entire Virgin empire indirectly enjoyed a fillip.

321. The question is how these costs can be divided up across the various parts of the Virgin conglomerate, such as Virgin Air, Virgin Records, Virgin Cola, etc. On top of that, it is also important and often hard to determine the time horizon within which a start should be made on collecting cost information.

322. Another illustration can be found in what is known as the most effective global billboard there is, Formula One. Racing on the Formula One circuit indeed seems to bring a halo effect to the whole brand. Jaguar's mere presence on the F1 starting grid appears to move cars in the showrooms. When Jaguar finished third behind two Ferrari's at Monaco in May 2001, customer traffic in the showrooms and sales increased dramatically and immediately according to Nav Sidhu, Jaguar team spokesman[213]. The exact correlation between spent and brand value will however be difficult to quantify.

323. This will above all happen in cases of mature brands, since the costs are hard to identify.

The time value of the costs also has to be included in the analysis. In the event that historical costs can be identified, it is necessary to examine how they are to be updated in order to express historical expenditure in the same manner as current expenses. We shall return to this method when, in the tax section, we go into greater detail on the 'cost-plus method'.

[213] L. K. Truscott IV, *Formula for Success*, Fortune, 29 October 2001 pp. 38 – 54.

324. The 'historical cost method' proceeds on the basis of a calculation of the total cost of creating a brand. For the aforementioned reasons, less practical utility and reliability is ascribed to it[214].

325. The 'replacement cost method' examines what the expected marketing expenses are in order to develop a comparable brand. In practice, it can be possible to make an estimate of the costs and the time horizon in order to develop given levels of to which the brand is well known. However, it is a lot less easy to make an accurate forecast of the anticipated consumer retention and purchasing behaviour[215].

C. Income-based approaches

326. Another technique is to proceed on the basis of the expected future net income that can be directly allocated to a brand, and to discount this to a net current value.

327. Various approaches are used. For instance, it can be based on the price difference between a brand product and a more generic product that has no particular emotional value for consumers. The drawback, however, is that this method often over-estimates the value of relatively small brands that launch highly priced products and services as against brands that offer products in higher volumes at relatively lower prices.

328. Another approach is to fix the annual royalties that are due for exploiting a brand under licence. Of course, a royalty valuation does not avoid the brand's having to be valued. A further possibility is to proceed on the basis of demand and supply in order to discern from that the strength of a brand.

329. In this, both the impact of products and services that are marketed via resellers and that of those that are sold directly to consumers are included. In the part dealing with tax, we shall come back to the 'profit methods' that the OECD describes.

330. In the literature can be found the so-called 'royalty relief method', which we consider can be classified as an application of this approach[216]. This approach is founded

[214] D. Haigh, *Brand Valuation – The Need for Tax Planning when Valuing Brands*, International Tax Report, February 1997, pp. 5-6; D. Haigh, *International Tax Planning and Brands*, Tax Planning International Review, 2000, p. 5; D. Haigh, *Getting the Best from Brands*, International Tax Review, February 1997, p. 31.

[215] D. Haigh, *op. cit.*, International Tax Report, p. 6; *op. cit.*, Tax Planning International Review, p. 5; International Tax Review, p. 31.

[216] D. Haigh, *op. cit.*, International Tax Report, Tax Planning International Review, pp. 5-6; International Tax Review, p. 31.

on the theoretical assumption that a royalty based on turnover should be due where a brand is licensed from a third party. In the event ownership of a brand is retained, royalties are avoided, hence the term 'royalty relief'. This method is often applied in practice by reason of its simplicity. Nevertheless, this approach does not solve the problem of the limited availability of possible open-market references.

D. Formulary approaches or approaches based on economic use

331. Formulary approaches are based on an amalgam of criteria and are generally developed and marketed by prominent, or at least frequently quoted consulting firms.

332. In our view, the best known method is that developed by *Interbrand Plc.*[217]. Keller describes Interbrand as 'probably the premier brand valuation firm'. He adds that its goal is to identify an approach that incorporates marketing, financial and legal aspects; follows fundamental accounting concepts; allows for regular revaluation on a consistent basis and is suitable for acquired and home-grown brands[218]. In the first instance, the method is directed towards customers that wish to use it in the context of external financial reporting. Nonetheless, the organisation is of the opinion that the approach can also be of use for internal management purposes.

333. The valuation is done according to a three-step approach[219]:

A. *Financial budgeting:* in the first phase, a detailed examination is done of internally and externally available data together with historical information on the mutual connections between these data. The result of this is that insight is gained into how the brand to be valued relates to competing brands and how the market share and the margins will probably evolve in the future. The aim is to arrive at a reliable set of assumptions and a band of expected income from activities that are conducted under the brand name.
B. *Identification of the income generated under the brand name:* a detailed analysis of the market and the brand is used to achieve a division of the income between the brand and all other intangible assets that are deployed within the undertaking, like formulae, copyrights, etc. This allocation process is essentially arbitrary, but is nevertheless based

[217] Interbrand, cf. above.

[218] K.L. Keller, *Strategic Brand Management*, p. 361.

[219] D. Haigh, *op. cit.*, International Tax Report, p. 6; Tax Planning International Review, p. 6; International Tax Review, p. 32.

on all available results from market investigations on what it is that makes a consumer buy and what evokes loyalty in him.
C. *Determining the discount factor:* the underlying basis is the cost of a risk-free, long-term loan. Then, so-called 'beta factors' are added, which quantify the risk for the market in general and for the brand in particular. These beta factors are determined by reference to a standard sector-bound analysis (or 'industry risk analysis'), supplemented by a specific brand risk analysis. The resulting composite discount rate is then applied to discount forecast brand cash-flows.

334. The starting point can also be a weighted average of the profit after tax as an indicator of the profitability of a brand. The aim is that only such factors are taken into account as are directly related to the identity of the brand.

335. This, of course, is not simple, since, say, customer retention can be influenced positively by the presence of a reliable and efficient distribution system that may not be included in the brand valuation but rather in valuing or assessing logistical support processes.

336. Once profitability has been identified, a multiplier effect is applied. This multiplier is the result of seven factors that affect the strength of a brand and are also subjected to an Interbrand-specific weighting.

337. The first is *leadership*, or the leadership potential of a brand. This embraces a brand's ability to profile itself as a market leader and endure so as to turn to profit the benefits that go hand in hand with a dominant market position. An illustration of this is Gillette disposable razors.

338. A second factor is *stability*. Brands that retain their image and consumer trust over long periods have a greater value. An example of this is Mercedes, which continued to retain its stability despite a potential dilution of the brand equity a few years ago as a result of safety vicissitudes surrounding the Class A model. Another example is BMW. More than two-thirds of customers are repeat buyers which allows the company to price its cars 10% to 30% higher than comparable models[220].

339. The *market* is the third factor. In certain product brands, brands are automatically endowed with greater honour than in others as a result of their potential for generating a greater turnover

[220] Quote from Karl-Heinz Kalbfell, BMW's brand management director in Business Week, *BMW: Speeding into a tight turn*, 29 October 2001, p. 20.

in a more stable environment with greater barriers to entry for potential competitors. Dell Computers thus profits from extra sales as a consequence of its capacity for building computers in accordance with customer specifications on the basis of an inventive on-line system ('build-to-order system'), whereby the company acts as a sort of portal within which orders are centralised and further distributed to the producer[221]. Dell's brilliance seems to be in identifying innovative business models, which are then executed to perfection, rather than in spending vast sums on R&D for developing new products. It appears that Dell only spends around 1.5% of revenues on R&D, compared to some 3.5% in the case of Compaq. However, there seems to be just four days of stock in Dell's warehouses compared to some 24 days at Compaq[222].

340. *Geographical spread* is a further parameter: brands that project an international image have more potential than purely regional or national ones. An example is Coca-Cola. For the sake of completeness, it is to be noted that this does not automatically mean that the brand has a perpetual 'mega' value as a so-called 'mega-brand'. Indeed, careful screening of marketing spent opportunities is vital[223].

341. A further element is the *trend sensibility* of a brand. This means the capacity that a brand possesses to retain a constant value in the perception of the consumer. This can be found, for instance, in the pharmaceutical sector. It is not necessarily the most innovative medicines that will eventually make a career as a 'blockbuster'[224]. These are often medicines that have proved their effectiveness in the minds of consumers in relieving certain classic ailments[225].

342. Then, *support* also has an impact: brands that are consistently supported over time as a rule have a greater value than those for which no investments are made by the organisation, hence centrally. Eminent sources echo this. Keller[226] refers to Philip Morris as a single-mindedly focused organisation that has concentrated its marketing

[221] Stock is labelled the 'physical embodiment of bad information' according to Paul Bell (Dell Computer). See F. Cairncross, *Inside the Machine – A Survey of E-management*, The Economist, 11 November 2000, p. 7

[222] A. Park and P. Burrows, *Dell, the conqueror*, Business Week, 24 September 2001, pp. 54-58.

[223] D. Foust and G. Khermouch, '*Shaking up the Coke Bottle*', Business Week, 3 December 2001, pp 58-59. It appears that Coke's bottlers complain that an extra $300 million that chairman Douglas Taft spent on marketing in 2001 to help reinvigorate its core brand was wasted on ineffective ads.

[224] A 'blockbuster' is a successful drug. In practice, the term is used for items that achieve sales of at least $1 billion.

[225] For a more in-depth commentary, see: M. Corstjens and M. Carpenter, *From Managing Pills to Managing Brands in Harvard Business Review*, March-April 2000, pp. 2-3.

[226] K.L. Keller, '*Managing Brands for the Long Run: Brand Reinforcement and Revitalising Strategies*', California Management Review, Volume 41, Number 3, Spring 1999, p. 104.

communications for its Marlboro cigarette brand on a western cowboy image. Since the mid-1970s, Marlboro has been America's number-1 cigarette brand. The romantic images of the rugged cowboy were taken worldwide and successfully transferred to billboards and print ads when Marlboro's cigarette commercials were banned from television and radio.

343. BMW strives to be well known on the basis of a unique image and until recently made use in this of a coupling between the brand and being James Bond's preferred car. BMW was uniformly decreed as the quintessential 'yuppie' vehicle of the eighties, as a result of which sales of the brand dropped between 1986 and 1991 (in the US) as new Japanese competition emerged. Convinced that a high status was no longer a sufficiently desirable and sustainable position, marketing and advertising efforts switched the focus to BMW's product developments and improvements, such as responsive performance, distinctive styling, and the leading-edge engineering of the cars as the 'Ultimate Driving Machine'[227]. Coca-Cola can also be taken as an example. We see that the advertising spots are similar from country to county (and the spoken words are thus dubbed).

344. Finally, there is the *protection*, which is the legal protection that a brand enjoys. A registered trade mark of course creates barriers to entry. An example is Kodak, which has deprived competitors of any initiative of copying them by patenting its process, together with its brand name.

345. Another widespread methodology is that developed by *Financial World Magazine*[228]. This proceeds on the basis of company sales and, based on expert estimates of margins, a rough estimate of the operational profit that can be ascribed to a brand. This is then compared to that which a comparable, but non-brand product would generate. The extra profit, the so-called 'premium profit', is corrected in order to take account of the tax effect. Subsequently, the aforementioned multiplier effect is also calculated on the basis of Interbrand's seven factors that assess the strength of a brand[229].

[227] K.L. Keller, *The Brand Report Card.*, p. 10.

[228] K. Badenhausen, J. Artinian and C. Nikolov, *Most valuable Brands – Many of the Newer Brands are also the Fastest-growing*, Financial World, September/October 1997, pp; 62-70.

[229] A. J. Silk, *Brand Evaluation Methodology: a Simple Example*, Harvard Business Review, 26 January 1996, ref. 9-596092, pp. 1-3; M. Birkin, *Why Brands Are Valued*, Admap, March 1995, pp. 18-19; T. Ambler, *Brand Equity as a Relational Concept*, Journal of Brand Management, June 1995, p. 387; K. A. Longman, *Valuing a Brand*, Journal of Brand Management, April 1995, pp. 273-279; R. L. Meschi, *Value Added: Refinements in our Brand Valuation Methodology*, Financial World, 1 August 1995, p. 52.

By way of illustration, we found an interesting contribution in the Harvard Business Review regarding the valuation of the Kellogg's brand[230].
The starting point is a worldwide turnover of $5.5 billion. The operating result amounts to $ billion.

Worldwide operational result	$ 1.000
LESS: estimated operational result from a non-brand product (*)	0.088
Adjusted operating result Year N:	0.912
Adjusted operating result Year N–1:	0.843
Weighted average operating result over Years N and N–1:	0.889
(Relative weighting N/(N–1) = 2:1)	
LESS: corporation tax (US rate of 34%):	0.302
Net result after weighting over Years N and N–1:	0.587
Estimate of the multiplier	18.76
Estimated value of the Kellogg's brand: ($ 0.587 x 18.76)	$ 11.01

(*) The operating result of a non-brand product is estimated as follows:
- Assumption: median of the capital/turnover ratio in the foodstuff production sector: 32%
- Estimated capital investment required to realise $ 5.5 billion turnover for similar non-brand products: 32% x $ 5.5 billion = $ 1.76
- Assumption: return on capital investment for similar non-brand product: 5%
- Estimated operating result for similar non-brand product: 5% x $ 1.76 billion = $ 0.088

346. Keller mentions that many marketing experts feel it is impossible to reduce the richness of a brand to a single, meaningful number and that any formula is too much of an abstraction and too arbitrary. These methods make indeed a host of potentially oversimplified assumptions to arrive at one measure of brand equity. Keller quotes Sir Michael Perry, chairman of Unilever, who objects for philosophical reasons: 'The seemingly miraculous conjuring up of intangible asset values, as if from nowhere, only serves to reinforce the view of the consumer skeptics, that brands are just high prices and consumer exploitation. At Unilever, we have consistently rejected this approach'[231].

[230] A. J. Silk, *op. cit.*, pp. 2-3. The figures are based on 1994.

[231] K.L. Keller, *Strategic Brand Management*, p. 365.

Section 3

VALUATION METHODS IN A TRANSFER PRICING CONTEXT

§ 1. Introduction

347. Tax practitioners may wonder to what extent the aforementioned methodologies are 'enforceable' against the tax authorities.

348. As already stated above, we propose making a general survey of the various approaches that the OECD proffers in its guidelines alongside a number of pragmatic approaches that are generally widespread and generally accepted.

349. It is worth noting that the OECD[232] recognises that the application of the arm's length principle can be difficult in the case of inter-company transactions concerning intangible property because 'such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction. Further, for wholly legitimate business reasons due to the relationship between them, associated enterprises might sometimes structure a transfer in a manner that independent enterprises would not contemplate'.

§ 2. The comparable uncontrolled price (CUP) method

350. The CUP method[233] is based on substantiating the comparability of a transaction between associated parties with that between either unassociated parties *inter se* ('external comparables') or between an associated party and a third party ('internal comparables').

351. We have tried above to argue that it is in practice very difficult, if not virtually impossible, to find sufficiently comparable transactions given the large extent of typical, subjective, emotional elements that underlie brand appreciation in the perception of consumers.

[232] OECD Report, paras. 6.13 and 6.28.

[233] OECD Report, paras. 2.6-2.13 and 6.23-6.25.

352. Moreover, several intangibles may be involved in one and the same transaction, such as the strength of the distribution network, logistical efficiency and the associated guarantee of timely delivery, etc. This method is thus seldom if ever applied in practice.

353. In support of this, we found an interesting contribution in the literature[234]. The authors conclude, after analysing 40 major brands, that the profitability of a brand is not only dependent on relative market share, but also on the product or service segment within which it is launched. This is particularly relevant in view of the fact that certain segments are dominated by so-called 'premium brands', whilst in other ones, it is rather objective specifications that prevail, so called 'value brands'. Premium brands can be found, for instance, in the cosmetics sector and many players thus realise 15% operating result[235] before tax or more.

354. This is even the case for market players that possess a market share of only a fifth to even a tenth of that of the market leader. An example would be skin-care products. The story is different in the meat industry, where 'premium brands' serve less than 40% of the market.

355. In this sector, it seems that brands with a relatively high market share only achieve a return on sales of 10%. It seems that, in the first segments, of premium brands, most brands are profitable. However, if the segment is characterised by value brands and private label brands[236], a lower return is generally noticeable.

356. The fact that comparability in order to apply a CUP is hard if not impossible to find is shown by the following listing according to market share and segment.

A. 'High-road brands'

357. First and foremost are what are called '*high-road brands*', which are catalogued as premium brands and also possess a relatively high market share. They usually generate more than 20% return on sales (ROS). The key to success lies in the innovation that guarantees that consumers will stay loyal and are prepared to pay extra in exchange for constant improvement and changes to the product or service in terms of shape, size and/or function.

[234] V. Vishwanath and J. Mark, *Your Brand's Best Strategy – What Really Drives Profit? In Consumer Goods, Market Share Alone is not the Answer*, Harvard Business Review, May-June 1997, pp. 123-129.

[235] Also called 'return on sales'.

[236] This is a reference to the own brands of the major supermarkets; for a useful comment and illustration, see K.L. Keller, '*Strategic Brand Management*', p. 16.

358. Examples are Kraft Macaroni, where new sorts of pasta are constantly launched in all sorts of shapes and flavours. Gillette, too, can be mentioned, having introduce the Sensor shaving system after investing approximately $200 million in research and development because competitors were successfully copying their classic disposable razors.

359. It might be difficult to 'unbundle' the brand portfolio within diversified groups. An example is luxury-goods giant LVMH (Louis Vuitton, Moët Hennessy), which has moved into everything from airport duty-free shops through cosmetics retailing to art auctions. As a result of significant take-over activity over the last four years, it appears that not all brands generate the juicy 20%-plus margins of LMVH's leading business such as Louis Vuitton leather goods and the drinks division which includes venerable brands such as Hennessy Cognac and Veuve Clicquot champagne[237].

360. The high-end brands usually also succeed in creating additional barriers to entry by optimising the distribution system. An illustration of this is the 'Direct Delivery System', under which the producer also takes responsibility for displaying the products in the supermarket, as a result of which it gains direct information about stock rotation and customers are assured a quicker service for, say, perishable goods. Other players that make use of this are e.g. Coca-Cola, Frito-Lay and Nabisco, since there is always just a limited space in which products can be displayed and it is therefore the major players with premium brands that can nab the best places. Newcomers would have to make massive investments before acquiring the same expansion force.

B. 'Hitchhikers'

361. The category of hitchhikers encompasses premium brands with a relatively limited market share. Hitchhikers realise an average of between 15 and 20% return on sales. They generally follow the high-road brands and will therefore seldom try and gain market share by lowering their prices.

362. They also use a policy of innovation and try and combine this with forms of 'niche marketing'. Of course, they are relatively vulnerable since, in terms of price-setting, they

[237] C. Matlack, *Falling From the Lap of Luxury, LMVH's detour from high-end brand marketing isn't paying off'*, Business Week, 3 December 2001, pp 38-39.

are heavily dependent on the market leader(s). An example is to be found in cereal products. More than 60% of this market is dominated by premium brands, like Kellogg's, where the consumer pays at least 30% more than for a value brand.

363. Useful references are also to be found in the automotive industry. In the last few years, the sector has been characterised by increasing profitability. The reason for this is that more and more sub-groups are being approached with specific models. The standard four-door family saloon has long-since no longer been described as the best buy in the classic sales arguments. Quite the contrary, 4x4 off-road vehicles, people carriers, etc. are proposed by preference and also constantly being redesigned and adapted from an ergonomic standpoint. Chrysler is one of the precursors of this diversification and has also reaped its fruits.

C. 'Low-road brands'

364. The 'low-road brands' are characterised by a relatively high market share, but limited profitability because they used to be value brands. They are characterised by an average return on sales of 5 to 10%. The policy in this segment is directed towards cost efficiencies that ultimately can give rise to lower prices. Steps in the value chain that can be eliminated will thus quickly disappear so that the funds released can be deployed for alternative purposes.

365. Thus, in practice, stock limitations are introduced and there may be a limit on the number of varieties in products that can give rise to complexities in the production process and/or distribution system.

366. The result is often shrinkage in the number of production facilities and/or outsourcing of production activities, reduction in the number of suppliers and standardisation of components, packaging and designs.

367. Successful managers will manage to crank a value brand up to the level of a premium brand. We might consider here the beer sector or sports shoes, two articles that were previously sooner catalogued as 'value' products.

D. 'Dead-end brands'

368. 'Dead-end brands' are neither profitable nor do they have a prominent presence on the market. They generally achieve returns on sales of less than 5%. The market place is littered with brands that have either failed to establish an adequate level of brand equity or seen their sources of brand equity disappear because of changes in the marketing environment. Unilever commented, in explaining the decision to review 20% of their brands and lines of business for possible sell-offs that: 'If businesses aren't creating value, we shouldn't be in them. It's like having a nice garden that gets weeds. You have to clean it up, so the light and air get in to the blooms which are likely to grow the best'[238]. There remain two options that are open to dead-end brands. Either the product or service is taken from the market or a dramatic reorganisation is carried out in order to get the brand into one of the aforementioned quadrants. One strategy might, for instance, comprise trying to lower prices in order to break the dominance of a low-road brand.

369. In practice, this will only be possible, i.e. will not give rise to going-concern problems, on condition that indirect costs within the business can partly be shifted onto other components of the product or service portfolio, for instance by consolidating suppliers or packaging materials.

370. Another possibility is to bring a number of smaller brands together in the hope of being able to bring about benefits of scale. This is also called a 'string of pearls' strategy. An example can be found in the cat food produced by Heinz ('Nine Lives'), whereby eight factories were closed, can production was no longer outsourced and alliances were concluded with certain suppliers.

371. Other examples can be found whereby, say, deep-freeze ice cream was revalued as a premium product thanks to Häagen Dazs, with the consumer finding constant satisfaction in variations on the theme of classic ice cream. In the coffee industry as well, this trend can be seen, contributed to by the catalytic effect of major resellers like Starbucks. Diverse varieties are launched in a range of quantities and forms under different brand names, with the emphasis on origin (like Java and Colombia). The

[238] K.L. Keller, *Managing Brands for the Long Run*, p. 120.

question is whether the classic major producers can keep up with this trend. Indeed, Starbucks is not even just a cup of coffee. In 1983, it was a small Seattle-area coffee retailer. While on vacation in Italy, the current chairman, Howard Schultz, was inspired by the romance and the sense of community felt in Italian coffee bars and coffee houses. He felt that Starbucks was still one big step away from the heart and soul of what coffee meant throughout the centuries. And so Starbucks began to focus its efforts on building a coffee bar culture, opening coffee houses like those in Italy. 'Starbucks locations thus far have successfully delivered superior benefits to customers by appealing to all five senses – through the enticing aroma of the beans, the rich taste of the coffee, the product displays and attractive artwork adorning the walls, the contemporary music playing in the background, and even the cozy, clean feel of the tables and chairs'[239]. The company's sales and profits each grew by more than 50% annually through much of the 1990s.

372. The OECD states in the Report that, in a comparables analysis with respect to intangible marketing assets, account has to be taken of elements like 'consumer acceptability, geographical significance, market shares, sales volume, and other relevant factors'[240].

373. The Report mentions brand-name athletic shoes as a possible illustration[241], whereby the standard to be taken is a comparable transaction in the open market involving an athletic shoe that is marketed under another brand name in a comparable context. According to the Guidelines, elements of comparability are the quality and specification of the shoe, and also 'the consumer acceptability and other characteristics of the brand name in that market'. Only if this cannot be achieved does the OECD Report propose taking a non-branded shoe as a potential comparable if 'adequate evidence is available'.

374. On the basis of the foregoing, non-tax argument, it seems to us in practice to be not so simple, if not impossible, to make such an analysis with reliable results. The OECD also states that it can indeed be impossible, for instance where a branded product occupies such a dominant position that a generic product in essence is traded on another market. Recourse can then be made to the 'profit-split' method[242], into which we will go in further detail below.

[239] K.L. Keller, *The Brand Report Card*, p. 4.

[240] OECD Report, para. 6.24.

[241] OECD Report, para. 6.25.

[242] OECD Report, para. 6.26.

375. In an American context we have found evidence that indicates an increasing 'sympathy' for the CUP, whereas until recently this method was virtually indefensible before the courts. One of the reasons probably lies in the fact that the American transfer pricing regulations (Section 482) lay down a higher degree of comparability than that we find in the OECD Report.

376. One relevant case concerned the grant of licences for the production, formulation and sale of herbicides within the (then) 'Ciba-Geigy' group[243]. Although there was very strong comparability between the controlled transactions (between associated parties) and the uncontrolled transactions (between independent entities), the court did not share this opinion. Note that this case dates back to as long ago as 1985.

377. A Swiss parent company had granted an exclusive licence to an American subsidiary for the production, formulation and sale of herbicides protected by patent. A royalty of 10% was charged. The American Revenue, the IRS, was of the opinion that an arm's length royalty could not exceed 6%. Reference was made to a licence that the Swiss parent company had granted to an unassociated German company for the production, formulation and sale of the same herbicides.

378. In response, the taxpayer referred to two licence agreements that the Swiss parent company had granted to other unassociated German and Dutch companies. However, these agreements covered only the formulation and sale (but not the production) of the same herbicides. These licences generated a 5% royalty and also contained an obligation to purchase the active chemical ingredients used for formulating the herbicides from the Swiss licensor.

379. The taxpayer omitted to provide cogent quantification for adjusting the purchase obligation, and estimated that an all-in 10% royalty was reasonable. Furthermore, the taxpayer was able to produce documentation regarding offers from unassociated American undertakings to pay a royalty of 10 to 15% in exchange for a licence for producing, formulating and selling the herbicides in the United States. However, not a single offer had led to a 'consummated transaction' with the Swiss parent company or with the American subsidiary.

[243] Ciba-Geigy Corp. v. Comr., 85 T.C. 172 (1985), acq. 1987-2 C.B. 1; J. Mogle, *op. cit.*, pp. 23-24.

380. The court rejected both the arguments of the taxpayer and the open market references that were submitted by the American Revenue.

The basis of the argumentation was that the conditions of 'the same or comparable circumstances', which is required under a 'CUP approach', did not appear to be honoured in that case.

381. Nor did the court make any attempt to introduce any adjustment in order to quantify differences between the inter-company transactions and those between unassociated parties in order to arrive at an arm's length royalty percentage.

382. The court rejected the 'open-market references' on the basis of the impossibility of quantifying differences in a geographical market, the number of years to which the licences related, the impact of requirements with regard to the purchase of raw materials and other factors. However, the court did look further into a witness statement by an independent undertaking with regard to the royalty that that company would be prepared to pay for the same rights. Thus, what was concerned was only a 'possible' transaction.

383. Eventually, a 10% royalty was accepted. The court examined the capital investment that the licensee had made in the infrastructure for manufacturing the active ingredients for the herbicides. These investments resulted in considerable incremental profits. Indeed, after deduction of the 10% royalty, paid to the Swiss licensor, the American licensee was still able to retain 90% of the incremental production profit and more than 80% of the total profit made through exploitation of the licence agreement.

384. This economic analysis of the profit and return on the capital invested by the licensee bolstered the court in its final judgement that the 10% royalty was not excessive. It strikes us that such an approach is also supported in the OECD Report, since the Report states that 'given that the licensee will have to undertake investments or otherwise incur expenditures to use the licence it has to be determined whether an independent enterprise would be prepared to pay a licence fee of the given amount considering the expected benefits from the additional investments and other expenditures likely to be incurred'[244].

[244] OECD Report, para. 6.14.

385. The importance of the 'capital investment' is also accentuated in paragraph 6.20 of the OECD Report, which lists the relevant factors in determining an arm's length remuneration.

386. An illustration of the increasing 'sympathy' for the comparable uncontrolled price method[245] can be seen in the case surrounding the remuneration for the use of certain commercial intangible assets within the 'Hyatt' hotel chain[246].

387. This case led to a determination by the court that the two American companies, Hyatt Corp. and Hyatt Int. Corp., had received an arm's length remuneration from subsidiaries in the period of 1976 and 1988 for *inter alia* the use of the Hyatt name and brand.

388. The court stated that an arm's length royalty for use of a name and brand was 0.4% (of gross turnover) instead of the 1.5% (of gross turnover) that the American Revenue, the IRS, had proposed for the exclusive right of using the Hyatt name and brand outside the United States. According to the court, the 1.5% reference was drawn from a franchise agreement that also covered a number of services that were not provided in the current case. For the court, the IRS proposed an altered adjustment[247] on the basis of a profit-split analysis.

389. In connection with the 'altered' adjustment, the court stated that the initial supplements were 'arbitrary, capricious and unreasonable'. The court also rejected the taxpayer's argument that the trading name and brand had no value for which any fee was owed by the overseas group members, since there were reciprocal benefits. Thus, hotel guests in the United States should also be able to opt for a Hyatt hotel on the basis of good experience abroad, instead of the other way round. However, this was not upheld by the court as a valid counter-argument.

[245] This increasing 'popularity' for the CUP method amongst the courts can be found with regard to transactions involving goods. An illustration of this can be found in Compaq Computer Corp. v. Comr., T.C. Memo 1999-220; M. Oates *et al.*, *Complete Taxpayer Transfer Pricing Victory in the United States*, Tax Planning International Review, 1999, pp. 15-17; X., *Practitioners Say Court Rulings Show that Profit-based Approach not Always Best*, Tax Management Transfer Pricing Report, 9 February 2000, p. 852.

[246] H Group Holding Inc. v. Comr., T.C., Memo 1999-334; M. Moses, *H Group Shows Need for Evidence on Transactions, Lawyers Say*, Tax Management Transfer Pricing Report, 13 October 1999, pp. 503-504; X., *Hyatt, IRS Debate Whether Chicago Parent Earned Trade Name, Management Fee Income*, Tax Management Transfer Pricing Report, 29 October 1997, p. 430; X., *Failure to Report All Intangibles Causes Risks in Audit, Practitioners Say*, Tax Management Transfer Pricing, 13 August 1997, pp. 223-224; S. Wrappe and K. Chung, *Income Reallocation for Hyatt Group*, Tax Planning International Review, 1999, p. 24.

[247] Which resulted in an adjustment of $24 million instead of the initial $46 million.

390. Ultimately, the court proposed a tailored comparable uncontrolled price. The starting point was a typical franchise agreement in the American luxury hotel sector. Such agreements typically seemed to provide for a 2% royalty. On the basis of information on the 'Hilton' chain, the court suggested that 1% related to covering the costs, whilst the other 1% represented a 1% profit component on reservations, marketing, expertise, other services and a royalty for use of the name. Of the 1% profit component, half was allotted to the trading name.

391. Finally, a further adjustment to 0.4% was made by the court in order to take account of the fact that trade names in the international hotel industry were said to be less important.

§ 3. The 'comparable uncontrolled transaction method' (CUT)

392. The CUT method is analogous to the CUP method, with the exception of the fact that the comparability of a 'transaction' is analysed. This concerns a licence over the same or comparable intangible assets in favour of third parties. The same considerations come into play here as in the case of the CUP method. Comparability is in practice difficult to underpin or can only be underpinned inadequately.

§ 4. The 'adjusted comparable price or transaction method'

393. This method is based on the concept that differences between a transaction between associated parties and one between unassociated players can be identified and quantified. The utility of this method can thus very much be cast into question for the reasons that we have described under the CUP method.

§ 5. The 'resale price method'

394. The 'resale price' method is only briefly touched on in chapter 6 of the OECD Report. It is stated that a 'certain form' of the resale price method can be used in the event that the associated undertaking transfers the assets to third parties by granting a sub-licence[248].

[248] OECD Report, para. 6.23.

This should mean that an arm's length gross margin can be determined that enables the associated undertaking to recover its costs and to realise an appropriate profit component. In our experience, this method can be called highly uncommon in such cases.

§ 6. The 'discounted cash-flow method' (DCF)

395. The DCF method is generally accepted by tax authorities, stock markets and accountancy experts. It is only briefly commented on in the OECD Report, viz. in dealing with the 'other methods'[249]. In chapter 6 of the OECD Report, it is pointed out that in applying the arm's length principle, *inter alia*¸ account has to be taken with the anticipated advantages from the intangible assets, which can be determined by an updated net value calculation[250].

396. The OECD Report also mentions that independent undertakings can also make use of the anticipated profit, under consideration of all relevant factors. In this, account is taken of the extent to which later developments are to be foreseen and anticipated. Then, it should be possible to judge whether the prognoses concerning the anticipated profit were sufficiently reliable so as already to establish the price of the transaction at its inception on the basis of those prognoses, without reserving the right to make adjustments in the future[251].

397. entering into contracts with a shorter term or stipulating contractual provisions dealing with price-adjustments in order to protect themselves against future developments that are unforeseeable.

398. Thus, for instance, the percentage of the royalty fees can be increased as sales by the licensee increase[252]. Provision can also be made for a possible renegotiation regarding the pricing arrangements in the event of major unforeseen developments. As an example, the OECD Report refers to a situation in which a royalty based on the turnover in a patented medicine seems to be far too high due to the unexpected development of a cheap, alternative treatment[253]. Also, in the US Advance Pricing

[249] OECD Report, para. 3.22.

[250] OECD Report, para. 6.20.

[251] OECD Report, para. 6.29.

[252] OECD Report, para. 6.30.

[253] OECD Report, para. 6.31.

Agreements practice, one notices that a 'step royalty' approach can be used in conjunction with the 'Comparable Profits Method' to resolve cases where the IRS and the taxpayer disagree over the royalty for an intangible[254].

399. This method is particularly suited with regard to fully developed commercial intangible assets ('marketing intangibles') that are sold or licensed as a cash-generating asset. The method is founded on the concept that a brand constitutes an intangible asset that generates an identifiable flow of income over time.

The value of the brand is then the net current value of the income flow. The valuation process encompasses a calculation of the economic return of the products that are marketed under the brand.

400. The following steps constitute the valuation process:

(a) Identification of the expected operating results that the products will generate over the next five years;
(b) Less: capital cost, i.e. the cost of the capital that is entered as a fixed asset within the undertaking;
(c) Less: tax effect on the remaining profit;
The brand's contribution to the result is calculated next:
(d) Analysis of the role of the brand in various market segments and geographical markets;
(e) Application of the index obtained to the result obtained under (c);
(f) Discounting of the result in order to take account of the risk surrounding maintenance of the brand.

401. In practice, the DCF method is hard to apply where the future operational result is dependent on a combination of intangible assets, given that the effect of any one intangible asset is hard to isolate. Practical hurdles can also arise where the lifetime is hard to estimate, as also the impact of the asset (now or in the future) on the income or the future cost of maintaining the brand. Even in the case of so-called 'mega-brands'

[254] For further comments, see Tax Management Transfer Pricing Report of 18 April 2001, p. 903.

such as that which is said about Coca-Cola, constant market support is crucial in order to secure consumer trust.

§ 7. The 'cost-plus method'

402. The cost-plus method[255] is fairly unusual in the case of intangible assets. An exception is formed, however, by those intangible assets that have a limited impact given that there may be a causal connection between cost and income in this case. However, the OECD Report consider that a causal connection is in general very improbable[256]. Indeed, the Report says *inter alia* in this connection that it can be difficult to determine '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[257]. Furthermore, a higher return from sales of products with a brand name can in 'many cases... be due as much to the unique characteristics of the product or its high quality as to the success of advertising and other promotional expenditures'[258].

403. In marketing theory as well, support can be found for this argumentation. It would appear not to be unusual for companies to spend 3 to 10% of their income on advertising. Worldwide, in 1998, more than $417 billion was spent on advertising, which, in the most industrialised countries, represents 1 to 3% of GDP[259]. Moreover, advertising forms only a part of the total marketing expenditure. Nevertheless, measuring marketing effectiveness is not easy.

404. Developments in the collection of marketing data, e.g. scanner data and the development of econometric models, however, mean that the effectiveness of historical spending can be measured so that the extent and allocation of future marketing budgets can be optimised. Kraft General Foods, Procter & Gamble, Nestlé, Unilever, Hewlett Packard and IBM are just a few examples[260].

[255] OECD Report, paras. 2.32-2.48.

[256] OECD Report, paras. 6.6 and 6.27.

[257] OECD Report, para. 6.6.

[258] OECD Report, para. 6.39.

[259] M. G. Dekimpe and D. M. Hanssens, *op. cit.*, p. 2.

[260] M. G. Dekimpe and D. M. Hanssens, *op. cit.*, p. 2.

405. It does, however, need to be pointed out that this is only suited to measuring marketing effectiveness in stable, mature environments where advertising spending or price reductions can be used to realise a temporary gain in sales or market share.

406. It is less suited in evolutive, trend-sensitive environments. In the literature, a number of trends are described that show advancement in the measurement of long-term effectiveness.

407. Nonetheless, it strikes us that there is such uncertainty in applying a cost-based method that reliable substantiation of a causal connection between costs and income, and thus the value of intangible assets, is virtually ruled out.

§ 8. The 'residual profit-split method'

408. The OECD lists a number of methods under 'other methods' that are advanced 'when traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all'[261].

409. The residual profit method is such an 'other method', on the basis of which a licence fee can be calculated by effecting a split of the profit of the licensee in such a manner as can be expected in the context of unassociated parties in a joint-venture relationship. At the basis lies a 'functional analysis' of the licensee, whereby the functions, risks, deployed assets and available capital are listed, as a function of which a fair income is allotted to the participating parties. The remaining result is divided between the licence fee for the owner and the profit that is generated by exploitation of the intangible asset. This split is necessary since no one would take out a licence for a fee that swallowed up the entire expected profit.

410. This method requires an in-depth and time-consuming analysis that is ultimately not lacking in any element of subjectivity. The OECD Report at the same time also states that – although the Report is not intended to offer a full list of all means of applying the profit-split method – application of the method is dependent 'on the circumstances of

[261] OECD Report, para. 3.1.

the case and the information available'[262]. We have already successfully applied the method in practice in valuing so-called 'informal capital', in respect of which a ruling can be obtained *inter alia* in Belgium.

411. We consider it worth offering a practical example to illustrate how the oft-used 'residual profit-split method' is typically deployed in application of the 'other methods' described by the OECD.

Suppose a multinational group called 'PbC' (Poor but Clean) purchases a number of activities concerning the exploitation of the liquid washing products of an unassociated group. The agreement covers an activity that generated more than USD 400 million in the hands of the assignor and that encompassed three brand names, viz. one in the UK, one in Belgium and France, and one in Germany. PbC has some USD 1 billion available for the purchase of the brands and other assets in connection therewith.

412. The brand that is marketed exclusively in Belgium and France, 'Fancy Nancy's' is to be acquired by the Belgian PbC company, which will subsequently grant a licence to the associated French PbC entity. Production will be taken care of by a group member established in Germany, and from there the products are to be sent to Belgium or France for further distribution to the customers. The brand management is consolidated within the Belgian company, where, at the same time, the possibilities of pan-European expansion of the brand will be explored. The licensee, PbC France, will be responsible for limited publicity costs with regard to keeping the name known on the local market.

413. The valuation of 'Fancy Nancy's' is based on detailed prognoses of sales, gross margins and operating costs. The model deployed generates standard yardsticks of operational profitability per market and per product, inclusive of Earnings Before Interest and Taxes (EBIT) figures and after-tax free cash flow for the period 2001-2010. The valuation model proceeds on the basis of a 9.5% capital cost (which accords with the WACC, or weighted average cost of capital, within PbC), a 2.5% perpetual growth percentage (unlimited over time i.e. for the period after 2010) and a 35% tax rate.

[262] OECD Report, para. 3.23.

414. In application of the residual profit split, the total profit with regard to the marketing of 'Fancy Nancy's' on the French market is split into two components: (i) the profit attributable to the 'routine' distribution functions of PbC France, and (ii) the incremental (non-routine) profit associated with the value of the 'Fancy Nancy's' brand. Accordingly, a certain percentage ROS is subtracted from the yearly forecasted EBIT to compensate the licensee (PbC France). The then remaining residual profit is deemed to result from the use of the intellectual property owned by PbC Belgium and should therefore form the basis for the compensation towards PbC Belgium. Afterwards, the net present value (NPV) of these annual residual profits is calculated based on a WACC of 9.5%.

In the case at hand, as regards the first component above, a specific return on sales is allocated to PbC France, which is in line with the return that independent distribution undertakings realise in the sale of non-branded products. On the basis of a so-called 'benchmarking study', a 3% percentage is selected, which, in this case, represents the median within the arm's length interval. This profit is deducted from the total budget profit on the sales in France (the annual budgeted EBIT). The balance, the so-called 'residual profit' represents the share in the total profit that can be allocated to the 'Fancy Nancy's' brand in sales on the French market by PbC France.

415. The royalty is determined as the NPV of the EBIT divided by the NPV of the net sales. The result of this exercise is a royalty of 14.5% that, on the one hand, allows PbC an arm's length return on the routine distribution activity to be realised, whilst PbC Belgium enjoys an income that is in line with the value of the 'Fancy Nancy's' brand purchased.

§ 9. The 'market capitalisation' method

416. The market capitalisation method is called an 'inexact CUP method' by the American tax authorities[263]. The method is advanced in a 'Field Service Advice' to officials and in an 'Advance Pricing Agreement', whereby a buy-in was required with regard to already existing intangible assets in a cost-sharing arrangement. The FSA said the regulations contemplate a two-sided analysis of both routine and non-routine

[263] See: Field Service Advice 20002314 of 29 February 2000; Tax Management Transfer Pricing Report, 14 June 2000; C. J. Faiferlick, R. E. Ackerman, J. Wills and T. Reichert, *Market Capitalization: Not a Reliable Transfer Pricing Method*, Tax Management Transfer Pricing Report, 21 February 2001, pp. 753-757.

contributions by controlled taxpayers. 'In particular, in the second step, the residual profit remaining after the allocation to the routine contributions is to be divided based on the relative value of the controlled taxpayers' contributions of intangible property, each measured against a common measuring stick', the FSA said, citing Regs. § 1.482-6(c)(3)(i)(B).

417. The method assumes that the value of intangible assets can be determined in a reliable fashion, proceeding on the basis of the stock market value of the shares, in other words the total value of all outstanding shares at the closing quotation on the day of the transfer. It is assumed that the total value of the undertaking is equal to the sum of its assets[264].

418. When not all assets are thus transferred, a number of deductions are made. A residual profit method is applied and a number of adjustments and assumptions are at the same time unavoidable. The residual value is equal to the net present value of the intangible assets, which is based on the expected profit or cost-savings as a result of use of the intangible assets.

419. This method is not averse to controversy. In particular, it is not obvious for determining the fair value of assets even if they are booked in the balance sheet. We would cite the effect of depreciation as an example.

420. Moreover, there are generally different intangible assets present within the undertaking and a segregation valuation is not an obvious solution. In a comment on the advisability of using the method for Lucent Technologies Inc., a commentator[265] has stipulated that it might be difficult to isolate a specific intangible under this method. He concluded that applying the method is 'like throwing a dart with a blindfold on'. We would also cite the example of goodwill, the quality of the workforce, intangible assets that are bound up with information technology, infrastructure and synergy, the lever effect of a combination of intangible assets. Furthermore, the method takes no account of the varying impact of a brand, depending on the market segment or geographical market.

[264] This position can be disputed since valuations on the stock market are done from the standpoint of the investor and not from the standpoint of the company. We would cite for instance companies with high price/earnings ratios that can have more to do with the optimistic expectations of investors than any objective valuation.

[265] See tax management Transfer Pricing Report, April 18 2001, p. 905 for a comment by Daniel Lloyd, assistant Director of tax planning for the Morristown, N.J. Company.

421. On top of that, the fact is that, since the value of tangible assets is not volatile on a day-to-day basis, but stock market prices on the other hand are, any change in value is automatically allocated to the intangible fixed assets.

422. The utility of this method is strongly criticised in an interesting contribution in the Tax Management Transfer Pricing Report[266], in which its utility is disputed in assessing the buy-in value of intangible assets in cost-sharing arrangements. Thus, for instance, it is stated that costs of research and development are over-estimated in applying the market capitalisation method, since the stock exchange takes account of the relevant *future* expenditure. Given that this method takes into consideration the net current value of profit, attributable to present and future assets, inclusion of the parties' R&D activities in the calculation will over-estimate the residual value, and consequently also the value of the intangible assets transferred. The transferee will accordingly possibly pay twice for the future intangible assets, once upon purchase and a second time in the development and maintenance of new intangible assets.

423. Another criticism is directed towards the fact that the market capitalisation method proceeds on the basis of a licence that is *open-ended over time*. However, in reality the lifetime of intangible assets can vary. Furthermore, the market capitalisation method does not take account of external circumstances that can all of a sudden strongly affect the value of an intangible asset in view of the fact that the method only takes a snapshot of the value.

424. We would cite the example of the successful introduction of a similar asset by a competitor.

425. Also as regards the *risk profile*, there are certain shortcomings in the market capitalisation method. In the event an entire undertaking is valued by the stock market, a number of risks are 'impliedly hedged', in other words spread out over various parties (group members) in various geographical regions. Examples are market risks and R&D risks. The economic circumstances can in general also vary depending on the region or party. Examples are geographical market differences, differences in market size and location-specific costs.

[266] C. J. Faiferlick [*et al.*], *op. cit.*, pp. 753-757.

426. A further criticism of market capitalisation lies in the fact that 'market sentiment' in general has an effect on stock market prices and this can hardly be called an objective yardstick for valuation purposes[267] [268].

§ 10. Other methods

427. Since the OECD Report does not contain any exhaustive list of all ways in which profit can be divided[269], taxpayers can for instance also opt for applying any other acceptable method.

428. A method used in practice is the 'economic return method' or 'ERM', as developed by Jim Mogle. In applying the ERM, an arm's length fee is determined for a transfer of an intangible asset between associated parties by analysing the expected economic return on the part of the transferor or transferee, updated in order to take account of the time value of money and the expenses associated with the risks inherent in the activity.

429. The method is based on a general economic principle that the transferor and the transferee each wish to recover their respective costs that relate to the development or use, as the case may be, of the intangible asset, increased by the operational profit as a remuneration for the funds invested and risks run.

430. In order to calculate an arm's length interval for the royalty fee in applying the ERM, one of the following three analyses of expected economic return has to be undertaken for the transferor or transferee/user[270]:

(a) analysis of the return on investment on the part of the transferee: in other words, the transferee will only be interested if the expected income is greater than the net present value of the related capital investments and start-up costs;

[267] D. Haigh, *op. cit.*, International Tax Report, p. 6; Tax Planning International Review, p. 5; International Tax Review, p. 31.

[268] For a critical analysis see also: K. G. Rivette and D. Kline, *Discovering New Value in Intellectual Property*, Harvard Business Review, January-February 2000, p. 10.

[269] OECD Report, para. 3.23.

[270] J. Mogle, *op. cit.*, pp. 37-38.

(b) analysis of the return on costs on the part of the transferor: in other words, the transferor is only interested in the event he receives more than the sum of the net present value of the research and development costs or acquisition costs incurred, the costs associated with the transfer and the costs or forfeited income occasioned as a consequence of opportunities that can no longer be exploited by the transferor as a result of the transfer;

(c) a combined analysis of the transferor and transferee.

431. In practice, this method generally boils down to an application of the 'transactional net margin method'[271] (or its American counterpart the 'comparable profit method'[272]) in the hands of the transferee and a 'return on capital' (or 'ROCE') approach in the hands of the transferor. The ROCE is generally defined as the ratio between operational profit and operational assets. Operational profit represents payments to all providers of debt and capital.

432. The operational assets are in principle the net fixed assets, stocks and receivables. In applying this method, the (time-consuming) quest for open market references is avoided, since it is internal data such as capital cost and interest rate that are taken as a basis.

433. Although this method can only be applied in the event that no more suitable method can be found that is proclaimed by the OECD, it does in fact find some support in the OECD Guidelines. Indeed, the Guidelines[273] state that one 'must take into account for the purposes of comparability the perspective of both the transferor... and the transferee'. From the standpoint of the transferor, applying the arm's length principle should comprise examining at what price a comparable, independent undertaking would be prepared to transfer the goods.

434. From the standpoint of the transferee, a comparable, independent undertaking may or may not be prepared to paid such a price, depending on the value and usefulness of the intangible asset to the transferee within its business.

[271] OECD Report, para. 3.26-3.57.

[272] The TNMM is not named for intangibles in the OECD Guidelines; however, in the American guidelines, the CPM is included as a possible method in the event that one of the two parties possesses intangible assets; Regs. 1.482-8, 9e example.

[273] OECD Report, para. 6.14.

§ 11. Final considerations regarding the valuation issue in a transfer pricing context

435. It strikes us that the increasing empathy in the US for the CUP method in combination with the fact that this method is undisputed by the OECD Guidelines as that which is labelled as the most recommended does mean that, in practice, a 'less good' CUP has to be chosen above a method that at first blush considers the 'comparability' requirement as less important. In the end of the day, the taxpayer has to take into account the fact that any subjectivity in the analysis cannot be ruled out and it is in our view perhaps for that reason in practice more advisable always at least to test the result obtained by applying a CUP (or some other traditional transactional method) against the results obtained by applying a method based on profit. Ultimately, everyone is interested in the bottom line, in order to see whether the methodology applied gives a fair result[274].

436. In practice, methods are often applied that were not specifically designed for tax purposes. We would cite the example of the amalgam of 'discounted cash flow' models, which can be seen under a variety of nomenclatures and in a whole gamut of variants and the are ultimately seldom dismissed out of hand in tax audits.

437. In addition, we note that the 'adjustments' that the courts effected in the aforementioned cases were not exactly lacking in arbitrary qualities. The judge in Hyatt was probably by no coincidence the same judge as also caused a hullabaloo with a decision issued in a case concerning the non-American rights over the brand name 'DHL' in 1998. This was an interesting case on the difference between economic and legal ownership of intangible assets held by a company in the United States and Hong Kong. In these contributions, we restrict ourselves to the specific discussion point on valuation[275].

[274] See also, for examples, the commentary on Hyatt in Tax Management Transfer Pricing Report of 9 February 2000, (p. 852) by Deloris Wright, a prominent transfer pricing economist in the United States (Charles River Associates Inc., Golden, Colo.): 'People tend to open up the regulations and follow step by step as if it were a recipe ... Regardless of the letter of the law, keep your business hat on'.

[275] For a more detailed analysis, see: D. R. Wright and H. A. Keates, *The DHL Case: What Lesson Can be Learned?*, International Transfer Pricing Journal, IBFD, May/June 1999, pp. 74-78; M. M. Levey, R. J. Cunningham, M. S. Emmer and D. A. Grech, *Tax Court Sends Messages to Taxpayers in DHL*, Intertax, Volume 27, Issue 6-7, 1999, pp. 226-231; M. Moses, *Practitioners Tackle Valuation, Attribution of Network Profits in Transfer Pricing*, Tax Management Transfer Pricing Report, 21 March 2001, pp. 815-816; X, *IRS's Initial DHL Trademark Valuation Not Abandoned at Trial, Attorney says*, Tax Management Transfer Pricing Report, 18 April 2001, pp. 906-908.

438. In 1992, a number of valuations were carried out that resulted in a valuation of $20 million for the DHL brand name. These valuations were confirmed by an external report, although it was not clear what the reference date was for the valuation or whether what was involved was the worldwide brand name or only that in the United States.

439. The American Revenue, the IRS, came to a much higher result and contended before the court that the value was $300 million (after an initial valuation of $600 million). The judge here also made a number of adjustments with the aim of filtering the standpoints of the taxpayer and IRS down to an acceptable compromise.

440. The decision was that the value of the worldwide rights was $150 million, which was subsequently reduced to $100 million taking account of a number of uncertainties surrounding the ownership of non-American rights to the brand. It is not unlikely that a certain arbitrary character can be imputed to such an approach.

CHAPTER VI

MIGRATION OF INTELLECTUAL PROPERTY RIGHTS

441. Bill Gates, who has more than once been confirmed by Forbes magazine as the richest man in the world, would today be a lot richer still if Microsoft had started up in Bermuda[276].

442. The message in this statement is clear; proper tax planning has a direct impact on the bottom line of international company groups. Said simply, a tax rate of 40% means that, of every EUR 1,000 of net profit, only EUR 600 is retained. If the tax charge can be reduced via optimisation to 25%, then in that case EUR 750 is retained, which with somewhat larger sums can lead to considerable savings: savings that lead to higher profits and thus create more value for the shareholders.

443. It is into this tax planning that we wish to look in greater depth in this chapter. Which business models lead to the most optimal tax structure and what factors have to be borne in mind in so doing?

444. In this book, we have already looked at the various ways in which intellectual property rights can be built up: an undertaking within the group can develop them on its own, it can work with a so-called R&D contract, or the work can be done under a cost-sharing arrangement. In this regard, we have pointed out that, if there is a desire to engage in tax planning, this has to be done in good time since intellectual property rights (ever more quickly) gain in value, even where there are start-up losses in the first few years.

445. However, the tax planning may not just be limited to avoiding too heavy a tax charge on the income attracted by the intangibles; avoiding double taxation and withholding taxes must be taken into account in setting up a tax-efficient structure[277].

446. Tax planning can be directed at both existing and new intellectual property rights. In what follows, we deal successively with the ideal post-migration structure, the conditions that each structure has to satisfy, and the various models that can be worked with. But first, we would dwell a while on the various reasons or junctures that can play a role in the decision to engage in tax planning.

[276] The Economist, *A Survey of Globalisation and Tax. Gimme Shelter: Is Tax Competition Among Countries a Good or Bad Thing?*, 29 January 2000.

[277] A. Smits, *op. cit.*, p. 299.

Section 1

REASONS FOR MIGRATING IP

447. Over and above the main reason of wanting to save tax, the relative ease of achieving this is an important reason to consider tax planning in connection with intellectual property rights. By contrast with moving production or a sales unit, the same amount of work is not necessary for moving intellectual property rights. Even the full R&D department does not necessarily have to be accommodated in the tax-friendly location.

448. It is required, nonetheless, that the most important functions and risks should be housed there, in accordance with the transfer pricing model for which one opts (see below).

449. It is also important that the legal relations between the various group companies are cast in well designed contracts that correctly reflect the true situation.

Section 2

JUNCTURES AT WHICH TO CONSIDER PLANS

450. A major hurdle for effecting tax planning in respect of intangibles is that, in moving these valuable assets (once they are valuable), tax will be charged on any capital gains. It is therefore important to keep a look out for a moment that may arise when a more optimal tax structure can be implemented.

451. A good juncture at which to think of tax planning is at the time of an *acquisition*, since at that time it is often possible to acquire the intangibles separately and immediately accommodate them in a tax-favourable location. In this manner, it is avoided having to pay for any capital gain on the migration of the intangibles from the target company (or group). The other way round, it will of course be necessary to take account of the tax treatment in the hands of the seller in order to be able to assess this in its entirety.

452. If an international group (for various reasons) has to go through a *reorganisation*, then a great deal of assets are moved around. Generally, a large number of functions are centralised (*inter alia* by working with a 'shared service centre') and this can be a good opportunity for mapping out the intellectual property rights of the group. On the basis of the result of the exercise, it can be decided whether or not a part (or all) of these rights should be set up under a tax-friendly structure.

453. The ideal, of course, is a situation in which *a new activity is being started up*. At that juncture, any direction is still open for potentially valuable intangibles that will be developed over subsequent years. Very often, it will be weighed up what is most interesting: paying the cost price for the development of the intangible in a low-tax location or having the (uncertain) future royalty flows taxed at low rates. In practice both benefits can possibly be combined when the IP is developed in a low tax branch of a head office in a high tax jurisdiction. Depending on the countries involved, the losses

generated by the branch in the build-up phase can be offset against head office profits. Once the branch becomes profitable, it should be possible to transform it into a subsidiary, without triggering capital gains taxation.

454. Finally, a *change in the law* can also be a good occasion for considering tax planning. Thus, a country may introduce a tax-favourable scheme for holding intangibles, or it may for instance become possible to repatriate income tax free from a low-tax location to the top holding company.

Section 3

FEATURES OF AN IDEAL STRUCTURE

455. The ideal tax structure (including the planning aspects in respect of intangibles) bears a number of features allowing the creation of a low overall effective tax rate on a lasting basis. In the following we summarise what, in our view, are the most important of these features for you.

§ 1. Low taxation of the income from intangibles

456. A first feature of the ideal post-migration structure is that the majority of the income from the group's intellectual property rights flow back to an entity (which we shall call the 'IP company' in the following), which is established in a low-tax environment. For this, the IP company will be located in a place where there is a favourable tax system, either one that is the result of the local general law or one that is based on a special scheme (e.g. based on a ruling). In any case, the result aimed at is the same: low tax on the entity's income.

A. New intangibles to be built up

457. However, it can be that the option is to select a *high-tax location* for accommodating the intangibles. This may be the case where the intangibles still have to be built up and it is expected that this will entail considerable expenditure. If for many years there are nothing but expenses, and losses are thus accumulated, then preference can be given to the fact that it is possible *to carry over the tax losses without limit* (as is the case, for instance, in Belgium), in order then to offset these losses against royalty income.

458. We would here point out that one should *not get transfixed by the corporation tax rate* in the country where it is intended setting up the IP company. There are a good many components that have to be borne in mind; an example of these is the possible use of losses as is mentioned in the previous paragraph. Other factors include the possibility of

depreciating the intangible, possible incentives (tax and otherwise) for investments in intangibles and/or personnel (of great importance in the build-up phase), the deductibility of financial charges, etc. Certainly, a number of non-tax factors also have to be taken into consideration in the choice of location, such as the cost price of property, labour costs, the availability of people and infrastructure, the presence of a broadband network, etc.

459. An observation of no little importance in this context concerns the underpinning of the structure and in particular the so-called '*substance*' that the IP company has to possess. In practice, one often enough encounters businesses that are prepared to engage in tax planning, but do not devote very much attention to substance. Thus, ubiquitous shell companies are created in the most exotic of locations, and people think they have optimised their tax position.

460. In a situation like that, there is sooner a risk of achieving the contrary result. Suppose that a company is set up in country X, without there being any management there and where the true management is left located in the home country (country Y). For the formalities in country X, use is made of a local firm of lawyers, as is often the case in practice. The consequence of this is that the country Y tax authorities can judge under their internal law that the IP company is fiscally regarded as resident in country Y, and that it is taxable there on its worldwide income. If country X has concluded a double taxation treaty with country Y, then possible double taxation may be avoided under that treaty. If there is no such treaty, then there is a risk of being taxed in country Y and in country X, which will nullify the advantages of the structure (even if there had been no tax charge in country X). If the company in our example also forms part of an American group, then the situation could arise that the company is incorporated in country X but is in actual fact managed from country Y and its income (in view of its passive nature – e.g. royalties) is again subject to tax in America under its 'Sub-part F' rules.

461. Without going into the ins and outs of this story, it is clear that not paying any attention to underpinning the structure (and in particular the IP company) can lead to negative tax consequences, which can be much greater than the benefits that one might have hoped to achieve. Hardly model risk management (see also below under 'IP horror stories').

462. Thus, it must always be ensured that substance is guaranteed by means of adequate local presence in terms of functions and risks. Thus, for instance, taking care of maintaining the intangibles will be a factor that plays a role, and responsibility for any court cases in the event of infringement will also have to lie with that entity.

B. Existing intangibles

463. The foregoing also to a large extent applies for the migration of existing intangibles, except that, here as well, account must be taken of a number of special points:

- what tax charge is there on capital gains that are realised in the case of a migration to a tax-friendly location and what relation does this bear to the savings that it is hoped to realise[278]?
- what anti-avoidance provisions might possibly come into play if it is intended to transfer intangibles to a low-tax location? In some countries, the transaction is ignored and all future income is still taxed in that country.

§ 2. Favourable treatment in the country of application

464. Low taxation of income does not help much where the group companies that apply the intangibles and pay royalties for doing so in their country of establishment *cannot deduct the royalty as an expense*. Indeed, a large number of countries contain anti-avoidance provisions in their internal law that curb the possibility of payments to tax havens or other favourable locations.

465. Deducting royalties alone is not sufficient, however; necessary attention should also be paid to the possible application of *withholding taxes*, since under internal law a royalty can be subject to deductions of tax at source, which in many cases can be reduced or even neutralised under double taxation treaties. However, if there is no double taxation treaty in the country where the IP company is established, a withholding tax may still be charged, depending on the circumstances, and it must then be examined whether it qualifies for a tax credit in the country of the IP company. If not, there arises an expense that makes the structure less attractive. It is thus advisable to examine beforehand whether an interesting treaty network is available.

[278] T. Mac, *Exploiting Intangibles the Cost Effective Way*, International Tax Review, October 2001, p. 17.

§ 3. No direct tax charge on the top holding company

466. If the first two features are present, it is nonetheless still too soon to cry victory, since it is very possible that there are rules in the country where the top holding company is established that enable the local tax authorities to levy a direct and immediate tax charge in the top holding company's country on income that is subject to low taxation in the hands of foreign subsidiary. This is mostly the case where the IP company is used to generate income passively (e.g. by just receiving royalties). An example of this effect is the American 'Sub-part F' rules, but a large number of other countries have similar rules.

§ 4. Tax-free repatriation of low-taxed profits

467. If the above features are present, then we are a good way down the road to realising effective tax planning. However, hurdles can yet arise in the form of repatriation of the income, since the intention cannot be to generate low-taxed income for years on end in an entity specially created for the purpose only then to have to realise that the reserved profits cannot be paid out to the parent company in a tax-friendly manner.

468. A possibility thus had to be incorporated (mainly) to allow the low-taxed profits to flow upstream to the top holding company by way of dividends. It will therefore be important to examine the rules that apply in that quarter in the country where the top holding company is established.

469. As an incidental, a look also has to be taken at the tax treatment of dividends in the IP company's country. For instance, will a withholding tax be charged?

§ 5. Flexible liquidation possibilities

470. Even if all these features are present, account still has to be taken of the fact that tax systems have a tendency to change, just like the business or economic parameters that were the impetus for setting up the tax structure.

471. When, at a given time, it becomes tax-detrimental, or operationally untenable, to keep the structure going, there must be a card up one's sleeve allowing for a flexible, tax-friendly way of dismantling the structure. However, that is only possible if sufficient attention has been paid in setting it up to the consequences of a possible liquidation.

472. Thus, in setting up the structure in the IP company's country, one must look at features such as the tax treatment of capital gains (or write-downs), the liquidation rules for companies, any withholdings that play a role at that time. Of course, it is not possible to provide for all changes in the rules ahead of time, but it is advisable to keep track of any changes in the legislation.

§ 6. Other points for attention

473. The features discussed above in our view constitute the most important factors for achieving optimal tax planning. Nonetheless, there are a number of aspects that may not be lost sight of:

- it has to be examined what transaction taxes (such as VAT, registration duties, etc.) are applicable, so that one is not faced with unexpected costs;
- in fixing a properly balanced remuneration, a genuine valuation of the intangibles will be crucial (in this regard, see chapter V);
- good tax planning is impossible without a suitable legal framework (see also above).

Section 4

MODELS FOR ACHIEVING OPTIMAL PLANNING

474. It looks nice to summarise the features of an ideal post-migration structure, but that does not of itself achieve the intended result.

475. In practice it will seldom be so easy just to migrate the intangibles and reshape the ensemble into a low-tax structure with the necessary underpinning. In a good many cases, hurdles will pop up, such as the difficulty of moving people, the tax cost of migrating IP, political resistance within the group, the cost price, etc. In the following, we discuss three possible models for working on a migration of intangibles, each one more radical than the previous. These models have been extensively explained in an interesting contribution by our colleague Mary Walsh of PricewaterhouseCoopers Dublin[280].

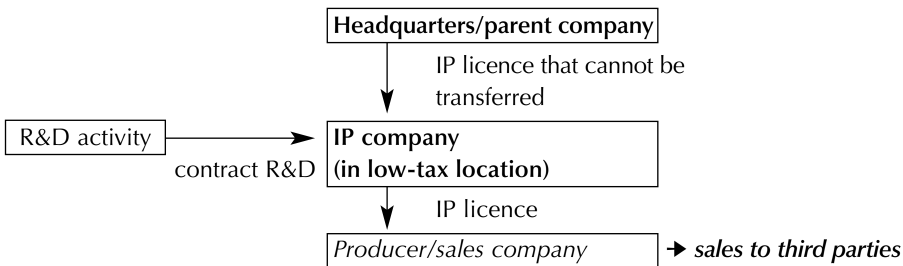
476. According to Walsh, the tax-friendliest structure for building up, financing and applying intangibles is that in which the existing intangibles are retained and the future intangibles are financed centrally by an entity in a low-tax location.

477. The migratory path contains the following three scenarios: first, there is development of intangibles by the low-taxed entity and/or direct acquisition of intangibles from third parties by the low-taxed entity. The second scenario is the full transfer (sale) of existing intangibles to the low-taxed entity followed by an R&D contract. And finally, licensing existing intangibles by the high-taxed to the low-taxed entity. This is, for example, the case for intangibles with a short lifetime that require constant development, since this makes it easier for the low-taxed entity to develop improved versions of the intangibles, which will gain in value whilst the initial intangible gradually falls in value towards the end of its economic lifetime (this is often the case, say, in the software industry). A licence agreement can assume the form of a declining royalty for intangibles with future improvements that are undertaken via a cost-sharing or a contract R&D arrangement.

[280] M. Walsh, *Get the Best Value From Intangibles*, International Tax Review, February 2001, pp. 23-26.

478. The various business models for holding intangibles, the licence model, the franchising/services model and the entrepreneur structure, are discussed in the following. This is done in increasing order of the operational changes within the multinational group, specifically the increasing functions and the risk profile of the low-taxed entity. The more functions and risks that are to be found in the low-tax location, the higher the portion of group profits that will arise in the jurisdiction, with the consequence of increasing the tax benefits of the structure.

§ 1. Licence model



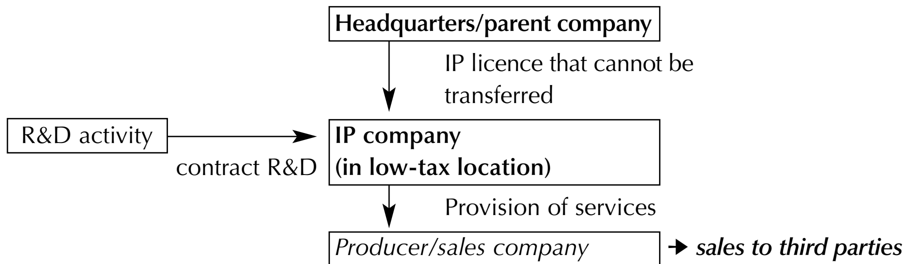
479. In this model, either the low-taxed entity owns the intellectual property rights or it acquires the non-assignable intellectual property rights under a licence from the current owner. The future intangibles are built up under a contract R&D arrangement, with a cost-plus remuneration. On top of that, the existing intangible is licensed to sales and production companies in the group (or to third parties that exploit the intangible).

480. The benefit of this structure is that only minimal operational changes are required, since only relatively limited functions (and workforce) are needed in the low-taxed entity. Furthermore, the majority of the commercial systems, structures and business processes of the multinational undertaking remain unaffected.

481. However, the licence model does entail a number of fiscal challenges. Thus, there is a transfer pricing aspect, together with the possible application of the 'controlled foreign corporation' legislation in the top holding's country, given the relatively passive nature of the entity. And finally, this model is difficult to underpin with non-tax arguments.

482. As concerns indirect taxation, the grant of rights to intellectual property is a taxable service for VAT purposes. In principle, the licence model does not require any additional VAT registrations, but failure to abide by the VAT formalities can lead to an additional cost of up to some 25% of the value of the intangible.

§ 2. *Franchising/service model*

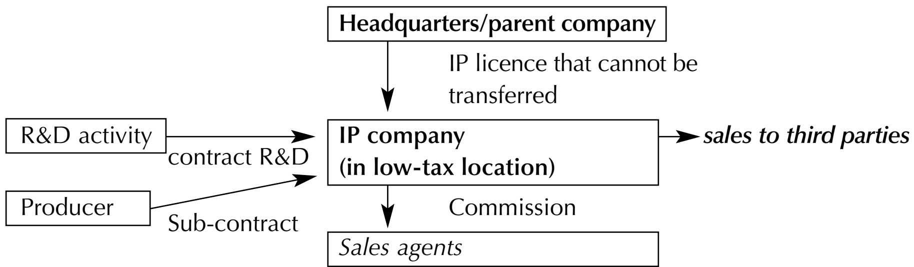


483. The model encompasses the centralisation of a broad range of services together with marketing and trade intangibles. This consists of providing know-how and the experience that is connected to intangibles (i.e. more than just licensing the intangible), and the format for being able to run the business, the management system for doing this and a certain identity for the structure as a whole. The relationship between the parties is similar here to that between a franchiser and a franchisee.

The business model discussed here is mainly used in the retail and service sector.

484. From a business viewpoint, it makes sense to offer intangibles as part of a broader whole. The negative aspects, on the other hand, are the possibility of disconnecting the services and the intangibles, fixing the transfer prices and the risk of the low-taxed entity's constituting a permanent establishment. Another drawback is that the various services give rise to the application of various VAT systems, with the consequence of a great deal of formalities and additional administrative burdens.

§ 3. *Entrepreneur structure*



485. In this business structure, the IP company is the entrepreneur, which contracts with customers and bears all commercial risks. The entrepreneur also contracts with foreign subsidiaries (and third parties) for production, R&D, sales support, etc. via an arrangement that works on the basis of costs and commissions. This structure, too, has its pros and its cons. Thus, the tax advantages are in proportion to the function and risk profile.

486. Furthermore, here as well, the question of transfer pricing is relevant. Other inconveniences are the dividend payment to the (high-taxed) parent and the risk of the entrepreneur's constituting a permanent establishment.

487. As regards the VAT aspect, the same factor comes into play as in the previous business structure, being the possibility of several VAT registrations and the extra costs that might be associated with these formalities.

Section 5

'IP HORROR STORIES'

488. In the following we deal with two cases in which tax planning was done with respect to intangibles without taking account of the requirements discussed above. As a result, the tax authorities were able successfully to call the taxpayer to order.

§ 1. The 'Sherwin Williams' case

489. Using the *Sherwin Williams* case, we shall try and show how the American tax authorities deal with the migration of intangibles where the structure used is not set up with precision and careful consideration. Although the case was situated in an American context, the issue dealt with is sufficiently relevant. For the sake of completeness, the case was promulgated on July 19, 2000.

490. Sherwin Williams is a group whose business is the production, distribution and sale of paint and related products. The American company ('Sherwin Williams'), as the result of heavy marketing efforts, developed hundreds of valuable brands and trading names, which it transferred in 1991 to two subsidiaries in Delaware. The subsidiaries subsequently relinquished use of these intangibles back to Sherwin Williams under licence agreements. On top of that, they also made various loans to Sherwin Williams.

491. The IRS did not accept the migration of the intangibles and rejected the deductibility of the royalties and interest paid in the hands of Sherwin Williams on the grounds of the following arguments.

492. The IRS first of all stated that the licence agreements between the subsidiaries and Sherwin Williams were lacking in any economic and substantive basis and were intended solely to create deductible items in the hands of Sherwin Williams. It went on to contend that no royalties should be paid in any case since the value of the intangibles was maintained not by the subsidiaries but by Sherwin Williams by means of advertisements, production, marketing and quality control. It continued in saying that neither the fee for

transfer of the intangibles nor the royalties paid satisfied the arm's length standard. Moreover, Sherwin Williams was certain that use of the intangibles would be reattributed to it, since it was the main shareholder of both subsidiaries, and the management and control of Sherwin Williams for a large part overlapped with that of the subsidiaries. The IRS consequently concluded that Sherwin Williams was still the owner of the intangibles.

Sherwin Williams tried to overturn the IRS's standpoint with a number of standard arguments, to show that the intangibles had been transferred for economically justifiable reasons and that there was true substance present in the subsidiaries. Sherwin Williams was unable, however, to support any argument with evidence, whilst, with careful tax planning and underlying documentation, it would have been a relatively simple matter to defeat the position taken by the IRS.

493. Thus, it is unfortunate that the two Delaware subsidiaries only incurred very few operational costs and only had an extremely small workforce, whilst the companies received a large sum in name of royalties.

494. In order to limit the risk of a dispute with the tax authorities as to whether or not there is sufficient substance within the IP company, it is advisable that the operating costs of that vehicle (activities that are carried on, personnel that has to be paid, etc.) be proportional to the income that the IP vehicle receives.

495. Outsourcing activities to the parent company, as occurred in the Sherwin Williams case, is best avoided. If it is nevertheless desired to outsource certain activities, it is advisable to have these activities carried out by independent parties. Of course, the facts and circumstances have to be examined on a case-by-case basis, and this suggestion cannot be taken as a general rule.

496. The Sherwin Williams case shows that care is called for in the migration of intangibles. As stated above, it is not sufficient to set up a company and transfer all intangibles to it. As has probably been made clear by this story, the 'substance is key' rule always applies in such exercises. The legal framework that is created must at all times tally with the economic reality.

§ 2. *Acquisition structure*

497. John Henshall[280] describes another interesting case in which the taxpayer had paid too little attention to underpinning its tax planning. The case concerned an American group ('ABC Inc.'), that dealt in packaging and logistics for satellites; it will be easily realised that there is a major barrier to entry for possible competitors in this field, since customers attach more importance to knowledge and experience than the cost price of the service provided. For that reason, with a view to conquering the European market, ABC Inc. bought the UK group 'Load a Lot Ltd.' (the largest European player with a turnover of some USD 369 million).

498. ABC Inc.'s tax advisers conceived a fairly simple plan for having the cost of the acquisition borne by the UK group (via a so-called 'cost push-down'). In implementation of the proposal, ABC Inc. set up a UK subsidiary (ABC Ltd.) for the purpose of the acquisition. ABC Ltd. took out a loan from a British bank in order to fund the purchase. This plan was rejected as being too simple.

499. The advisers then thought up a new plan, in which a newly created Dutch company would purchase the intellectual property of Load a Lot Ltd. before the acquisition took place. Load a Lot would then have to pay a royalty for use of the intangible. The Dutch company would seek a ruling in order to gain certainty as to the tax deduction of the depreciation on the intellectual property rights purchased, which should be deducted from the royalty income, resulting in a somewhat low profit. As a consequence of this, the acquisition cost would be converted into a tax-deductible royalty cost in the UK, which, via a limited tax charge in the Netherlands, should allow low-taxed income to flow upstream to the United States. This plan was accepted and the transaction was implemented: USD 296 million was allocated to the intellectual property and the other USD 74 million to the shares.

500. It was decided to carry out a transfer pricing study in order to underpin the deduction of the royalty in the UK. It was shown by this study that the intellectual

[280] J. Henshall, *op. cit.*, pp. 639-640.

property comprised more than 100 different names, secret production processes, old patents and copyrights. Of these, only two intangibles were of value: the 20-year-old brand name and the copyright to the software. The 'secret' production processes appeared not to be so secret, since the staff turnover rate was some 25% per annum.

501. The value thus had to be sought in the brand name of Load a Lot. A brand name has a value because it offers a promise of future qualitative services on the basis of previous experience. On this view, the fact that the Dutch company did not use the brand name itself but licensed it to another company without exercising control over quality was possibly misleading to the customers. ABC had set up a so-called 'bare licence' and, if its competitors learned of this, they could challenge use of the name.

502. The tax consequences were particularly painful: in the UK, the split of the price was not accepted as being at arm's length, so that it could not serve as a basis for calculating a royalty; in the Netherlands, given the low value of the intangibles, there was insufficient depreciation basis, so that the royalty income was taxed at the full rate; in addition, the necessary tax credits were obtained in neither the Netherlands nor the United States. This ultimately led to:

- a tax charge of 30% in the UK on the non-deductible royalties;
- a withholding of 20% in the UK;
- Dutch tax at a rate of 35% on the royalty income.

503. Although is was eventually possible to avoid a part of the double taxation, there nonetheless remained very little over from the tax savings that had initially been postulated. The message here as well is thus: good tax planning can lead to a great deal of savings, but if and only if it is preceded by a thorough study and proper underpinning.

CHAPTER VII

EXTINCTION OF INTELLECTUAL PROPERTY RIGHTS

Section 1

LEGAL ASPECTS OF THE LOSS OF INTELLECTUAL PROPERTY RIGHTS

§ 1. Loss of intellectual property

504. In addition to cases where the holder of an intellectual property right transfers it to a third party, he can also lose his exclusive right in a number of ways. An example is the expiry of the term of protection.

505. The term of protection for most intellectual property rights is limited. Only know-how has an unlimited term of protection, due to the non-public nature of the intangible asset item, provided that the knowledge remains secret in nature.

506. *Patents* in principle enjoy protection for a period of twenty years, counting as from the date the application is filed[281]. After the lapse of this period, the patentholder in principle loses his exclusive right and his invention in principle falls within the public domain, as a result of which third parties gain the right to apply the invention for commercial purposes (which, for example, is the case with generic medicines).

507. For some inventions, this limited term of protection is nonetheless regarded as being too short, for instance for the drugs industry. Since the grant of a patent on active ingredients or the composition of active ingredients can and may not immediately be followed by commercialisation of the patent due to time-consuming clinical trials and official licensing procedures, the drugs industry is battling with a major problem[282] [283].

[281] Art. 33 TRIPs; art. 63 EPC; under some legal systems, however, patents are granted for shorter terms of protection.

[282] Although attempts are being made to shorten this official licensing procedure, it can still take many years before a new drug is actually brought onto the market, as a result of which the term within which the patentholder may commercialise its invention has been shortened to a substantial extent.

[283] See, for the licensing procedures, *inter alia* Council Directive 65/65/EEC of 26 January 1965 on the approximation of provisions laid down by Law, Regulation or Administrative Action relating to proprietary medicinal products, O.J. L 22, 1965, p. 369, as amended by Council Directive 75/318/EEC of 20 May 1975 on the approximation of the laws of Member States relating to analytical, pharmaco-toxicological and clinical standards and protocols in respect of the testing of proprietary medicinal products, O.J. L 147, 9 June 1975, p. 1, as amended.

508. In order to cope with this issue, the drugs industry is offered the possibility of applying for a supplementary protection certificate (SPC). Under the EU Supplementary Protection Certificate Regulation, the duration of such a certificate can be up to five years[284].

509. Since this issue is not restricted to the drugs industry, a new article 62(2)(b) has been introduced to the European Patent Convention, under which the Signatory States to the EPC are empowered to lengthen the term of a patent where commercialisation of the patent is made dependent on an official licensing procedure in the signatory state.

1. Trade marks

510. Under art. 18 TRIPs, the first registration of a trade mark is valid for a period of at least seven years. The registration of a trade mark can be extended for like periods without limitation, however.

511. As regards Community trade marks and Benelux trade marks, this term of protection is extended to ten years counting as from the date the application is filed. The filing can be renewed for ten years in each case, provided the formal requirements are complied with and the renewal fees are paid[285].

2. Copyright

512. The term for which protection is granted to a copyright-protected work begins to run at the time the creation is in any way set down in a physical form and continues until the author's death. Under the Council Directive of 29 October 1993 harmonising the term of protection of copyright and certain related rights, the exclusive right endures in favour of the heirs and legatees for seventy years after the death of the author[286]. The Berne Convention reduces this term to minimum 50 years after the death of the author.

513. Under article 2(7) and article 7(5) of the Berne Convention, this term is calculated as from 1 January of the year following the death of the author.

[284] Art. 13 of Council Regulation (EEC) No 1768/92 of 18 June 1992 concerning the creation of a supplementary protection certificate for medicinal products, O.J. L 182 , 1992, p. 1.

[285] Art. 46 ETMR.

[286] However, art. 12 TRIPs offers signatories to that Agreement the possibility of calculating the protection of copyright works (other than photographic works or works of artistic expression) on a basis other than the life of the author; in such cases, this term will not be shorter than fifty years after the end of the calendar year in which publication is permitted, or failing such permitted publication within fifty years after creation of the work, fifty years after the end of the calendar year in which it is created.

514. The term of protection of works created by joint working expires for all successors in title seventy years after the death of the last-surviving joint worker (sec. 2(2) CA); this protection extends to the whole work, including to the part to which the last-surviving joint worker did not contribute[287] [288]. Anonymous or pseudonymous works are protected until seventy years as from the time at which the work is made accessible to the general public in a permissible manner.

§ 2. *Non-use*

515. Obtaining an exclusive right to use an invention or trade mark in mercantile dealings means that the holder of the intellectual property right has to undertake actually to use the right, otherwise he may, under certain conditions, be deprived of the exclusivity right[289].

516. For instance in Belgium, with regard to patents, where a term of four years has elapsed counting as from the filing of the patent application or of three years counting as from the grant of the patent, without the patent being exploited in Belgium and without the patentholder being in a position to justify this with valid reasons, the Minister has the ability to issue a compulsory licence[290]. Such applications have to be submitted to the Minister for Economic Affairs, and abide by the procedure and conditions laid down in sections 31 *et seq.* of the Patents Act.

517. Whilst the possible penalty for non-use under patent law thus comprises the issue of a compulsory licence, *trade mark law* goes considerably further.

518. Thus article 15(1) read together with article 50(1)(a) ETMR provides that the rights of the holder of a Community trade mark may be declared lapsed on petition to the

[287] Liège Court of First Instance, 20 January 1927, Pas., 1928, III, 149 and Brussels Court of Appeal, 10 March 1970, R.W. 1970-71, 511, note by Corbet.

[288] For audio-visual works, account is only taken of the time of death of the chief producer, the screenplay writer, the text-writer and the author of musical works that are specially written for the work (sec. 2(3) CA).

[289] In this regard, it should be noted that this obligation applies only to industrial property rights, and to copyright.

[290] Article 91(1) gives a (non-exhaustive) list of examples, namely *'import restrictions on or other government requirements for goods or services protected by the trademark'.*

O.H.I.M. in Alicante or by a counterclaim in infringement proceedings, where for an uninterrupted period of five years the trade mark has not been used in a customary manner within the Community for the goods or services for which it is registered. The holder of the relevant trade mark is able, however, to state any valid reasons establishing why the trade mark has not been used.

519. There is no possibility of issuing a compulsory licence over a trade mark, it even being expressly ruled out[291]. Where use of the intellectual property right by a third party is subject to monitoring by the holder (*inter alia* under a licence), this is acknowledged as use of the trade mark for the purposes of maintaining the registration[292].

§ 3. Estoppel (personal bar) due to toleration

520. This penalty also requires to be viewed separately from estoppel (personal bar) due to toleration, which is only effective if invoked. Estoppel due to toleration means that the holder of an older national or Community trade mark or an older sign that has tolerated the use of a newer Community trade mark for five successive years may no longer claim on the basis of the older trade mark that the newer trade mark should be declared void, or object to use of the newer trade mark for the goods or services for which the newer trade mark is being used, unless the newer trade mark has been applied for *male fides*[293] [294].

§ 4. Renunciation of rights

521. The right to a trade mark lapses as a result of a voluntary striking of the Benelux filing or international registration[295]. Registration of a Community trade mark can also be voluntarily renounced[296].

[291] Article 21 TRIPs.

[292] Article 19(2) TRIPs.

[293] Art. 53, first and second paragraphs ETMR.

[294] See also sec. 14 *bis*, first paragraph BTMA.

[295] Section 5(1)(a) and (b) BTMA.

[296] Article 49, ETMR.

§ 5. Nullity

A. Trade marks

522. In trade mark law, there are grounds on which trade marks may be void or voidable.

523. *Grounds on which a trade mark is void* (referred to as 'absolute grounds for invalidity') are contained in article 51 ETMA, being (1) where the Community trade mark has been registered in breach of the provisions of article 5 ETMR concerning the nationality of the holders of Community trade marks, (2) in principle, cases in which grounds for refusal could have been invoked upon registration[297] and (3) where the applicant was acting in bad faith when he filed the application for the trade mark. Furthermore, the 'relative grounds' on which a trade mark may be voidable (upon an application by an interested party) are set down in article 52 ETMR.

524. As regards the grounds on which a Benelux trade mark may be invalid, reference can be made to section 14 BTMA.

B. Patents

525. The invalidity of a patent has to be pronounced by a court in such cases as are provided for by statute[298]. This involves *inter alia* cases in which the conditions for patentability are not satisfied and where no adequately clear and complete description of the invention is enclosed with the patent so that a man of skill might be able to carry out the invention.

526. In the event that a ground for declaring the patent invalid should affect it only partially, then the patent is limited to such extent, i.e. by changing the claims, description or drawings[299]. Partial or complete declaration of the invalidity of a patent is of retrospective effect as of the time the patent application was filed.

[297] Article 7 ETMR (see margin no. 25). However, a Community trade mark filed in contravention of article 7, paragraph 1(b), (c) or (d) ETMR cannot be held to be void where by means of the use that has been made of it after filing it has acquired distinctive power for the goods or services for which it was filed (art. 51(2) ETMR).

[298] Section 49(1) Belgian Patents Act.

[299] Section 49(2) Belgian Patents Act.

§ 6. Non- (or late) payment of fees

527. If the holder of a patent or trade mark does not pay the necessary fees in time, there may be a risk of his losing his exclusive right[300].

§ 7. Specific grounds for a declaratory judgement pronouncing the lapse of a trade mark

528. For Community trade marks, there are a number of specific conditions under which trade marks can be held to have lapsed. The circumstances in question are the following:

- where the trade mark has become a customary name in the trade for a good or service for which it has been filed due to an act or omission on the part of the trade mark holder[301]. In such cases, indeed, there is no longer any distinctive power;

- in the event that, as a consequence of use that is made of it by the trade mark holder or with his consent for the goods or services for which it has been filed, the trade mark may mislead the general public, in particular with regard to the sort, quality or place of origin of such goods or services[302].

[300] See *inter alia* articles 45 and 47(3) ETMR; article 86.3 EPC.

[301] Article 50(1)(b) ETMR.

[302] Article 50(1)(c) ETMR.

Section 2

TAX ASPECTS OF THE LOSS OF INTANGIBLES

529. When a new drug comes on the market and fairly quickly builds up a strong position owing to patent protection, then over the years during which the patent enjoys protection, the patent will constitute a particularly valuable intangible (and ownership of it will attract tax income).

However, it is very often the case that, as time goes by, the brand name of the drug will gain in importance, so that, when the patent lapses after 20 years, the drug will continue to sell well, but then due to the brand name and no longer due to the patent protection (whereby ownership of the brand name will generate tax income). This is particularly relevant taking into account that in 2002 alone, over 10 blockbuster drugs (i.e. drugs which generate annual revenues of over USD 1 billion) will lose their patent protection.

530. On a tax level, this means that this process has to be tracked carefully, since over the 'product life cycle', more income will flow to the owner of the brand name and increasingly less to the owner of the patent. If no account is taken of this, there is a chance that, if different group companies own the patent and the brand name, the tax authorities in the country where the company owning the brand name is established will argue that artificial profits are being shifted to the country of the company that owns the patent. Ideally, account is taken of this evolution at the time that the patent and brand name are registered.

More generally, this observation also applies to investments in intangibles to be newly developed on the basis of already existing intangibles (in this regard, see chapter VI regarding migration).

CHAPTER VIII

FINAL CONSIDERATIONS AND FORETHOUGHTS

531. Knowledge, competence and related intangibles have emerged as the key drivers of competitive advantage in developed nations. This does not originate from the relevance of knowledge itself, but stems from the rapid expansion of goods and factor markets, leaving intangible assets as the predominant basis of competitive differentiation in many sectors. The key sources of wealth creation in the third millennium lie with new enterprise formation; the renewal of incumbents; the exploitation of technological know-how, intellectual property, and brands; and the successful development and commercialisation of new products and services. Take the Internet as an example of one of the most important catalysts. It has speeded up the shift from tangibles to intangibles and taken it global. It has enabled supply chains and business models to fragment and reassemble in a variety of forms and has put intangible assets at the heart of businesses. For Yahoo, Amazon and reverse auctioneers like Priceline, Freemarkets, etc. their business model *is* what they are. The internet also makes intangibles more mobile and tradable. There is a constant need to focus on obtaining a deeper understanding of various forms of exploitation (e.g. imitability and replicability) with respect to intangibles and the role of markets in undermining traditional forms of competitive advantage. 'There is no such thing as a privileged product market position – unless it rests on some upstream intangible asset'[303].

532. We have tried to highlight why intangibles are so important, and would identify three reasons:

A. Markets value intangibles, whereas accounting practices have failed to keep pace with the changing nature of the corporate asset base:

Historical PE ratios around 14.5, combined with an increase of market to book ratios from 1.3 in 1982 to 6.5 in 1998[304], show that intellectual assets have probably never been meaningfully measured. The good news is that eminent sources, such as the SEC, now proclaim the relevance of 'looking into the future' when dealing with accounting.

[303] D.J. Teece, *Capturing Value from Knowledge Assets: The New Economy, Markets for Know-How, and Intangible Assets*, California Management Review, volume 40, Number 3, Summer 1998, p. 77.

[304] R.G. Eccles, *et al.*, p. 53 and p. 56.

Needless to say, however, our plea does not mean that one should no longer be critical and prudent when measuring value. Intangibles can vanish overnight: a brand can be damaged by rumour or failure, a patent can expire, a technology can be superseded. Nevertheless, techniques for valuing intangibles do not yet seem to have come to maturity, and so we have tried to emphasize the need for accounting and/or tax law to focus on the valuation of intangibles[305].

B. Intangibles drive investments:

Optimising shareholder value necessitates a company's making decisions about the balance between physical and intangible investments. Companies must be able to value R&D, customer relationships, brands, human capital, etc. According to an MIT Sloan School of Management study[306], investing in intangible assets has a tangible effect on a company's performance even though they generally reduce short-term profits. A total of 3,500 companies tracked between 1964 and 1998 enjoyed a 4.3% rise in their mean market-to-book ratio with each 1% increase in R&D spending. A 1% increase in advertising spending generated a 1.8% rise in the market-to-book ratio. The challenge will be for managers to resist the temptation to forego them in difficult economic times as, under most countries' accounting rules, those investments have an immediate negative impact on quarterly financial performance.
Emphasis is to be put on long-term value. In considering this, one could find useful inspiration in Michael Porter's ideas on innovation and location[307]. A decade ago, the challenges were to restructure, lower costs and raise quality. Today, continued operational improvement is a given, and companies are able to acquire and deploy the best technology. In advanced nations, companies must be able to innovate at the global frontier as producing standard products using standard methods will not sustain competitive advantage. Here again, the role of the legislature becomes evident. Innovation should be supported throughout an entire economy. Important policy choices are imperative, including the protection of intellectual property, the extent of tax-based incentives for innovation and the degree to which antitrust enforcement encourages innovation-based competition.

[305] J. Dunleavy, *Sustaining Value in the New Corporation*, PricewaterhouseCoopers, John Wiley, April 2001, Chapter 4: Growing Intangibles: From Valuation to Maximisation, pp. 91-125.

[306] Professor S.P. Kotari and B. Libert, *Value of Investments in Intangibles*, MIT Sloan Management Review, Fall 2001, pp. 13-14.

[307] M.E. Porter and S. Stern, *Innovation: Location Matters*, MIT Sloan Management Review, Summer 2001, p. 28.

C. If you can't measure something, you can't manage it:

Bill Gates has remarked 'Our primary assets, which are our software and our software-development skills, do not show up on the balance sheet at all'[308]. Since a company's combined non-physical assets cannot be measured in conventional accounting terms, they are often overlooked in management's agenda until a crisis situation occurs, such as going-concern threats, takeover bids, etc. Very few manage them systematically or strategically, or even at all. Successful companies cannot afford this attitude. Look at Dell[309], which has secured 42 issued and pending patents on its innovative business model. This 'patent wall' not only covers the customer-configurable on-line ordering system but also the methods by which that system is integrated with Dell's 'continuous flow' manufacturing, inventory, distribution, and customer service operations. It is unknown whether Dell will ever use the threat of a patent infringement suit to block a potential rival from copying its system too closely, but it has already leveraged those patents to bolster its market advantage. The clearest example is a 1999 $16 billion cross-licensing deal with IBM, whereby the patents were used as the collateral.

The message here is thus for companies to:

- understand the breadth and depth of their knowledge in order to spot cross-selling opportunities;

- leverage intellectual property like patents to exploit possible revenue streams from licensing;

- recognize the potential of their brands, so as to see where to invest to increase their value.

533. Our aim in this book has in no way been to give a complete overview of all the opportunities and limitations with regard to intellectual property rights or intangible assets. The express intention has been to clarify this topical matter from one particular angle: that of transfer prices within multinational companies.

[308] J. Dunleavy, *op. cit.*, p. 93.

[309] K.G. Rivette and D. Kline, *op. cit.*, p. 5.

534. Seen from this perspective, we can distil a number of rules of thumb, which can be summarised as follows:

- value added in business processes is increasingly often and to a great degree being provided by intangible assets rather than by traditional tangible fixed assets; this means that the profit potential within a group of undertakings is ever more frequently tied up in the assets and that those companies that hold them will be entitled to an ever larger share of the group profits (under application of the arm's length principle);
- this means that proper attention certainly has to be paid to the tax consequences of the manner in which intangibles are built up and applied within the group; maybe one undertaking is selected to build up the intangibles, followed by licences and payment of royalties, or maybe the option is taken to use the contributing undertaking in the application phase;
- the single major difficulty with intangibles, seen from the perspective of transfer pricing, is determining their value; the OECD Report acknowledge this complexity, but lack practical guidance, so that inspiration has to be sought in general valuation methods and techniques;
- where it is realised that ever more value is being generated by intangibles, then tax planning is recommended all the more; in this, one can go farther than just a fair allocation of income from the intangibles, by pro-actively (preferably in the start-up phase) accommodating the intangibles in a low-taxed IP company; on condition this is done in a well-substantiated manner, this offers a great deal of optimisation opportunities;
- in all of this, the legal aspects are always of importance; they determine to what extent legal protection can be obtained, to what extent licences can be granted, what can be done in cases of infringement, etc.; logical application of these principles will be a determining factor for the success of a transfer pricing policy; of importance is the fact that the OECD Report, under which it is economic ownership that prevails, must be applied in consideration of the legal framework within which intangible assets have to be located;
- furthermore, account has to be taken of transaction-bound taxes, that can impose an important extra cost if the required formalities are not adhered to;
- finally, it is important to ensure there is reliable documentation covering all transactions, that allows proper follow-up so that the documentation is not overtaken by the actual operational situation.

535. How long this issue will remain relevant in an ever-changing business environment is an open question. However, bearing in mind Peter Drucker's preview on the multinational in the year 2025, the topic will not quickly lose its appeal. Indeed, a multinational that is held together and controlled by strategy inevitably has alliances, joint ventures, know-how agreements and other 'transfer pricing-sensitive' items on its agenda…

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In recent decades, the importance to businesses of intellectual property rights (mainly trade marks, patents and copyrights) has seen a sharp increase, as a result of which it has become crucial to offer them adequate legal protection. This also means that these rights are increasingly identified as 'key value drivers' within international groups. From a tax point of view, these assets offer significant opportunities for legitimate modular planning of results. Particular transfer pricing techniques can be applied to achieve tax optimisation based on a fair allocation of profit potential according to the economic risk profiles and functions of the group entities. It is precisely these functions that can more easily be re-located in the case of intangible assets, thus giving rise to what are known as 'portable profits'. This is in contrast to generating profits from business activities within a physical infrastructure, which are hard to dismantle, e.g. via production facilities.

Already some 30% of world trade affects goods and services that are in some way associated with intellectual property, and this proportion is ever on the increase. Let us take the example of typical e-commerce businesses, which are started up without any significant investments in equipment and thus are confronted with few or no (financial) hurdles, and therefore contribute to a rapid proliferation of intangible assets.

It is also crucially important to pay attention to the legal protection, tax impact and planning possibilities from these changes.

This book is constructed around the 'life-cycle' of intellectual property rights, seen from a transfer pricing perspective. In so doing, the emphasis from a legal viewpoint is especially laid on copyright, trade marks, know-how and patents. After introducing and describing these rights, we look at their structure (including whether property rights are developed by a company itself, or cost-sharing agreements) and application (i.e. own use, licensing or transferring property rights and combating infringements); subsequently we look at the valuation (with an emphasis on trade marks), migration and extinction of such rights.

These various phases are illustrated throughout using specific examples. The relevant international case law is also referred to, together with administrative practice. In this respect, the authors have also called on the expertise of the worldwide network of tax and legal experts within PricewaterhouseCoopers and Landwell.

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