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INTERNATIONAL TRANSFER PRICING

Marketing intangibles

Examples to show how the Tax Office will determine an appropriate reward for marketing activities performed by an enterprise using trade marks or trade names it doesn't own.



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ABOUT THIS GUIDE

This guide is part of a suite of publications about international transfer pricing produced by the Tax Office.

The other publications in the suite are:

- *International transfer pricing: introduction to concepts and risk assessment* (NAT 2725) (we recommend that you read this overview before reading the other guides)
- *International transfer pricing: advance pricing arrangements* (NAT 2748)
- *International transfer pricing: applying the arm's length principle* (NAT 2726)
- *International transfer pricing: a simplified approach to documentation and risk assessment for small to medium businesses* (NAT 12032), and
- *International transfer pricing: attributing profits to a dependent agent permanent establishment* (NAT 14314).

INTRODUCTION

The creation and use of intangible property in multinational enterprise groups are becoming increasingly significant in Australia. Issues relating to the creation and use of intangible property have been discussed in a number of the Tax Office transfer pricing rulings (for example, in paragraphs 235 and 334 of TR 94/14 and paragraphs 5.39 to 5.43 of TR 98/11).

TR 97/20 notes at paragraph 2.23:

However, the general principles and guidelines in relation to tangible property concerning comparability and the selection of the most appropriate method are also applicable to intangible property.

The Organisation for Economic Cooperation and Development (OECD) has addressed a range of special considerations for intangible property in chapter VI of its 1995 *Transfer pricing guidelines for multinational enterprises and tax administrations* (hereafter referred to as the OECD Transfer Pricing Guidelines). In this regard TR 97/20 notes at paragraph 1.13:

When applying Division 13 and the Associated Enterprises Articles of Australia's DTAs, the ATO follows as closely as practicable the OECD guidelines on transfer pricing methodologies for the application of the Associated Enterprises Article of the OECD Model, being the considered view of many tax administrations with extensive experience on transfer pricing.

A related issue frequently encountered in Australia is an Australian subsidiary of an offshore parent incurring marketing expenditure to develop a brand in this country. In this guide we provide a series of examples to illustrate the Tax Office view on the principles for determining an appropriate reward for marketing activities performed by an enterprise in relation to a marketing intangible that it does not own.

The examples are based on the guidance in paragraphs 6.36 to 6.39 of the OECD Transfer Pricing Guidelines, headed 'Marketing activities undertaken by enterprises not owning trademarks or tradenames'. In light of this guidance, the key matters that determine our approach to such situations are:

- the contractual arrangements between the trade name owner and marketer, in particular the duration of the agreement, the nature of the rights obtained by the marketer in respect of the trade name, and who bears the costs and risks of the marketing activities
- whether the level of marketing activities performed by the marketer exceeds that performed by comparable independent enterprises
- the extent to which the marketing activities would be expected to benefit the owner of the trade name and/or the marketer, and
- whether the marketer is properly compensated for its marketing activities by a normal return on those activities or should share in an additional return on the trade name.

Our approach to different situations is illustrated in the examples contained in the guide.

The overriding consideration governing our approach is the application of the arm's length principle to the particular facts and circumstances by considering what would have been agreed between independent enterprises dealing at arm's length in similar circumstances.

The examples contain a number of assumptions, in an attempt to address some of the key features of each situation. In the complex reality of modern business, we recognise that some or all of these assumptions will not hold in all situations and that in reality the situations are likely to be more complex. Nor do the examples cover every situation that is likely to occur.

In June 2003 we released *Large business and tax compliance*, which lists a number of issues large businesses can expect us to challenge. This guide illustrates the issues that enterprises not owning trade marks or trade names can expect us to challenge in relation to the treatment of marketing activities they undertake.

EXAMPLE 1

This example illustrates a renewable long-term royalty-free contractual arrangement (with exclusive right), where the marketer/distributor does not bear the costs and risks of developing the market.

Company A, a resident of Country X, manufactures watches which are marketed in many countries around the world under the trade name *Rist*.¹ Company A is the registered owner of the trade name *Rist*. The trade name is widely known in the countries where the watches are sold and has obtained considerable economic value in those markets. But it has never been marketed in Australia and is unknown in this market.²

In year 1 Company A decides to enter the Australian market and incorporates a wholly owned subsidiary in Australia, Company B, to act as its distributor in this country. At the same time, A enters into a long-term royalty-free marketing and distribution agreement with B.³

Under the agreement, B is granted the exclusive right to market and distribute watches bearing the trade name *Rist* in Australia⁴ for five years, with an option for a further five years. B obtains no other rights relating to the trade name *Rist* from A and in particular is prohibited from re-exporting watches bearing the trade name. The sole activity of B is marketing and distributing watches bearing the trade name *Rist*. It is assumed that *Rist* is not part of a portfolio of products distributed by B in Australia. B undertakes no secondary processing, as it imports packaged watches into Australia ready for sale to the final consumer.

Under the contract between A and B, B purchases the watches from A in Australian dollars, takes title to the branded watches and performs the distribution function in Australia, incurs the associated carrying costs (for example, inventory and financing receivables) and assumes the corresponding risks (for example, inventory, credit and financing risks).

Under the contract between A and B, B is required to develop the market for *Rist* watches in Australia. One consequence of this is that B develops the Australian marketing strategy for *Rist* watches, with minimal input from A. However, the costs and risks of developing the market are to be primarily borne by A, which is to reimburse B for the cost of advertising and other marketing efforts B incurs in developing the trade name *Rist* in Australia. As compensation for providing these marketing activities to A, B is to receive a fee based on the level of marketing expenditure it incurs and including an appropriate profit element.

Assume for the purpose of this example that the price B pays A for the *Rist* watches can be analysed independently from the compensation B receives for the marketing it undertakes on behalf of A. Consequently, assume that the price paid for the watches is arm's length and that this price enables B to earn an arm's length reward from selling the watches for the distribution function it performs and the associated risks it assumes.⁵

In years 1 to 3, B embarks on a strategy that is consistent with its agreement with A to develop the market for *Rist* watches in Australia. In the process, B incurs marketing and distribution expenses, with the marketing expenses being reimbursed by A. According to the contract, B is also remunerated by A for the marketing activities it provides. By the end of year 2, the trade name *Rist* has become established in Australia as a result of B's efforts.

Our enquiries in relation to years 1 to 3 establish that all marketing expenditure B incurred was reimbursed by A, consistent with the contract between them, and that the compensation paid to B for the marketing activities it performed on behalf of A was comparable to that paid to independent advertising and marketing agents.

Tax Office approach

Assume that we select this issue for a transfer pricing audit of B. The facts of the example are consistent with B acting as an agent and being reimbursed for its promotional expenditure by A, the owner of the trade name marketing intangible.

As noted at paragraph 6.36 of the OECD Transfer Pricing Guidelines:

The issue is whether the marketer should be compensated as a service provider, ie. for providing promotional services, or whether there are any cases in which the marketer should share in any additional return attributable to the marketing intangibles.

Paragraph 6.37 of the OECD Transfer Pricing Guidelines sees the situation of an agent (B in this example) to be relatively clear and concludes:

In that case, the distributor would be entitled to compensation appropriate to its agency activities alone and would not be entitled to share in any return attributable to the marketing intangible.

In this example we conclude that the compensation received by B for the marketing activities is arm's length. Therefore, we would not propose any adjustment in respect of this issue.

1 The trade name *Rist* is hypothetical.

2 To simplify the examples, assume that the actual names of Company A and Company B bear no resemblance to the trade name *Rist* and are not used for marketing purposes.

3 See paragraph 6.11 of the 1995 OECD Transfer Pricing Guidelines.

4 For the purpose of this example, assume that A retains legal ownership of the trade name *Rist* in Australia and that any intellectual property registration requirements in relation to B's right to market and distribute products bearing the trade name *Rist* in Australia, and to have such rights protected by law, have been satisfied.

5 For simplification, this analysis assumes that B does not undertake any marketing activities strictly associated with its distribution function. Ordinarily, there is not such a clear distinction between marketing and distribution activities. In many marketing/distribution arrangements between independent enterprises (particularly where the marketer/distributor bears the costs and risks associated with the marketing activities), the distribution function will necessarily encompass some level of marketing activities that would not be separately rewarded. In such cases, the distributor expects to receive its reward through selling the products it distributes. It is also often unlikely to have sufficient reliable comparable data to establish arm's length consideration for the distribution function separate from the marketing function.

EXAMPLE 2

This example illustrates a renewable long-term royalty-free contractual arrangement (with exclusive right), where the marketer/distributor bears the costs and risks of its marketing activities.

The facts in this example are the same as in example 1, except for the following.

- 1 Under the contract between A and B, B bears the costs and assumes the risks associated with its marketing activities. The agreement between A and B does not specify the amount of marketing expenditure B is expected to incur, only that B is to use its best efforts to market the watches. B receives no reimbursement from A in respect of any expenditure it incurs or any other indirect or implied compensation from A and expects to earn its reward solely from the sales of branded watches to third party customers in the Australian market.
- 2 This difference means that, all other things being equal, the arm's length price of the watches determined for the purpose of Example 2 is likely to differ from the arm's length price determined for the purpose of Example 1. This is because B is not the same entity in Example 2 as in Example 1. The contractual arrangements between A and B are very different and the risks assumed by B are greater (for example marketing risks) in Example 2 than in Example 1. Given that the only controlled transaction between A and B in Example 2 is the transfer of the branded watches, and that the contract between A and B provides for no compensation from A to B for its marketing activities, B can obtain its reward only through selling *Rist* watches to third party customers. So, the arm's length price in Example 2 is likely to be less than the arm's length price determined for the purpose of Example 1. It also follows that the criteria used for identifying comparables will differ in the two examples.

In years 1 to 3, B embarks on a strategy that is consistent with its agreement with A and, in the process, incurs marketing expenses. As a result, B has high operating expenditures and slim margins in years 1 to 3.⁶ By the end of year 2, the trade name *Rist* has become established in Australia as a result of B's efforts.

Where the marketer/distributor actually bears the costs and risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. Our enquiries in relation to years 1 to 3 conclude that B would have been expected to have incurred this level of marketing expenses if it were unrelated to A.⁷

Given that B bears the costs and associated risks of its marketing activities under a long-term contract of exclusive distribution rights for the trade name product, there is an opportunity for B to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. We also conclude that the benefits obtained by B result in profits similar to those made by independent marketers and distributors in the first few years of comparable long-term marketing and distribution agreements for similarly unknown products.⁸

Tax Office approach

Paragraph 6.37 of the OECD Transfer Pricing Guidelines notes:

As regards the first issue – whether the marketer is entitled to a return on the marketing intangibles above a normal return on marketing activities – the analysis requires an assessment of the obligations and rights implied by the agreement between the parties. It will often be the case that the return on marketing activities will be sufficient and appropriate.

In this example we conclude that B's return is arm's length and that its marketing activities, as illustrated by its marketing expenses, are not abnormal. We therefore conclude that B is appropriately receiving a normal return on its marketing activities (including any enhancement to the value of the distribution rights it has obtained under its contract with A), that any increase in the value of the trade name *Rist* should remain with A (the owner), and that B is not entitled to share in any additional return attributable to the trade name.

In this case, B is fully and appropriately compensated for its marketing activities from sales of the branded products and the market share it obtains as a result of the marketing activities. No separate or additional compensation from A to B is warranted for the marketing activities B undertakes. On the facts of this example, we would not propose an adjustment.

⁶ See paragraph 1.32 of the OECD Transfer Pricing Guidelines.

⁷ This example uses the level of marketing expenditure incurred by B as a simplifying tool. It would be improper to conclude as a general rule that the level of advertising and other marketing expenditure incurred by a marketer (as with any other cost-based approach) provide the sole or necessarily a reliable indicator of the level of risks assumed by a marketer for the purpose of a comparability analysis. Other indicators (such as market share, sales growth, surveys of advertising effectiveness) may provide equal or better measures to determine the level of risks assumed by a marketer. Such indicators might also be used in conjunction with a cost-based approach.

⁸ It is assumed that sufficiently reliable comparable data is available for companies in a similar position in the market with similar functions, assets and risks to B. This is unlikely to always be the case in practice.

EXAMPLE 3

This example illustrates a renewable long-term royalty-free contractual arrangement (with exclusive right), where the marketer/distributor bears the costs and risks of developing the market and incurs marketing expenses far beyond those of comparable independent enterprises.

The facts in this example are the same as in example 2, except that the market development functions undertaken by B in example 3 are far more extensive than those undertaken by B in example 2.⁹

Where the marketer/distributor actually bears the costs and risks of its marketing activities, the issue is the extent to which the marketer/distributor can share in the potential benefits from those activities. Our enquiries in relation to years 1 to 5 conclude that the level of marketing expenses B incurred during these years far exceeded that incurred by independent marketers and distributors with similar long-term marketing and distribution agreements.¹⁰

Given the extent of the market development activities undertaken by B, it is evident that B has assumed significantly greater costs and risks than comparable independent enterprises (and substantially higher costs and risks than in example 2). There is also evidence to support the conclusion that the profits realised by B are significantly lower than the profits made by comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

As in example 2, B bears the costs and associated risks of its marketing activities under a long-term contract of exclusive marketing and distribution rights for the trade name product, and therefore has an opportunity to benefit (or suffer a loss) from the marketing and distribution activities it undertakes. However, in this case B has undertaken a level of market development activities and borne extraordinary marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profits for B than are made by such enterprises.

Tax Office approach

On these facts, and coupled with the assumption that the transfer price for the branded watches is otherwise arm's length, we conclude that, by incurring extraordinary marketing expenditure, B has acted to increase the value of the intangible owned by A. In this regard, paragraph 6.38 of the OECD Transfer Pricing Guidelines notes:

In some cases, a distributor may bear extraordinary marketing expenditures beyond what an independent distributor with similar rights might incur for the benefit of its own distribution activities.

We also conclude that in an arrangement between independent enterprises B would be compensated by A, the owner of the trade name *Rist*, for the market development activities undertaken for A's benefit. In this regard, paragraph 6.38 of the OECD Transfer Pricing Guidelines further notes:

An independent distributor in such a case might obtain an additional return from the owner of the trademark, perhaps through a decrease in the purchase price of the product or a reduction in royalty rate.

In this example, we would be likely to propose an adjustment to B. The adjustment would be based on compensating B for the marketing activities performed and expenditure incurred for the benefit of A, consistent with what independent enterprises dealing at arm's length in similar circumstances might be expected to have agreed. For example, the adjustment might be based on one of the following.

- 1 Reducing the price paid by B for the *Rist* watches purchased from A. One way of effecting such an adjustment might be to apply a resale price method or transactional net margin method using available data about the profits made by comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements. An alternative might be to apply a residual profit split method. This method would split the combined profits from sales of the branded watches by first giving B and A a basic return for the functions they perform and then splitting the residual profit on a basis that takes into account the intangible assets owned by B and A¹¹ and the relative contributions of both B and A to the value of the trade name *Rist*.
- 2 Directly compensating B for the excess marketing expenditure it has incurred over and above that incurred by comparable independent enterprises. This may be appropriate, for instance, if independent enterprises might be expected to have agreed to B receiving a fee and a reimbursement of expenditure incurred in excess of a specified amount (based on what a distributor purchasing for the agreed price might be expected to spend on its own account). It is expected that such a fee would include an appropriate profit element.

In this example, the proposed adjustment is based on B's excess marketing expenditure being solely for the benefit of A. B would not be entitled to compensation from A for the excess expenditure to the extent that it may be expected to also have added value to an intangible asset owned by B, such as the distribution rights it has under its contract with A.

⁹ This could also affect the selection of comparables. This example assumes that the comparables chosen are undertaking similar market development activities, but this may not always be the case in practice.

¹⁰ See footnote 7.

¹¹ The intangible asset in B's case may constitute the contractual rights arising from the long-term distribution agreement.

EXAMPLE 4

This example illustrates a short-term royalty-free contractual arrangement (with exclusive right), with no option to renew, where the marketer/distributor bears the costs and risks of developing the market.

The facts in this example are the same as in example 2, except that B now enters into a three-year royalty-free agreement to market and distribute the watches in the Australian market, with no option to renew. At the end of the three-year period, B does not enter into a new contract with A.

Our enquiries in relation to years 1 to 3 establish that independent enterprises in Australia do enter into short-term distribution agreements where they incur marketing and distribution expenses, but only where they stand to make a reward commensurate with the level of risk they are assuming. Evidence from comparable independent enterprises shows that they do not invest large sums of money in developing marketing and distribution infrastructure where they obtain only a short-term marketing and distribution agreement, with the attendant risk of non-renewal without compensation.¹²

The potential short-term nature of the marketing and distribution agreement is such that B could not, or may not be able to, benefit from the marketing and distribution expenditure it incurs at its own risk. The same factors mean that B's efforts may well benefit A in the future.

The risks assumed by B are substantially higher than in example 2 and it has not been compensated on an arm's length basis for bearing these risks. In this case, B has undertaken market development activities and borne marketing expenditures beyond what comparable independent enterprises with similar rights incur for their own benefit, resulting in significantly lower profits for B than are made by such enterprises.

Tax Office approach

On the facts of this example, we conclude that the short-term nature of the contract between A and B makes it unreasonable to expect that B has the opportunity of obtaining appropriate benefits under the contract within the limited term of the agreement with A. We therefore conclude that B has acted to increase the value of the trade name intangible owned by A. We also conclude that in an arrangement between independent enterprises, B would be compensated by A for the market development activities it undertakes for A's benefit.

In this example we would be likely to propose an adjustment to B. This adjustment could be based on compensating B for the marketing activities performed and expenditure incurred for the benefit of A, consistent with what independent enterprises dealing at arm's length in similar circumstances might be expected to have agreed. For example, the adjustment might be based on one of the following.

- 1 Directly compensating B based on the marketing expenditure it has incurred and including an appropriate profit element. This may be appropriate, for instance, if there is evidence of arrangements between independent enterprises for expense reimbursement and fees payable for comparable marketing services.
- 2 Reducing the price paid by B for the *Rist* watches purchased from A during years 1 to 3. One way of effecting such an adjustment might be to apply a resale price method or transactional net margin method using available data about the profits made by comparable independent enterprises during the corresponding years of similar short-term marketing and distribution agreements.

¹² Determination of the arm's length price is ordinarily based on the conditions existing at the start of an arrangement. The subsequent fact that a contract is or is not renewed would ordinarily not be a factor in its initial pricing (see paragraph 1.51 and 3.14 (last sentence) of the OECD Transfer Pricing Guidelines). It may be otherwise, however, where there is evidence at the start of an arrangement that the contract would or would not be renewed.

EXAMPLE 5

This example illustrates the renegotiation of a renewable long-term royalty-free contractual arrangement (with exclusive right), before its term expires, into a renewable licensing agreement (with exclusive right) under which the marketer/distributor pays a royalty, and bears the costs and risks of developing the market.

The facts in this example are the same as in Example 2 with the following additions.

- 1 By the end of year 3 the trade name *Rist* is successfully established in the Australian market and A and B renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, which is to commence at the beginning of year 4, is for 5 years with B having an option for a further 5 years. Under this agreement, B agrees to pay a royalty to A based on the gross sales of all watches bearing the trade name *Rist*. In all other respects the new agreement has the same terms and conditions as in the previous arrangement between the parties. There is no adjustment made to the price payable by B for the branded watches as a result of the introduction of the royalty.
- 2 B's sales of *Rist* watches in years 4 and 5 are consistent with earlier budget forecasts. However, the introduction of the royalty from the beginning of year 4 results in B's profitability declining substantially.

In year 6 we become concerned about the significant reduction in B's profitability and notify our intention to start a transfer pricing audit of B. Our enquiries find no evidence of independent marketers/distributors of similar branded products agreeing to pay a royalty.

The evidence establishes that B's level of marketing expenditure, from year 4 on, is comparable to that of such enterprises, but that B's profits are significantly lower than the profits made by such enterprises during the corresponding years of similar long-term marketing and distribution agreements.

Tax Office approach

Where an Australian taxpayer obtains no rights to use a trade name other than to market and distribute a branded product, we would generally not expect the taxpayer to be charged a royalty in addition to the price of the product. We can be expected to challenge this practice in appropriate cases. Accordingly, based on the facts of this example and the evidence from comparable independent enterprises, we conclude that a transfer pricing adjustment is warranted in years 4 and 5, for example, to disallow the royalties paid by B.

We would not propose any adjustments for years 1 to 3 as we are satisfied that the return obtained by B in these years is consistent with that earned by comparable independent enterprises (as in example 2).

EXAMPLE 6

This example illustrates the renegotiation of a renewable long-term royalty-free contractual arrangement (with exclusive right), before its term expires, into a renewable licensing agreement (with exclusive right) under which the licensee agrees to pay a royalty for processing, marketing and distributing the branded product, and the licensee bears the costs and risks of developing the market. The licensee incurs expenses far beyond those of comparable independent enterprises.

The facts are the same in this example as in Example 3 with the following additions.

- 1 At the end of year 3, A stops manufacturing watches and contracts a third party to manufacture them on its behalf. As a result, B will import unbranded watches directly from the manufacturer and undertake secondary processing to apply the trade name *Rist* and package the watches before sale to the final consumer, in addition to the marketing and distribution it previously undertook.
- 2 As a consequence, at the beginning of year 4, A and B renegotiate their earlier agreement and enter into a new long-term licensing agreement. The new agreement, to start at the beginning of year 4, is for five years, with B having an option for a further five years.
- 3 Under the agreement, B is granted the exclusive right within Australia to process, market and distribute watches bearing the trade name *Rist* in consideration for agreeing to pay a royalty to A based on the gross sales of all such watches. B receives no compensation from A in respect of the renegotiation of the original marketing and distribution agreement. It is assumed, for the purpose of this example, that the purchase price B pays for the watches from the beginning of year 4 is arm's length and that no consideration in respect of the trade name *Rist* is embedded in that price.

In year 6 we become concerned about B's profitability in years 1 to 5. Our enquiries in relation to years 1 to 3 conclude that the level of marketing expenses B incurred during these years far exceeded those incurred by independent marketers and distributors with similar long-term marketing and distribution agreements.¹³ Given the extent of the market development activities undertaken by B, it is evident that B has assumed significantly greater costs and risks than comparable independent enterprises. There is also evidence to support the conclusion that the profits realised by B are significantly lower than the profits made by comparable independent marketers and distributors during the corresponding years of similar long-term marketing and distribution agreements.

In years 4 and 5, B bears the costs and associated risks of its marketing activities under the new long-term licensing agreement with A, and therefore has an opportunity to benefit (or suffer a loss) from those activities. However, our enquiries conclude that B has undertaken market development activities and incurred marketing expenditure far beyond what comparable independent licensees with similar long-term licensing agreements undertake and incur for their own benefit, resulting in significantly lower profits for B than are made by such enterprises.

Tax Office approach

Based on this evidence, we conclude that in an arrangement between independent enterprises B would be compensated by an additional return from A, the owner of the trade name *Rist*, for the market development activities undertaken for A's benefit (see paragraph 6.38 of the OECD Transfer Pricing Guidelines).

As a result, we conclude that a transfer pricing adjustment is warranted for years 1 to 5. For years 1 to 3 the possible bases for the adjustment would be as for example 3. In years 4 and 5 the bases for an adjustment would be similar, except that the adjustment may reduce the royalty payments from B to A, rather than the purchase price of the watches.

In the particular circumstances, we would not challenge the lack of compensation to B in respect of the renegotiation of the original agreement, given that B has suffered no loss of value as it effectively retains the same marketing and distribution rights under the new agreement as it had under the original agreement.

¹³ See footnote 7.

