Transfer pricing series instalment III: What is an intangible asset and what is intellectual property from a transfer pricing perspective?

Everyone thinks they understand and can identify an intangible asset or intellectual property. However, the definition of what constitutes an intangible or intellectual property is very dependent on the context of the question. It is the diversity in definition as to what constitutes an intangible or intellectual property that often leads to difficulties in identifying intangibles within a multinational group, often resulting in the adoption of transfer pricing positions that are at odds with the OECD Guidelines.

In the third instalment in our series on ‘Intangibles and Intellectual Property from a Transfer Pricing perspective’, we consider the breadth of activities that can be considered intangibles or intellectual property from a transfer pricing perspective, including some examples of practical ‘day to day’ scenarios that are often missed in assessing the use of intangibles within a multinational group.

What is an Intangible?

The Oxford English Dictionary provides a definition of intangibles that most people would be familiar with, being “something that is unable to be touched; not having a physical presence”. This definition is broad and while it does define the term ‘intangible’, it does not provide much guidance from a transfer pricing perspective.

A more defined definition of ‘intangible’ can be found in the world of accounting, in particular within the Australian Accounting Standards Board AASB 138. AASB 138 defines ‘intangible assets’ as “a non-monetary asset, without physical substance”. AASB 138 goes on to provide examples of intangibles from an accounting perspective, including:

- Computer software
- Patents
- Copyrights
- Motion picture films
- Customer lists
- Mortgage service rights
- Fishing licences
- Import quotas
- Franchises
- Customer or supplier relationships
- Customer loyalty
- Market share
- Marketing rights
- Etc.

In addition to the general and accounting definition of ‘intangible’, there are also legal definitions (many of which relate to rights that are able to be registered) and tax definitions. In relation to the definition of intangibles for tax purposes, it is important to note that Chapter VI of the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration 2017 (the 2017 OECD Guidelines) specifically states that the guidance material in Chapter VI of the OECD Guidelines relates to transfer pricing purposes only and is not intended to have any relevance to other tax matters, such as Article 12 of the OECD Model Tax Convention (which contains a detailed discussion of the definition of whether a particular payment should be subject to royalties and withholding tax).
For the purposes of this third instalment of our series, Chapter VI of the 2017 OECD Guidelines (at paragraph 6.6) defines the word intangible as:

“The word ‘in tangible’ is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”

In coming to this definition, the 2017 OECD Guidelines adopted a much broader definition to the definition within Chapter VI of the 2010 OECD Guidelines. In formulating the definition of ‘intangible’ in the 2017 OECD Guidelines, the OECD acknowledged (at paragraph 6.5) that:

“If an overly narrow definition of the term intangible is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use of transfer of an item in transaction between associated enterprises should require compensation in circumstances where no such compensation would be provided in transaction between independent enterprises.”

In taking this approach, the OECD goes on to note that the availability or extent of legal or contractual protection is not necessarily a condition for an item to be characterised as an intangible for transfer pricing purposes. The OECD also notes that it is important to distinguish intangibles from market conditions or local market circumstances (such as the competitiveness of a local market) which are not capable of being owned or controlled and therefore cannot be classified as intangible. While legal protection and market conditions may impact the value of an item or the arm’s length price of a particular transaction, they are not factors taken into account in defining an intangible for transfer pricing purposes.

**Sub definition of Intangibles**

Within Chapter VI of the 2017 OECD Guidelines, the OECD notes there are a number of categories of intangibles. These include:

**Marketing Intangible**

Within Chapter VI of the OECD Guidelines defines Marketing Intangibles as:

“An intangible that relates to marketing activities, aids in the commercial exploration of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include (for example) trademarks, tradenames, customer lists, customer relationships and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.”

Not all marketing intangibles are capable of registration or are recognised as an asset for accounting purposes (such as development of client lists), with the cost of development of some marketing intangibles often expensed. This category of intangibles may, however, contribute to generating significant economic value to a business and should be considered an intangible for transfer pricing purposes. Marketing intangibles might also be aggregated (i.e. brand name, logo, trademark) or used in conjunction with other non-marketing intangibles (such as patented technology).
According to the 2017 OECD Guidelines, common types of marketing intangibles include:

- Trademark
- Tradename
- Brand
- Domain names
- Copyright
- Registered designs
- Customer relationships
- Customer lists
- Consumer / customer data
- Loyalty programs
- Domain names
- Distribution channels

While transactions involving registered marketing intangibles are often identified in dealings within multinational groups, dealings involving intangibles that are not capable of registration often go unidentified and if the dealing has not been identified, the economic value attributed to the marketing intangible also goes unrecognised. For example:

A multinational group takes over a company in Australia and, over the next 12 months, transitions the Australian entity from the former Australian name and branding to the multinational group's branding and trademark. The multinational charges a royalty of 2% of sales for the use of its brand name to all subsidiaries. However, a review of the economic driver of sales in Australia indicates that the prime contributor to sales relates to the Australian sales teams' participation in two key industry events, which generate 80% of Australian sales. The cost of preparing for and participating in these industry events is borne by the Australian entity.

In the above example (which is a very common example), most multinational groups would levy a royalty for the company brand/trademark and be unaware of the internally generated Australian marketing intangible driving economic value in Australia, leading to an incorrect transfer pricing position.

**Trade Intangibles**

The 2017 OECD Guidelines define a ‘trade intangible’ as “an intangible other than a marketing intangible”. Given this definition is not very helpful in identifying a ‘trade intangible’, Chapter VI of the 2017 OECD Guidelines goes on to provide specific examples of ‘trade intangibles’ which include:

- Patents, which involves a legal right provided to its owner
- Know-how and trade secrets, which includes undisclosed information of an industrial, commercial or scientific nature, often related to manufacturing and R&D
- Etc.

As with marketing intangibles, most taxpayers would be able to identify transactions involving patented or registered trade intangibles, and while most multinational groups would also assert that they are able to identify transactions involving the use of know-how or trade secrets, experience indicates this is incorrect and is one of the reasons behind the issuance of the more extensive Chapter VI within the 2017 OECD Guidelines. The following is an example of the type of trade intangible commonly overlooked within a multinational group:

A multinational group based in Australia acquires a subsidiary in India, the purpose of which is to acquire the Indian subsidiary's market share and allow it to continue to produce the same products. However, the Australian parent believes that if it can increase the quality of the product manufactured in India, the Indian entity could potentially increase the price for its products, which would generate increased profit. It is the Group's intention to use the Indian manufacturer’s ability to produce low cost products as a means of meeting certain market demands. In order to get the new manufacturing facility up and running to the standard required by the Australian parent, the Australian entity sends over a team of 20 people (including technical experts, process controllers, quality assurance experts, etc.) in order to establish a range of processes and practices to enable the Indian subsidiary to produce products that are comparable (in terms of quality) to those produced in Australia. In this scenario, it is most likely
that the Australian parent will charge its Indian subsidiary for the use of the team of experts on a ‘cost plus’ basis – asserting the transaction relates to the provision of services. This method of remuneration (cost plus for the use of technical know-how) is a very common practice within multinational groups, however, the 2017 OECD Guidelines are clear that such services relate to the provision of an intangible (as opposed to a service), the pricing of which is outlined in Chapter VI of the 2017 OECD Transfer Pricing Guidelines. How the arm’s length price for such a dealing is established will be the subject of a subsequent instalment, however, guidance indicates it should not be calculated on a ‘cost plus’ basis.

What is NOT an Intangible?

While the 2017 OECD TP Guidelines go into detail as to what dealings involve the use of an intangible, it is equally important to understand what is not an intangible. Given intangibles must be capable of being owned and controlled for use in commercial activities, the following would not be categorised as an intangible:

› Goodwill, as it cannot be segregated or transferred specifically from other business assets (although care needs to be taken to ensure this is not confused with the term ‘brand’).
› Group Synergies, such as purchasing and borrowing power, streamlined management, integrated systems, etc. As these dealings are not capable of being owned or controlled by an enterprise, they are not defined as intangibles.
› Marketing specific characteristics, such as local labour costs, proximity to markets, etc. While these factors may impact the price paid for goods and services in a particular market, they are not intangibles as they are not able to be owned or controlled by an enterprise.

Summary

While most multinational groups are capable of identifying if a specific dealing involves the use of intellectual property, dealings that involve intangibles (particularly unregistered intangibles) often go unidentified or are often miscategorised as being related to services. The transfer of know-how, market intelligence, customer information, loyalty / warranty programs, etc., is very common between members of a multinational group, often leading to commercial outcomes that could not be otherwise achieved by an individual enterprise. However, it is the fact that in independent circumstances, independent enterprises would be compensated for the use of these non-physical or financial assets that defines them as ‘intangibles’ and requires such dealings to be considered under Chapter VI of the 2017 OECD Guidelines.

In our next instalment, we will consider whether legal and economic ownership of intellectual property or intangibles are the same concept. This will involve considering the contribution entities within a multinational group have made regarding the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) of the intangible or intellectual property in question.