SUSPECTING THE UNSUSPECTED: HOW TO APPROACH MARKETING INTANGIBLES IN A BUSINESS RESTRUCTURING OF A U.S. DISTRIBUTOR

INTRODUCTION..................................................................................................................................................1

I. SHARING MARKETING INTANGIBLES...........................................................................................................4

II. TRANSFER OF MARKETING INTANGIBLES...............................................................................................6
   A. IDENTIFICATION OF MARKETING INTANGIBLES....................................................................................8
   B. OWNERSHIP OF MARKETING INTANGIBLES.........................................................................................10
      i. Legal Ownership.......................................................................................................................................11
      ii. Economic Ownership..............................................................................................................................13
   C. ARM’S LENGTH COMPENSATION FOR MARKETING INTANGIBLES.....................................................23
      i. Measuring Arm’s Length Compensation...............................................................................................23
      ii. Compensation for Development of Marketing Intangibles.................................................................26
      iii. Valuation of a Bundle of Marketing Intangibles..................................................................................28

III. RESPECTING THE RESTRUCTURING TRANSACTIONS............................................................................31
   A. IDENTIFYING REALLOCATION IN PROFIT POTENTIAL.........................................................................31
   B. RISK ALLOCATION AND ECONOMIC SUBSTANCE..................................................................................33
   C. OTHER OPTIONS REALISTICALLY AVAILABLE.......................................................................................35

IV. POST-RESTRUCTURING ARRANGEMENT....................................................................................................37

CONCLUSION....................................................................................................................................................39
INTRODUCTION

Although no legal or universally accepted definition exists, business restructurings typically involve cross-border redeployment and internal reallocation of functions, assets, and risks by a multinational enterprise (MNE).¹ Business restructurings serve legitimate business purposes when an MNE wishes to maximize synergies and economies of scale, to streamline the management of business lines and to improve the efficiency of the supply chain.² They may also serve to preserve profitability or limit losses in a downturn economy.³

MNEs are constantly shifting business activities from high-tax to low-tax jurisdictions.⁴ Yet reduction of supply chain costs through a business restructuring may not necessarily maximize the primary driver of shareholder value, an MNE’s net income, if the effect of income taxes outweighs the supply chain savings.⁵ Once a vertically integrated enterprise begins to isolate functions, risk, or assets in specific entities within the corporate group and ultimately deploys them in certain jurisdictions, separately identifiable economic returns on functions and risks become significant.⁶ For this reason, companies often achieve tax savings by using specific-purpose entities to locate various aspects of their business processes in tax-favored

² OECD GUIDELINES para. 9.1.
³ Id. at para. 9.4.
⁴ Webber, supra note 1, at 149.
⁵ Id. at 154. A study on the optimal measure of shareholder value shows that in the United States, “the explanatory power of earnings is superior to cash flows. Bartov, Eli, Stephen Goldberg & Myung-Sun Kim, The Valuation-Relevance of Earnings and. Cash Flows: An International Perspective, VALUATION J. FIN. MGMT. & ACCT. 103-132, 108, vol. 12, No. 2 (2001). Moreover, the study found that earnings have a greater relative explanatory power over cash flows in Anglo-Saxon countries, but not in Germany or Japan. Id. at 129.
⁶ Webber, supra note 1, at 156 (citing Dan Irving, Gary Kilponen, Raffi Markarian & Mark Klitgaard, A Tax-Aligned Approach to SCM, SUPPLY CHAIN MGMT. REV. 57, 59, vol. 9 (2005)).
A business restructuring may entail cross-border transfers of valuable intangibles and termination or substantial renegotiation of existing arrangements.\(^7\)

Since the mid-90’s, business restructurings have often involved the centralization of both intangible assets and risks with reallocation of the associated profit potential.\(^9\) A centralized supply chain business model enables an entity to obtain the high profit and high risk associated with residual returns by assuming the risk-taking function of an entrepreneur and contracting with limited-risk manufacturers and distributors to perform routine functions.\(^10\) Transforming a vertically integrated business model into a centralized one entails migrating intangibles and “stripping” functions and risks from fully-fledged entities.\(^11\) The stripped intangibles, functions, and risks are centralized in an entity that functions as the entrepreneur in the business segment that is subject to restructuring.\(^12\)

Business restructurings result in reallocation of profits, which raises tax erosion concerns for countries in which former fully-fledged entities are residents.\(^13\) As usual, tax authorities grow apprehensive when not merely potential but actual erosion of the national tax base takes place.\(^14\) Business restructurings attract the scrutiny of tax authorities when companies, which have the resources to generate high margin profits, generate only routine margin profits, or even worse, end up with losses.\(^15\) Changes in contractual arrangements alleging adjustments to

---

\(^7\) Id.
\(^8\) OECD GUIDELINES para. 9.1.
\(^9\) Id. at para. 9.2.
\(^10\) Anuschka Bakker, Transfer Pricing and Business Restructurings: Streamlining All the Way 405 (Amsterdam: IBFD, 2009).
\(^11\) Id. at 404.
\(^12\) Id. at 404.
\(^13\) Id. at 405.
\(^14\) Webber, supra note 1, at 149. France, South Africa, Switzerland, Mexico, Argentina, and the United States have observation a reduction in tax revenue due to business restructurings. Id.
\(^15\) Bureau of National Affairs, International Comparisons – How Taxpayers and Tax Authorities are Responding, Implications for Risk Management, Transfer Pricing in a Recession 23, (Lillian Adams ed. Apr. 2009) [hereinafter Transfer Pricing in a Recession]. For example, Her Majesty’s Revenue and Customs in the United Kingdom would look for resources, including heavy investment, a highly-skilled and highly-compensated technical
entities’ risk profiles warrant added scrutiny. Government’s tax treatment and reactions differ, which leads to uncertainty for MNEs. Moreover, the recent economic recession might have increased MNEs’ interest in cost reduction through business restructurings.

The OECD Report on the Transfer Pricing Aspects of Business Restructurings (OECD Guidelines) intends to address how the arm’s length principle applies to business restructurings and the extent to which an associated reallocation of profits is consistent with the arm’s length principle. The OECD Guidelines expressly affirm that their content and the arm’s length principle should apply to business restructurings and post-restructuring transactions in exactly the same manner as they apply to transactions that were structured as such from the beginning.

This paper will address conversion of a U.S. full-fledged distributor into a limited-risk distributor for a foreign principal and will focus primarily on transfer of property rights to marketing intangibles to a foreign intellectual property (IP) company. The recently issued OECD Guidelines and U.S. transfer pricing law will serve as resource and enlighten this inquiry.

---

16 TRANSFER PRICING IN A RECESSION, supra note 15, at 23. Despite the recession, tax authorities may become concerned with companies reporting unfavorable financial results, especially if they operate on a limited risk basis. Id. at 22.
17 BAKKER, supra note 10, at 405. For example, the Dutch tax authorities have uneasily observed how full-fledged sales and distribution enterprises have been converting into representative offices and taking other steps to convert subsidiaries into unincorporated permanent establishments. Dutch tax authorities are most resistant to allowing deductions for reorganization costs for limited-risk entities, and they would reopen tax returns from previous years to question why as a higher-risk entity, the business had not earned higher profit margin. See TRANSFER PRICING IN A RECESSION, supra note 15, at 23. In contrast, in restructurings that transferring risks and intangible assets out of the United Kingdom, Her Majesty’s Revenue & Customs (HMRC) may defend its tax base by asserting that the UK subsidiary had developed valuable marketing intangibles for which it should be compensated. Id. at 24.
18 See OECD GUIDELINES para. 9.6. However, domestic tax treatment of an arm’s length payment, including rules regarding the deductibility of such a payment and how domestic capital gains tax provisions may apply to an arm’s length capital payment are also not within the scope of these OECD Guidelines. Id. at para. 9.8.
19 See id. at para. 9.9. The OECD Guidelines affirmed the OECD Member countries’ strong support for the arm’s length principle and the principle’s significance when emphasizing that it applies in the same way to all types of business restructuring transactions irrespective of whether they lead to a more or less centralized business model. Id. at para. 9.3
20 See id. at para. 9.2.
into the conversion as the MNE under observation steers its way through the law and issues on the forefront. Part I will introduce the base case whose business restructuring involving marketing intangibles this paper will follow. Part II will walk through the very steps of a conversion of a U.S. distributor implicating a transfer of marketing intangibles. Part II.A will explore identification of marketing intangibles, Part II.B will seek to determine their ownership, and Part II.C will discuss assessment of the arm’s length compensation due as a result of the conversion. Part III will inquire into what takes for a tax authority, such as the Internal Revenue Service, to respect the restructuring and post-restructuring transactions. Part IV will present the post-restructuring arrangement.

I. SHARING MARKETING INTANGIBLES

Company Ace (Company A) is a leading global designer, producer, and distributor of luxury watches. The company’s headquarters are located in Berne, Switzerland, and its footprint transcends borders to tap into high-end markets worldwide. Company A’s brands are symbolic for watches of refined aesthetics and impeccable craftsmanship. The status of the watches derives not only from the high quality of their technical features, but from the foremost position of Company A’s brands and their exposure. Company A aims to differentiate itself from its competitors by building prominent brand names with great value and implementing carefully developed and expensive marketing strategies. Company A has been developing its worldwide marketing strategies in Switzerland while assisting its distributors to implement them locally.

Company A has been selling its watches in the United States since 1958. Although its U.S. market share has expanded gradually, Company A gained a central position on the U.S.

---

22 This illustration is based on examples (A) (Conversion of a full-fledged distributor into a “risk-less” distributor) and (B) (Transfer of valuable intangibles to a shell company) in Part IV.D of the OECD Guidelines.
market only in the past forty years when it began distributing and selling exclusively through its own wholly-owned Distributor Utmost (DSub). DSub operates under Company A’s trademark and owns locally valuable brands and trade names. DSub has operated through its own retail points and has ten-year, renewable contracts with exclusive retailers with whom it has developed relationships over the years.

In response to business model optimization strategies developed in the 90’s and evergreen competitive pressures, in 2010, Company A decides to undergo a global business restructuring to optimize its business model. Company A intends to centralize certain functions and oversight of assets in well-selected jurisdictions, which offer strategic opportunities for maximizing efficiency and realizing cost savings, including tax savings. Company A decides to align its model by combining service functions in a central location in Ireland and transferring its intangible property to a Swiss IP holding company (IPCo). In exchange for lump-sum payments, DSub transfers the ownership of its brands and trade names to IPCo in Switzerland. Along with those of Company A’s distributors in other markets, DSub’s procurement, logistics, and customer support functions are transferred to a shared service center in Ireland. As a result of these developments, DSub becomes a limited-risk distributor and its post-restructuring profit potential is significantly lower than its pre-restructuring one.

23 Historically, DSub has been registering the trademarks used in the United States.
24 DSub’s agreements with U.S. retailers were last negotiated twenty years ago.
II. TRANSFER OF MARKETING INTANGIBLES

A fully-fledged distributor is responsible for exercising through its officers and employees marketing and selling functions within its territory and customer support. It makes its own purchasing decisions, manages its inventory on its own, and bears all market risks that are not limited by contract or industry practices. Ordinarily, a fully-fledged distributor is converted into a limited-risk one by termination or modification of its distribution agreement, migration of intangibles, and stripping of functions and risks. The anticipated result from the conversion is reduced potential volatility of the distributor’s profits and realization of lower, but more constant and stable level of profits.

25 Bakker, supra note 10, at 410.
26 Id.
27 Id. at 411. A limited-risk distributor differs from a fully-fledged distributor only by having its risks be limited by arrangements with affiliated entities to an extent beyond the normal practices for that distributor’s industry. Id. at 410-11. Compared with manufacturers, distributors tend to have low levels of tangible assets and employees and their risks encompass the lack of price protection with respect to their inventory and accounts receivable. Id. at 412.
28 Id. at 411-12.
Intellectual property often is the driver of tax benefits resulting from business restructurings.\footnote{Id. at 403.} Intangibles are a main source of competitive advantage.\footnote{MONICA BOOS, INTERNATIONAL TRANSFER PRICING: THE VALUATION OF INTANGIBLE ASSETS 33 (The Hague, Kluwer Law International 2003).} Firm-specific intangibles, such as trademarks, brand names, and know-how, are exclusive to the MNE that owns them and give it monopolistic power.\footnote{Id. at 34.} In turn, monopolistic power offers a dominant competitive position, at least temporary, thanks to the intangible’s capability to generate above-normal profits.\footnote{Id. at 21.} The more tacit intangibles are, the more embedded they are in people or organizations, which makes them less susceptible to demarcation and more difficult and more costly to transfer.\footnote{OECD GUIDELINES para. 9.80.} The OECD Guidelines instruct that an essential part of the analysis of a business restructuring is (1) the identification of significant intangibles that may have been transferred, (2) whether unrelated parties would remunerated their transfer, and (3) the arm’s length value of this remuneration.\footnote{Id. at para. 9.89. An illustration addresses the conversion of a fully-fledged distributor into a limited-risk distributor that may have developed local marketing intangibles in the years preceding the restructuring. Id. at para. 9.90.}

Through a conversion to a limited-risk distributor, a fully-fledged distributor may be stripped of intangible assets and profit potential. According to the OECD Guidelines, when a full-fledged operation is converted into a “limited risk, limited intangible, low remuneration,” questions arise whether the conversion (1) entails transfer of local valuable intangible assets and (2) whether these assets remain with restructured entity or get transferred to the foreign affiliate.\footnote{Id. at para. 9.90.} The OECD Guidelines advise that the analysis involves determination whether (1) local marketing intangibles exist at the time of restructuring, (2) their nature, (3) their value, and
(4) whether they are transferred to the foreign affiliate. If local marketing intangibles exist and are transferred to the foreign affiliate, whether the transfer should be compensated and arm’s length compensation should be determined. Additionally, the OECD Guidelines caution that transfers of intangible assets raise difficult questions as to: (1) the identification of the intangible assets and (2) their valuation.

A. Identification of Marketing Intangibles

As they look into implementing the restructuring, DSub and Company A should inquire to identify existing marketing intangibles. Difficulties may arise with identification because not all valuable intangible assets are legally protected and registered or appear in the accounting records. Intangibles are nonphysical assets that represent a source of value resulting from claims of future benefits, but much may be left to interpretation and conjecture to determine whether certain items truly are intangibles.

A universal definition of marketing intangibles does not exist. Generally, marketing intangibles are derived from advertising campaigns and promotion of products and services. The OECD Guidelines provide an illustrative list of intangible assets, which namely includes rights to use trademarks, trade names, designs, customer lists, distribution channels, unique

36 Id. at para. 9.90.
37 Id. If local marketing intangibles exist and remain with restructured entity, they should be considered in the functional analysis of this entity’s post-restructured activities. In that case, they may either influence the choice of transfer pricing method or be remunerated separately via royalties to the restructured entity over the “the life-span” of the intangibles.” Id.
38 Id. at para. 9.80.
39 Id. Intangible assets may be subject to special legal protection, such as assets representing intellectual property, or may be non-legally protected, including contractual rights, customer relationships, know-how, trade secrets, going concern, and goodwill. Trademarks, logos, and service marks are marketing intangibles enjoying legally protection under IP law, especially if registered. See Boos, supra note 30, at 17.
40 See id. at 16, 23.
41 Id. at 22.
names, symbols, or pictures, and know-how. Further, the definition of “intangible property” in the regulations expressly includes trademarks, trade names, or brand names, designs, franchises, licenses, contracts, campaigns, surveys, studies, forecasts, and customer lists, and know-how. The “other similar items” catch-all provision in this definition indicates that the Service has cast a wide net by specifying that a similar item would be deriving its value from its “intellectual content or other intangible properties.” Thus, taxpayers may prudent opt to be over-inclusive rather than underinclusive.

A trademark includes a word, name, symbol, or design, or any combination used, or intended to be used, in commerce to identify and distinguish the goods of a manufacturer or seller and to indicate their source. A brand name exclusively identifies a brand, the source of products of services, and may be registered as a trademark. Brand is the identity of a product, service, or a company, and it can take many forms, including a name, sign, symbol, color, design, or a slogan. Know-how is proprietary information or knowledge that assists or improves a commercial activity, but that is not registered for IP protection. Valuable long-term contracts with independent customers may be valuable intangible assets that carry significant profit potential.

---

42 OECD GUIDELINES para. 9.80, 9.81.
43 Treas. Reg. § 1.482-4(b)(1) (designs and know-how), -4(b)(3) (trademarks, trade names, or brand names), -4(b)(4) (franchises, licenses, and contracts), -4(b)(5) (campaigns, surveys, studies, forecasts, and customer lists).
44 Treas. Reg. § 1.482-4(b)(6) (other similar items).
46 See id.
47 See DAVID AAKER, MANAGING BRAND EQUITY (Free Press 1991).
49 OECD GUIDELINES para. 9, 91 (“Contractual rights can be valuable intangible assets. Where valuable contractual rights are transferred (or surrendered) . . . they should be remunerated at arm’s length.”). See id. at 9.92.
The definition in the regulations elaborates that “intangible property” is an asset that has “substantial value independent of the services of any individual.” However, provision of controlled services may sometimes result in the transfer of intangible property. The arm’s length result for an element of a controlled services transaction that constitutes a transfer of intangible property must be determined separately, under the rules for transfers of intangible property. Reducing knowledge to writing in the form of designs, systems, processes or other written forms may trigger a finding that a transfer of an intangible has occurred. High-value advertising services involving use of know-how arising from marketing research may need to be evaluated separately from the know-how itself. Intellectual property lawyers may discern marketing intangibles for transfer pricing purposes in “the economic value created by all of a company’s non-routine marketing activities or other market related factors.”

B. Ownership of Marketing Intangibles

Once they have identified certain marketing intangibles, DSub and Company A should determine the intangibles’ ownership for transfer pricing purposes. An owner of an intangible has the right to decide whether to transfer the intangible, the terms of the transfer, and the amount of compensation sought.

50 Treas. Reg. § 1.482-4(b).
51 See Treas. Reg. § 1.482-9(m)(2).
52 Treas. Reg. § 1.482-4(b).
53 See Treas. Reg. § 1.482-9(m)(2), -9(m)(5), Ex. 4 (research and development implicating significant know-how).
i. Legal Ownership

The regulations give priority to legal ownership determined under either (1) the intellectual property law of the relevant jurisdiction, (2) contractual terms indicating a holder of rights under a contract, such as a license, or (3) other legal provisions. Unless a cost sharing arrangement is applicable, an intangible asset may have only one legal owner for transfer pricing purposes.

Usually, legal ownership can be straightforward to determine when intangibles, such as trademarks and trade names, are registered and protected under intellectual property law. If DSub’s brands and trade names are registered in the United States, DSub will be able to establish its legal ownership by tracing their registration, any assignments, and licenses recorded at the U.S. Patent and Trademark Office and its litigation history. On the other hand, if Company A has the trademark registered in Switzerland or in any other country, Company A will be deemed the legal owner of its trademark.

As the legal owner, Company A may have licensed, or otherwise transferred, the U.S. rights to its trademark to DSub after the trademark’s registration. Unlike IP law, transfer pricing allows contractual terms and other legal provisions to establish ownership of intangibles. Hence, a licensee holding a bundle of intellectual property rights can be deemed an owner just as much as a registered owner is. For this reason, the parties should examine the license agreement with all subsequent amendments, relevant correspondence, and any sublicenses to establish whether these documents may affect the identity of the trademark’s owner.

56 Id. Intangibles transferred via sale, license, or otherwise may have one “sole owner” unlike intangibles developed under cost sharing arrangements, which allow for co-ownership through non-overlapping, divisional interests. Compare Treas. Reg. § 1.482-4(f)(3)(i)(A) (identification of ownership of intangible property) with Treas. Reg. § 1.482-4T(f)(3)(i)(B) (cost sharing arrangements) and Treas. Reg. § 1.482-7T(b)(1)(iii) (divisional interests).
The legal owner of an intangible is treated as transferring ownership of the intangible if the transferee acquires “all substantial rights” to the intangible. If a license grants the licensee all substantial rights to the licensed intangible, the licensee may be treated as the tax owner of the intangible even when the formal legal title or registered ownership is retained by the licensor. License of a bundle of too many rights may lead to a re-characterization as a transfer of ownership of the very intangible asset. Rights to marketing intangibles may be divided geographically, by field of use, or by time, or may be subject to reservations set by the legal owner. The license of a single stick, even if exclusive, instead of an entire bundle of sticks that make up intellectual property rights, may avoid an ownership characterization. However, the regulations prescribe that a licensee with exclusive rights to exploit an intangible for a limited period of time is considered the intangible’s owner with respect to these exploitation rights.

When cross-border licensing and registration of a trademark are implicated, identification of the legal owner becomes more complicated. For example, in DHL, the Tax Court found DHL to be the owner of the DHL trademark even though its licensee was the registered holder of the mark in various countries outside the United States. DHL was organized under U.S. law and operated a courier service business in the United States. DHL formed Document Handling Limited International (DHLI) as its Hong Kong subsidiary, which conducted a courier service business outside the United States. DHL had registered its trademark in the United States and

---

61 Ossi, supra note 60, at 521.
62 Valoir & Nijhof, supra note 54, at 32.
63 See id. at at 32.
64 Id.
65 Ossi, supra note 60, at 515 (citing Treas. Reg. § 1.482-4(f)(3)(i)).
66 *DHL Corp. & Subsidiaries v. Commissioner*, 76 T.C.M. (CCH) 1122 (1998), aff'd in part, rev'd in part and remanded, 285 F.3d 1210 (9th Cir. 2002) [hereinafter *DHL*].
67 DHLI conducted this courier service business outside the United States together with Middletown, N.V., a Netherlands Antilles corporation.
licensed it to DHLI under agency agreements, which prohibited DHLI from using the DHL trademark for five years after termination of the agreements, but did not obligate it to pay royalties for exploitation of the DHL trademark.

Despite DHL’s legal ownership in the United States, DHLI registered in its own name the DHL trademark in approximately hundred countries in which it operated. Based on the DHL-DHLI agency-license agreements, oral testimony, and an internal memorandum indicating that DHL held the worldwide rights to the trademark, the Tax Court held that DHL owned the worldwide rights to the trademark. The court, however, acknowledged that the DHL trademark was registered in the name of DHLI in nearly 100 foreign countries, which introduced uncertainty as to DHL’s ownership of the trademark outside the United States.

ii. Economic Ownership

However, neither DSub nor Company A may have registered the trademark, or they may have identified intangible assets that are not subject to registration or legal protection under IP law. The analysis becomes more complex if the promotional efforts of a trademark licensee or a distributor of trademarked products, such as DSub, significantly enhance the value of a trademark that is legally owned by another. Assets that represent intellectual property must be maintained and enforced or their value is lost.68 In most jurisdictions, including the United States, only the property owner, the holder of its legal title, is entitled to bring an enforcement

---

68 Valoir & Nijhof, supra note 54, at 32.
action. Intellectual property counsel recognize that the value of a mark would quickly deteriorate if not maintained through spending on advertising, sales, and related services.

If no license agreement is in place, DSub and Company A could turn to the existing distribution agreement to discern any provisions addressing ownership of intangible property for transfer pricing purposes. The distribution agreement may address only the very distribution arrangement and not foresee of intangibles, such as to development of distribution channels or a distribution network, customer lists, and contracts with retailers. In all likelihood, DSub’s distribution agreement would not contain the latter level of sophistication of contractual terms if the distribution arrangement was established well over four decades ago when the concept of marketing intangibles was still gaining popularity.

Under certain circumstances, the party incurring market development costs is properly considered the “economic owner” of the resulting market intangible. In addition to legal ownership, the regulations discern economic ownership, a remnant of the 1968 regulations’ developer-assister rules. As applied to trademark promotion activities, the developer-assister rule intended to address the problem of a U.S. distributor not being compensated adequately for such activities by a foreign affiliate that is the legal trademark owner. Effectively, the 1968 regulations determined the owner of a newly developed intangible under the developer-assister rule without necessarily giving due regard to legal ownership. The original developer-assister rule in the 1968 regulations provided that only one member of an MNE group could be identified as the owner.

---

69 Id. at 32. Accordingly, an exclusive licensee may join the owner’s suit, but a non-exclusive licensee may not. Under U.S. intellectual property law, the exclusivity needed to establish standing for enforcement of intellectual property rights is the legal right to control one or more of the sticks in the intellectual property bundle.

70 Id. at 33.


72 Ossi, supra note 60, at 513. The 1968 regulations would deem the legal owner to have acquired its ownership by a transfer from the “developer” of an intangible asset. Id.
as a developer, the one that "undertakes the development of intangible property." Parties that contributed to the development effort were considered "assisters" entitled only to appropriate compensation for the value of their assistance. Whether a party was deemed the developer or an assister was to be determined primarily based on the relative costs undertaken and corresponding risks of development.

Under the latest regulations, a U.S. distributor does not obtain ownership rights in a trademark by reason of its market development activities when it incurs unreimbursed expenses for promoting the trademark owned by its foreign parent. The final 1994 regulations retreated from the approach of the 1992 and 1993 regulations to recognize the legal owner of a legally protected intangible as the owner for transfer pricing purposes. According to the 1994 regulations, parties that participate in the development of the intangible are providing "assistance" to the owner and should be compensated for the value of their assistance, but are not considered to share ownership of the intangible. The developer-assister rule continues to apply only in the case of non-legally protected intangibles. Still, a U.S. taxpayer may elect to apply

---

73 Id. (citing Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1968)). See T.D. 6952, 1968-1 C.B. 218. Commentators believe that the scope of the 1968 regulation’s the developer-assister rule includes the creation of a new product, process, or other intangible property through research and development. Hence, trademark promotion activities of a licensee or distributor do not come within this scope because they involve the exploitation of a preexisting intangible. See id. at 513-14.

74 Id. at 513.

75 Id. Other relevant factors were the capabilities of the various members of the group to perform the development activities and the degree of control over the project exercised by the various members. Id. (citing Treas. Reg. § 1.482-2(d)(1)(ii)(c) (1968)).

76 Id. at 515 (citing Treas. Reg. § 1.482-4(f)(3)(iv), Ex. 2 and Ex. 3).

77 See id. (citing T.D. 8552, 1994-2 C.B. 93). The proposed 1992 regulations elaborated on the developer-assister rule of the 1968 regulations and illustrated with examples the application of this rule to “the development and enhancement of marketing intangibles.” Id. at at 514 (citing Notice of Proposed Rulemaking, 1992-1 C.B. at 1167). One of the “cheese” examples indicated that a U.S. distributor that “enhanced U.S. rights to the trade name” is considered the developer of a trade name whose legal owner is the foreign parent. Id. (citing Prop. Treas. Reg. § 1.482-2(d)(8)(iv), Ex. 4 (1992); Temp. Treas. Reg. § 1.482-4T(e)(3)(iv), Ex. 4 (1993)). The example reasoned that promoting a trademarked product represents “undertaking the development of intangible property,” and that the “enhanced” value of the trademark can be owned separately from the trademark itself. Id.

78 Id. at 515 (citing T.D. 8552, 1994-2 C.B. at 108).

79 Id. at 514 (citing Treas. Reg. § 1.482-4(f)(3)(ii)(B)).
retroactively the 1994 regulations to any open tax year. The election will also be effective for all subsequent tax years.

In *DHL*, the 1968 regulations applied, and the Tax Court held that the licensee should not be treated as the DHL trademark’s owner because the licensor had legal rights under IP law. DHL asserted that under the 1968 regulations DHLI was the legal owner of the rights to the DHL trademark exercised outside the United States because it incurred associated advertising and marketing costs and costs for the registration and protection of the trademark outside the United States. Relying on the contractual terms between the parties, the Tax Court found that DHL was the developer and it owned the enforceable worldwide rights to the trademark. The court determined that DHLI acted as a licensee when it incurred costs for the trademark’s promotion, registration, and protection in the exploitation, rather than for the development, of trademark.

Normally, the Service will respect the parties’ contractual terms, under a license or any other agreement, if they are consistent with the underlying substance of a transaction. If the contractual terms are inconsistent with the economic substance or if no written contracts exist, the Service will impute its own terms. If the form of the transaction comports to its substance and the transaction is undertaken with a business purpose, a controlled taxpayer may structure the transaction as it chooses even if the chosen form produces less taxable revenue than other forms. To evaluate the economic substance of an arrangement, the Service will look at the

---

80 Treas. Reg. § 1.482-1(j)(2).
81 *Id.*
82 *DHL*, supra note 66.
83 Ossi, *supra* note 60, at 517.
84 *Id.* at 517-18.
87 See *Bauch & Lomb, Inc. v. Commissioner*, 933 F.2d 1084, aff’d, 92 T.C. 525 (1989). Economic substance is presumed to be lacking if risk is allocated once the outcome of the allocation is already known or reasonably knowable. Treas. Reg. § 1.482-1(d)(3)(iii)(B).
parties’ actual conduct and their legal rights and obligations, as established by the contractual terms and local contract and property law.  

In pre-1994 cases, the Tax Court has been reluctant to disregard contractual arrangements to impute arrangements based on the Service’s perceptions of a transaction’s economic substance. In *Eli Lilly & Co.*, the Tax Court and the Seventh Circuit held that a foreign subsidiary’s legal ownership through assignment should be respected although the U.S. parent had incurred and deducted costs of developing the intangibles. Decisive were documenting indicating formal assignment by the U.S. parent, the subsidiary’s conduct of exclusive use, and its efforts to protect the intangibles from infringement, all of which the Tax Court found to be convincing evidence of ownership in both substance and form. In *Ciba-Geigy Co.*, the Tax Court refused to impute under the 1968 regulations a royalty-free joint development arrangement between a U.S. subsidiary and its foreign parent in the face of a license agreement without persuasive evidence of the parties’ express or implied intent to enter such agreement.

In a 1996 case, the Tax Court extended its ownership inquiry beyond the contractual terms to glean into the economic substance of the arrangement. In *Medieval Attractions, N.V.*, the Tax Court applied the 1994 regulations to identify the owner of marketing intangibles associated with the operation of a dinner theater. The U.S. taxpayer had used an underlying trademark for years before its foreign affiliate registered the trademark and the parties concluded a license agreement. The Tax Court determined that before the registration of the trademark, the developer-assister rule of the 1994 regulations governed ownership of the marketing intangibles.

---

89 Ossi, supra note 60, at 516 (citing *Ely Lilly & Co. v. Commissioner*, 84 T.C. 101, 1109 1116-17, 1125-26, aff’d in part, rev’d in part, and remanded, 856 F.2d 855 (7th Cir. 1988)).
90 Id. at 516.
91 Id. at 516 (citing *Ciba-Geigy Co. v. Commissioner*, 85 T.C. 172 (1985)).
92 Id. at 517 (citing *Medieval Attractions, N.V. v. Commissioner*, 72 T.C.M. 924).
The court found that the developer of the intangibles was the U.S. taxpayer because it had paid for the designs and marketing plans and had already used the trade name later registered as the trademark. Furthermore, the Tax Court engaged in analysis of the “substance of the relationship” to find that because its foreign affiliate had no legal recourse before the trademark registration, the U.S. taxpayer was free to use the nonproprietary idea payment of royalties.\textsuperscript{93} In effect, the court concluded that use of intangibles was compensable only if a party other than the developer-user legally owns the rights to the intangible.

The 1994 regulations contain an example, in which the Service imputes contractual terms based on economic substance of a transaction and allocates to a U.S. distributor a portion of the intangible income attributable to a trademark legally owned by the distributor’s foreign parent.\textsuperscript{94} The example rationalizes the allocation on the basis that the distributor had unreimbursed expenses promoting the trademark that were substantially above the level of such expenses incurred by comparable distributors.\textsuperscript{95} With an analogous outcome, in *DHL*, the Tax Court held that only non-routine promotional expenses could create ownership of a marketing intangible.\textsuperscript{96} In *DHL*, the Service sought to impute a royalty for DHLI’s royalty-free use of the DHL trademark. The taxpayer argued that no royalty should be imputed because the foreign affiliates undertook the economic costs of developing the DHL trademark.\textsuperscript{97} Without addressing the marketing intangibles associated with the DHL trademark, the Tax Court held that the party, which bore the economic burdens of investment in intangible property, should bear the related

\textsuperscript{93} Id. (citing *Medieval Attractions, N.V. v. Commissioner*, 72 T.C.M. 924).
\textsuperscript{94} Treas. Reg. § 1.482-1(d)(3)(ii)(C) Ex. 3.
\textsuperscript{95} Id.
\textsuperscript{96} *DHL*, supra note 66.
economic rewards.98 Although the opinion did not analyze the nitty-gritty of the underlying accounting records, it sought to match income from the intangible with related expenses.99 The Tax Court imposed a bright-line test asserting that economic ownership, in the form of a marketing intangible, arises only when expenses incurred by a licensee or a distributor go beyond the routine expenses a party exploiting such intangible is typically expected to incur.100 DHL failed to show that DHLI’s expenses were excessive and non-routine or affected the value of the non-U.S. rights to the trademark.101 Ultimately, DHL, the U.S. legal owner of the trademark was held taxable on the entire fair market of the trademark upon its sale although the licensee had incurred substantial expenses in promoting the trademark.102

This bright-line test relevant to incremental marketing activities, however, does not infuse much clarity because of an inherently improbable chance for reliably identifying comparable intangibles.103 Marketing expenses can be not only industry-specific, but also very company-specific because similar companies in one industry may vary in their product mixes, marketing strategies, and timing of implementation of these strategies with respect to change in market conditions.104 Moreover, companies may define, classify, and code for accounting purposes different types of advertising, marketing, and promotional expenses differently, which would render the underlying data less reliable and with low potential for reliable adjustments.105

The economics of establishing a market for modern breakthrough drugs indicate that early market entry comes with advantages, such as perceived product superiority impacts a drug’s success, and that pharmaceutical companies can employ optimal mixes of various prices

---

98 A Closer Focus, supra note 96. See DHL, supra note 66.
99 See DHL, supra note 66.
100 A Closer Focus, supra note 96.
101 Ossi, supra note 60, at 518.
102 Id. at 523.
103 A Closer Focus, supra note 96.
104 See Treas. Reg. § 1.482-1(c)(2)(i) (degree of comparability). See also A Closer Focus, supra note 96.
105 See Treas. Reg. § 1.482-1(c)(2)(ii) (quality of data and assumptions).
and marketing policies to enhance sales and profitability.\textsuperscript{106} Detailed tactical decisions involve pricing, conclusion of distribution contracts, and development of promotional campaigns.\textsuperscript{107} Once the product has been launched, the tactical decisions may be adjusted to accommodate changes in the market.\textsuperscript{108}

In a fairly recent case of marketing intangibles, \textit{GlaxoSmithKline (Americas), Inc.}, the Service claimed that Glaxo US was the economic owner of the U.S. marketing intangibles as a result of investing in the implementation of a marketing strategy developed by the CEO based in the United Kingdom.\textsuperscript{109} Glaxo US had been formed pursuant to a Glaxo UK strategy, conceived and directed by CEO of the Glaxo Group to establish a substantial presence in the U.S. market using Glaxo Heritage Products.\textsuperscript{110} As a result of implementing this U.S. marketing strategy while the Glaxo CEO was in charge, the annual sales, sales workforce, total assets, and net worth of Glaxo US increased exponentially and Glaxo US ranked as the second largest pharmaceutical company in this United States.\textsuperscript{111} Glaxo US admitted that the Glaxo Heritage Products were a


\textsuperscript{107} See NetMBA, \textit{The Marketing Process}, available at http://www.netmba.com/marketing/process/ (last accessed Apr. 30, 2011). The marketing process involves situational analysis and strategy formulation of a value proposition followed by tactical-decision-making, implementation of the marketing plan, and monitoring of the results. Market research provides specific market information that allows a company to optimally position its product within a group of consumers selected by the company as its target market.

\textsuperscript{108} See \textit{id.}


\textsuperscript{110} Brief of Glaxo US, \textit{supra} note 109, at 2, 7; Richard C. Stark, Hartman E. Blanchard, Jr. & Saul Mezei, \textit{Consistency, Sunshine, Privacy, Secret Law, and the APA Program}, TAX NOTES 655, 673 (Feb. 7, 2011) (Two of the three co-authors of this article represented the taxpayer in the Glaxo case.).

\textsuperscript{111} Brief of Glaxo US, \textit{supra} note 109, at 7. When he became Chief Executive of Glaxo, Glaxo U.S. ranked 65th in the U.S. market by sales, had fewer than 300 employees selling mostly vitamins and minor products, had annual sales of approximately $13 million, and had a balance sheet net worth of $30.5 million. By 1994, fourteen years later, when he retired, Glaxo U.S. was the second largest pharmaceutical company in the United States by sales, had 6,500 employees selling Glaxo Heritage Products, had annual sales of approximately $3.7 billion, and had total
principal source of its profits during the period under IRS examination.\textsuperscript{112} The Glaxo Group designed the worldwide marketing platform for these products, and first launched them outside the United States before bringing them to the U.S. market. Glaxo US applied the central marketing platforms and strategies established by Glaxo UK, introduced Glaxo Heritage Products in the United States, and conducted selling activities through a sales force to detail the products to physicians. The Glaxo Group insisted that it owned the trademarks and trade names for these pharmaceutical products. It directly reimbursed some of the U.S. FDA approvals and substantial part of the U.S. development, marketing, and launch expenses in the early years of the U.S. marketing strategy.

The Service contended that Glaxo US should be rewarded economically for its respective investment in market development through a share of operating income proportionate to its investment. According to Glaxo US’s legal brief, even if valuable marketing intangibles contributed to the U.S. sales of Glaxo Heritage Products, the Glaxo Group was their developer and owner. Glaxo US asserted that even if it assisted in the development of any marketing intangibles in the United States, its gross margins more than adequately compensated this assistance. Six years after Glaxo US entered the U.S. market, Glaxo US entered into a distribution-license arrangement covering U.S. sales of Glaxo Heritage Products.

\textsuperscript{112} Out of the Glaxo Heritage Products, eight Principal Products accounted for 96 percent of the Service’s adjustment. Most of the products subject to the Service’s adjustment were developed at Glaxo UK’s research facilities. The Glaxo Group discovered them through research, patented them, conducted pre-clinical development, led the design of clinical trials, and invented the technology for manufacturing of the active ingredient. Glaxo UK provided substantial scientific information and data to support approval in the U.S. market by the U.S. Food and Drug Administration. In the taxpayer’s own words, these products represented either a “new class of drugs” or “commercially significant improvements on an existing drug therapy.” Id. at 7, 8, 9.
Astoundingly, the Glaxo Group had determined that Glaxo US, the distributor, would be earning excessive levels of the system profit at the expense of Glaxo UK, the inventor. Both product prices and royalty rates were adjusted “to achieve appropriate gross margins” for Glaxo US in the next two years before this license arrangement was terminated. In effect, the royalties under this license agreement stripped these excess profits of Glaxo US. Once the license was terminated, amounts equivalent to the royalties charged were added to product prices, and the gross profit rates remained similar to their license pre-termination levels. The Service chose the patent owner, Glaxo UK, as the tested party and tested its returns rather than the returns of the distributor, Glaxo US, and required Glaxo US to retain most of the profit as a return for its promotional activities. Ultimately, the case was settled for $3.4 billion, the largest single payment made to the IRS to resolve a tax dispute.

If no owner can be identified under either intellectual property law or contractual terms, including terms imputed by the Service, the taxpayer who has control of the intangible property will be considered its sole owner. The regulations provide an example illustrating the control standard as applied to ownership of a customer list. In this example, a U.S. distributor develops a customer list of several hundred creditworthy customers through its sales and marketing activities while operating as an exclusive licensee of U.S. rights to market products under a trademark. Because the licensee has knowledge of the content of the customer list and has practical control over its use and dissemination, the licensee is considered the sole owner of

---

113 Id. at 10.
117 Treas. Reg. § 1.482-4(f)(3)(i)(B)(ii), Ex. 2 (customer list resulting from sales and marketing activities). The foreign parent is the registered owner of the trademark.
the customer list. The same result would likely obtain if DSub identifies among its existing marketing intangibles its distribution channels, valuable contracts with retailers, and potentially know-how about the U.S. market. DSub will be deemed their owner as the one with knowledge of the content of these intangibles and practical control over their use and dissemination, and so DSub will be due arm’s length compensation for their outbound transfer.

C. Arm’s Length Compensation for Marketing Intangibles

DSub claims that the de-risking of its functions and any transfers of intangible property were remunerated at arm’s length. An outbound transfer of intangible property by a U.S. entity, however, is a taxable event generally resulting in an exit cost, so the transferor may prefer to minimize the value of the intangible to minimize the associated tax burden.\textsuperscript{118}

i. Measuring Arm’s Length Compensation

Contribution of intangibles by a U.S. corporation to a foreign corporation generally involves recognition of capital gain income treated as a contingent royalty, which is subject to the commensurate-with-income standard.\textsuperscript{119} The commensurate-with-income standard applies to any transfer of intangible, including sales and licenses and has been construed to apply to transactions involving provision of services that include transfer of embedded intangibles.\textsuperscript{120} The arm’s length consideration for a transfer of intangible must be commensurate with the income attributable to the intangible and is subject to periodic adjustments.\textsuperscript{121}

\textsuperscript{118} See I.R.C. § 367(d); Treas. Reg. § 1.367(d)-1T.
\textsuperscript{119} See I.R.C. § 367(d); Treas. Reg. § 1.367(d)-1T.
\textsuperscript{120} Treas. Reg. § 1.482-4(a), -9(m)(2).
\textsuperscript{121} Treas. Reg. § 1.482-4(a).
The OECD Guidelines express concern that “[v]aluation of intangibles can be complex and uncertain.”122 Yet transfers of intangible assets are compensable, and intangible assets have determinable values and are transferable at the right price that a seller would be willing to accept, even a company’s crown jewels.123 Marketing researchers have concluded that brands are some of the most valuable assets a company may own, and brand equity studies continue to gain popularity.124 Brand equity is the commercial value that derives from positive consumer perception of a well-recognized brand name.125 As consumers develop positive associations of a brand, brand equity is built and brand value increases.126 The stronger a brand, the clearer position it occupies in consumers’ minds, and the more value it has.127 Well-executed brand-building strategies can deliver clear and measurable competitive advantages to companies.128 Most of all, brand value can be measured, monitored, and enhanced to strengthen a brand’s effectiveness.129 In transferring the brands and trade names, DSub should beware of significantly underestimating their values.

In the United States, the selection and application of a transfer pricing method derives from a comparability analysis that accounts for all of the functions, assets, and risks borne by a

---

122 OECD GUIDELINES para. 9.81. For further guidance on intangibles and cost contribution arrangements (i.e., cost sharing arrangements), the OECD Guidelines direct to Chapters VI (Special Considerations for Intangible Property) and VIII (Cost Contribution Arrangements) of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

123 David D. Stewart, Officials Dissect OECD Transfer Pricing Guideline Revisions, 60 TAX NOTES INT’L 146 (Oct. 18, 2010) (According to David Ernick, Associate International Tax Counsel at Department of Treasury, “there are no situations where you have a crown jewel that someone wouldn’t agree to transfer.”).


A significant comparability factor applicable to intangible property is profit potential. Unique intangibles pose valuation problems because only an intangible asset with similar profit potential is truly comparable to the intangible asset at hand. In an example of transfer of valuable intangibles, the OECD Guidelines acknowledge that reliable evidence from comparable uncontrolled transactions of ownership of brand names and associated risks may not necessarily exist.

Congress intended for the commensurate-with-income standard to ensure that taxpayers calculate properly the profit potential of intangibles whose rights they transfer. According to the regulations, that the most reliable way to measure an intangible’s profit potential is through calculating the net present value of the benefits to be realized from the intangible, either as anticipated profits to be realized or costs to be saved. The calculation must also take into account the required capital investment. The profit potential calculation will include costs to be saved by the transferee, IPCo, by way of having these costs already previously incurred by DSub. Therefore, the unreimbursed capital investment that DSub had incurred in the form of marketing expenses toward building brand equity and promotion of the trademarks will factor in the profit potential calculation with respect to the trade names and brands.

130 Treas. Reg. § 1.482-1(c) (best method rule).
132 Id.
133 See OECD GUIDELINES para. 9.191.
134 Treas. Reg. § 1.482-4(a) (A transfer of intangible property shall be “commensurate with income attributable” to the intangible.)
136 Id.
137 See id.
ii. Compensation for Development of Marketing Intangibles

The distribution or license agreement between Company A and DSub might have included provisions that require DSub to promote the brands and trademarked products through its own marketing and advertising efforts. Such provisions may be quite broad and contain only general language merely stating, “DSub should market and advertise the trademarked products.” On the other hand, they may be more extensive to specify a required level of marketing efforts and responsibilities as to new retail client development and continuous client service. These clauses may state predetermined levels or tiers of spending on promotion and advertising, allocation of ownership of the intangible benefits arising from DSub’s services, benchmarks and metrics to assess these benefits, a reimbursement configuration, and attribution of rights to the associated revenue. The content of these provisions would have an impact on determining the arm’s length consideration for DSub’s contribution toward the value of Company A’s trademark that DSub had been using.

The arm’s length consideration for a contribution by a taxpayer that develops or enhances, or may be reasonably anticipated to develop or enhance, the value of intangible property owned by another is determined broadly under the regulations.138 License agreements may account for market penetration expenses to compensate the distributor or licensee through royalty adjustments.139 Typically, if a purchaser receives the right to exploit an "embedded" intangible, such as a trademark, in ways other than through reselling the tangible property, the arm’s length consideration for the embedded intangible may need to be determined separately from the tangible property.140 Yet a royalty consideration for the distributor’s specified levels of marketing activities required by contract with no separate compensation and the distributor’s

139 Ossi, supra note 60, at 524.
140 Treas. Reg. § 1.482-4(b).
exclusive right to re-sell tradmarked products may be embedded in the transfer price paid by the distributor.\textsuperscript{141}

The consideration for marketing activities may be embedded in a royalty based on sales of tradmarked merchandise within contractual terms of a license for exclusive rights to use a trademark.\textsuperscript{142} The royalty is lower in the early years of the license in recognition of the licensee’s high marketing expenses relative to its sales revenue.\textsuperscript{143} Such arrangement minimizes the risk to the distributor or licensee by shifting the economic burden of marketing to the trademark owner.\textsuperscript{144} If the consideration is embedded within contractual terms, no separate allocation is made, but the contribution is evaluated for comparability purposes.\textsuperscript{145}

Further, a distributor or licensee may be compensated by grant of long-term exclusive license and an opportunity to exploit increased customer demand in later years.\textsuperscript{146} The distributor or licensee is expected to undertake market development to its own benefit, to enhance the value of its exploitation rights.\textsuperscript{147} A distributor may undertake incremental marketing activities above and beyond those required by the terms of the license, without separate agreement.\textsuperscript{148} The specified term of the license agreement may be sufficiently long that distributor may reasonably anticipate a benefit from these early incremental marketing activities through increased sales or revenue from the tradmarked products.\textsuperscript{149} No adjustment would be warranted for this incremental marketing if the distributor may reasonably anticipate that these activities would increase the value only of its intangible property, its rights under the license, and

\begin{itemize}
\item \textsuperscript{141} Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 2.
\item \textsuperscript{142} Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 3.
\item \textsuperscript{143} Ossi, supra note 60, at 524.
\item \textsuperscript{144} Ossi, supra note 60, at 524.
\item \textsuperscript{145} Treas. Reg. § 1.482-4(f)(4)(i). See Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 2 and Ex. 3.
\item \textsuperscript{146} Ossi, supra note 60, at 524.
\item \textsuperscript{147} Id.
\item \textsuperscript{148} Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 4.
\item \textsuperscript{149} Id.
\end{itemize}
not the value of the trademark owned by its foreign parent. On the other hand, a separate service agreement may compensate the distributor and obligate it to perform incremental marketing activities above and beyond those required by the terms of the license.

These fact-intensive examples leave factual questions unresolved, especially for technologically dependent tangible products in marketing-intensive industries. Brand equity exists, and has measurable value associated with changes in a business’s levels of sales. The omnipresent inquiry revolves around distinguishing and measuring the impact of a distributor’s services, including marketing, advertising, and customer retention, when “embedded intangibles” are involved. Moreover, problematic is isolating the U.S. distributor’s contribution to its own profitability, as measured by increased sales or increased value of marketing intangibles, from its contribution to the MNE’s worldwide profitability.

iii. Valuation of a Bundle of Marketing Intangibles

A transfer may involve the transfer a bundle of assets if it provides a reliable measure of the arm’s length result. DSub and Company A should anticipate that by transferring the trademarks and the brand to IPCo and assuming only limited-risk distribution functions, it may also be conveying in an outbound transfer its contracts with the retailers and know-how about the local market and distribution channels. The regulations state that the combined effect of two or more separate transactions may be considered if the transfers are so interrelated that aggregating them is the most reliable means of determining the arm’s length consideration. However,

---

150 Reg. § 1.482-4(f)(4)(ii), Ex. 4.
151 Treas. Reg. § 1.482-4(f)(4)(ii), Ex. 5.
valuation of marketing intangibles is left to the leniency of the Service and the courts when a taxpayer aggregates several assets into a single transfer and does not produce persuasive valuations of individual assets. This is one of the messages of the *DHL* case, which involved stripping a trademark and selling the rights to it to a foreign affiliate.\(^{154}\) The Tax Court upheld the Service’s transfer pricing adjustments of income and capital gain in the *DHL* case.\(^{155}\)

Although during earlier negotiations they had agreed to a value of $50 million, DHL’s shareholders established a price of $20 million for the DHL trademark.\(^{156}\) The Service asserted an allocation of additional capital gain income to DHL because its valuation of the DHL trademark led to an arm’s length sale price of $300 million in place of the $20 million accepted by DHL and its valuation consultants. The Service used the same valuation method in its pre-trial and trial valuation, but the use of subjective assumptions influencing the method led to considerably different results and a $300 million difference between them.\(^{157}\) DHL argued that $20 million was an appropriate arm’s length compensation because the sale involved solely the U.S. rights to the trademark, and not the worldwide ones, and that the $50 million proposal from the negotiations established a ceiling on the trademark’s value. Reasoning that the parties wanted


\(^{155}\) *DHL*, supra note 66.

\(^{156}\) DHL granted DHLI an option to purchase the DHL trademark when three foreign investors acquired 12.5 percent of DHLI’s and Middlestown’s stock. DHLI exercised its option to purchase the DHL trademark once the foreign investors had exercised their option to purchase additional 45-percent interest in DHLI. Once the $20 million price was determined, the sellers hired a consulting firm to appraise the value of the trademark, and the firm provided a comfort letter supporting a value of $20 million.

\(^{157}\) See Marc M. Levey, *Tax Court Sends Messages to Taxpayers in DHL*, in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* 2006, at 281 (PLI Tax Strategies, Course Handbook Series No. 82, 2006). DHL argued that at trial the Service’s experts presented $300 million, an amount substantially lower than the Service’s $600-million position in the Notice of Deficiency. The Service argued that the experts used the same “relief-of-royalty” method during the examination and at trial, and the $300 million difference resulted from DHL’s failure to provide adequate information. In fact, the difference resulted from use of differing long-term growth rate, market discount rate, implied royalty rate, and tax rate.
May 2011

...to protect their interests and close the deal soon, the court recognized that they used “a certain amount of subjectivity in setting prices and arranging terms.”\(^{158}\)

The Service had calculated a $300 million value for certain “off balance sheet assets” of DHLI that the Tax Court accepted.\(^ {159}\) The Service sought to allocate the entire $300 million amount to the trademark as the sole intangible asset purchased while DHL insisted that a portion of the purchase price was attributable to the DHL network, a going-concern-value intangible in addition to the trademark, that provided an intangible benefit from DHL’s existing infrastructure and operating know-how that created a “barrier to entry” of others into the same marketplace. The Tax Court accepted the latter argument and valued the intangibles by allocating to them a residual value by subtracting the value of the tangible assets from the overall sales price.\(^ {160}\) Then, the court set on to untangling the trademark from the aggregate of intangible assets. Taking into consideration its significant value, the judge allocated half the value of the purchased intangible assets to the DHL network. The other half, $150 million, the judge allocated to the worldwide value of the DHL trademark to encompass the value of customer relationships and goodwill built by DHL and DHLI over their history. The Tax Court went further to divide the DHL trademark value between U.S. and worldwide rights, finding that two-thirds of the value should be attributed to the worldwide rights based on DHL’s and DHLI’s relative profits.

Transfer of a bundle of intangibles, including marketing ones, may lead to assigning subjective values to individual intangible assets. This case is instructive because it shows that by failing develop solid arguments for the valuation of the transferred assets, DHL opened the door...

\(^{158}\) The court did not find the consultants’ valuation persuasive because it was produced after the deal had closed.  
\(^{159}\) The foreign investors acquired 57.5 percent interest of Middlestown-DHLI’s value at a price of $287.5 million. Because a 57.5 percent of the purchased intangibles amounted to $171.5 million, the Service found that the total value of the Middlestown-DHLI intangibles was $300 million. 
\(^{160}\) To determine the total intangible value included in the sale, the Tax Court subtracted the $200 million value of the tangible assets from the $500 million sales price. *DHL*, supra note 65.
for the Service and the court to construct and allocate values as they see fit. DHL had a single valuation of $20 million for the sales price allocated to the DHL trademark and offered no alternate one at trial to guide the court.

III. RESPECTING THE RESTRUCTURING TRANSACTIONS

The OECD Guidelines specifically address the treatment of transfers of intangible assets that were previously owned and managed by a local operation to a central location situated in another tax jurisdiction.\textsuperscript{161} The perspectives of both the transferor and transferee must be considered to determine that the conditions of a transfer of an intangible asset and its value are arm’s length.\textsuperscript{162} For example, that a transfer is motivated by sound commercial reasons to centralize holding of intangible assets does not mean that the transfer is arm’s length the perspectives of both the transferor and transferee.\textsuperscript{163}

A. Identifying Reallocation in Profit Potential

Corporate profits are subject to tax when they take the form of taxable income. Profit potential is encompasses “expected future profits” that may or may not translate into taxable income.\textsuperscript{164} However, neither profit potential nor business opportunities are compensable on their own terms.\textsuperscript{165} Both profit potential and a business opportunity must be associated with

\textsuperscript{161} OECD GUIDELINES para. 9.82.
\textsuperscript{162} Id. at para. 9.81, 9.85.
\textsuperscript{163} Id. at para. 9.84.
\textsuperscript{164} See id. at. 9.65.
\textsuperscript{165} Id. See Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983) (holding that transfer of a business opportunity is not individually compensable). See also David D. Stewart, Excess Returns Proposal in Line with OECD Guidelines, Country Digest: United States, 60 TAX NOTES INT’L 346 (Nov. 1, 2010) (statement of David Ernick, Associate International Tax Counsel at Department of Treasury).
identifiable rights and assets to be compensable. According to the OECD Guidelines, when identifying a reallocation of profit potential, the threshold inquiry is whether a transfer of something of value, such as rights or other assets, or a termination or substantial renegotiation of existing arrangements has occurred.

A tax administration examining a transaction will certainly add another layer by inquiring whether any change in profit potential that has occurred as a result of the restructuring would have been compensated under similar circumstances between uncontrolled parties. For example, if DSub voluntarily terminates its contracts with retailers where the retailers become legally or commercially obligated to enter into similar arrangements with IPCo, the contractual rights and attached profit potential that used to lie with DSub will lie with IPCo. Such “tripartite transaction” may amount to a transfer of valuable contractual rights from DSub to IPCo that may have to be remunerated at arm’s length, depending on the value of the rights surrendered by DSub.

In the United States, the arm’s length consideration for transfer of a marketing intangible must be commensurate with the income attributable to the intangible and so must reflect the current value of the intangible’s profit potential. The OECD Guidelines call for tax authorities to recognize the restructuring transactions if the compensation for the restructuring itself and the post-restructuring activities produce arm’s length result. Nevertheless, taxpayers must affirmatively prove their case in this context of business restructurings. The OECD Guidelines underscore that the parties’ actual conduct would be fundamentally consistent with the form of

---

166 See Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983); BAKKER, supra note 10, at 416.
167 OECD GUIDELINES para. 9.65. See Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983) (holding that transfer of a business opportunity is not individually compensable).
168 See OECD GUIDELINES para. 9.65.
169 See id. at 9.92.
170 See id.
171 See Treas. Reg. § 1.482-4(a).
172 See OECD GUIDELINES para. 9.188.
the restructuring and the economic substance of the arrangement would not differ from its form.\footnote{See id.}

\section*{B. Risk Allocation and Economic Substance}

The U.S. regulations discuss in detail the treatment of risk and allocation of risk as intended to apply to test the arm’s length character of transactions between commonly controlled parties.\footnote{Treas. Reg. § 1.482-1(d)(3)(iii)(B).} The Service will generally respect the allocation of risk expressed or imputed by the contractual terms if the allocation is consistent with the economic substance of the transaction.\footnote{Id.} Determining economic substances includes analysis: (1) whether a business restructuring has changed the allocation of risk between parties and (2) whether post-restructuring transactions are consistent with the arm’s length standard.\footnote{BAKKER, supra note 10, at 405-06.}

A distributor may be taking on market risk of fluctuations in demand, risk of success or failure of its capital-intensive activities, and general business risks related to its ownership of tangible and intangible property.\footnote{See Treas. Reg. § 1.482-1(d)(3)(iii)(A)(1), (2), (6).} Risk is a state of uncertainty where the outcome may involve possible losses.\footnote{DOUGLAS HUBBARD, HOW TO MEASURE ANYTHING: FINDING THE VALUE OF INTANGIBLES IN BUSINESS 46 (John Wiley & Sons 2007).} An entity that undertakes more risk will have a greater expectation of profit and will seek greater compensation for taking on greater risks.

Consistent with the U.S. regulations, the OECD guidelines caution that an entity does not have a real capability to assume risks if it has no financial capacity to assume these risks.\footnote{See OECD Guidelines para. 9.191.} To bear allocated risks, a controlled taxpayer must have a financial capacity to fund losses resulting

\begin{flushleft}
\footnotesize
173 See id.
\footnotesize
\footnotesize
175 Id.
\footnotesize
176 BAKKER, supra note 10, at 405-06.
\footnotesize
\footnotesize
178 DOUGLAS HUBBARD, HOW TO MEASURE ANYTHING: FINDING THE VALUE OF INTANGIBLES IN BUSINESS 46 (John Wiley & Sons 2007).
\footnotesize
179 See OECD Guidelines para. 9.191.
\end{flushleft}
from the risk allocation. Marketing intangibles are created only when an entity’s marketing and promotional efforts turn out successful. If these efforts fail, the entity incurs only loss of financial and other resources, but no marketing intangibles may be created or enhanced. IPCo should be well funded to undertake the risks of marketing strategy development and maintenance of its newly acquired marketing intangibles. Furthermore, if DSub continues to participate with implementation of Company A’s marketing strategy in the United States, it should be properly reimbursed for all marketing-related expenses.

Parties involved in arm’s length dealings tend to bear greater share of risks over which they have more control. The Service will examine the extent of a controlled taxpayer’s control over the business activities that directly influence the magnitude of income or losses realized. The contractual arrangement upon restructuring should not allocate the risks of brand name ownership to an entity that does not have capacity to exercise control over the brands. If it does, the economic substance of the arrangement will differ from its form. To undertake marketing and brand development, IPCo must have employees and directors, who have the authority and effectively perform control functions with respect to risks associated with strategic development of brand names.

The Service will evaluate the results of a transaction as structured by DSub unless the structure of the transaction lacks economic substance. The OECD Guidelines also underscore the need to examine the parties’ actions and not only their formal agreement. Having allocated risk at arm’s length, a controlled taxpayer must maintain a pattern of conduct that is

---

182 Id.
183 See OECD Guidelines para. 9.192.
184 See id. at para. 9.192.
185 See id. at para. 9.191.
187 See OECD GUIDELINES para. 9.192.
consistent with the purported risk allocation.\textsuperscript{188} Therefore, DSub should not be performing
functions already stripped and should not be incurring risks of loss that were assumed by IPCo as
a result of the restructuring arrangement.

\textbf{C. Other Options Realistically Available}

Although it will respect the form of a transaction that has economic substance, the
Service will consider alternatives available to DSub to determine whether the terms of the
transfer would acceptable to an uncontrolled taxpayer faced with the same alternative under the
same circumstances.\textsuperscript{189} On an arm’s length basis, a controlled taxpayer would enter a transaction
only if none of the alternatives are preferable to it in terms of price or profits to be realized.\textsuperscript{190} In
addition, when using an unspecified method, such as one involving a net present value
calculation to determine an intangible’s profit potential, a controlled taxpayer must evaluate the
terms of the transaction by considering the realistic alternatives to it.\textsuperscript{191}

The Service will undertake a comparability analysis in determining whether the
consideration actually charged by DSub should be adjusted to account for material differences
between the alternative and DSub’s actual transaction.\textsuperscript{192} The Service will evaluate the terms,
risks, and potential benefits of the actual transaction and the alternative to determine what would
be the proper arm’s length charge for each, and whether the charge resulting from the alternative
warrants an adjustment.\textsuperscript{193} The Service may adjust the consideration charged in the controlled

\textsuperscript{188} Treas. Reg. § 1.482-1(d)(3)(iii)(B)(1).
\textsuperscript{189} See Treas. Reg. § 1.482-1(f)(2)(ii).
\textsuperscript{190} Treas. Reg. § 1.482-4(d)(1), -4(d)(2) (If a transaction results in foregone profits, its transfer price is likely not arm’s length).
\textsuperscript{191} Treas. Reg. § 1.482-4(d)(1).
\textsuperscript{192} See Treas. Reg. § 1.482-1(f)(2)(ii).
\textsuperscript{193} Treas. Reg. § 1.482-1(d)(1), (2), (3).
transaction based on the cost or profit of the alternative.\textsuperscript{194} However, the Service will not re-characterize the transaction as if DSub had adopted the alternative.\textsuperscript{195}

DSub may have a viable alternative option if it had concluded a distribution agreement with Company A that provides an exit alternative, or several, for DSub to choose in place of transferring its intangibles to IPCo and allowing Company A to take on its risk-related functions. The distribution agreement may not contemplate any alternatives, and the parties may not have concluded a distribution agreement whatsoever. In that case, DSub will still have a realistically available alternative option. DSub could choose between option A, implementing the conversion, and option B, carrying on with its status quo of fully-fledged distributor, and even option C, implementing the conversion proposed by Company A only with certain modifications. Each one of these options implicates alternative paths that will affect the nature of number of the transfer pricing transactions that would require arm’s length compensation. Hence, the amount of total arm’s length compensation received by DSub would vary accordingly.

If a distributor has been quite profitable while operating as a fully-fledged entity, a well-documented payment intended as indemnification may help convince the Service that pre-restructuring profitability was not related to ownership of with marketing intangibles, but was commensurate with enhanced functions and risks.\textsuperscript{196} Taking on this approach will be advisable if the distributor operates in an industry associated with considerable advertising or other marketing activities financed by distributors.\textsuperscript{197}

\textsuperscript{194} \textit{Id.}
\textsuperscript{195} See Treas. Reg. § 1.482-1(f)(2)(ii). The Service may not necessarily allocate income to an entity because the entity, such as a parent company, has the power to determine which party in a controlled group will earn income. See \textit{generally Hospital Corp. of America v. Commissioner}, 81 T.C. 520 (1983).
\textsuperscript{196} \textsc{Bakker, supra} note 10, at 418.
\textsuperscript{197} \textit{Id.}
IV. POST-RESTRUCTURING ARRANGEMENT

Upon restructuring, the Swiss IPCo becomes the new owner of the U.S. rights to the brands and trade names for the transfer pricing purposes. The restructuring agreements may specify ownership for tax purposes different from the legal title for intellectual property purposes for the maintenance of an intangible asset.198 This way, the parent, Company A, can keep legal title while allowing tax ownership by an affiliated subsidiary.199

Upon its conversion to a limited-risk distributor, DSub will provide only routine functions on behalf of Company A in the United States. Likely, these services will involve coordinating distribution, pre-sale just-in-time receipt of limited inventory, and processing and intermediating sales to retailers. Limited-risk service providers often operate on a cost plus basis with their routine services priced at cost plus a preset profit.200 After the restructuring, DSub should be remunerated on a cost plus basis for the limited-risk distribution services it performs.201 The OECD Guidelines determine that if remunerated on a cost plus basis for its services with respect to development and execution of a marketing strategy, a company would not have a contractual incentive to maximize the value of brand names or market share.202 If a transfer of an intangible asset is followed by a new arrangement where DSub will continue to use transferred intangible, to assess the arm’s length nature of the commercial arrangement, the arrangement must be examined in its entirety, including both the restructuring and the post-restructuring stages.203 The OECD Guidelines suggest that the transferor may continue to use the intangible in a new legal capacity, as a licensee of the transferee, or a “stripped” distribution

198 Valoir & Nijhof, supra note 54, at 33.
199 Id.
200 See TRANSFER PRICING IN A RECESSION, supra note 15, at 23.
201 See OECD Guidelines para. 9.191.
202 See id.
203 Id. at para. 9.86.
arrangement using a trademark that was transferred.\textsuperscript{204} In such case, however, advance negotiation of the conditions of future use would be prudent, and the negotiation will be influenced by the determination of the arm’s length compensations for the transfer and post-restructuring transactions with respect to the transferred intangible (\textit{i.e.}, license fees), and transferor’s expected profitability from future use of the asset.\textsuperscript{205}

Still, DSub and Company A would be well advised to structure their post-conversion activities defensively to ensure that DSub truly operates as a limited-risk entity with respect to marketing-related functions in the United States. Providing for clear understanding in the new, renegotiated contracts of which entity will handle intellectual property maintenance and enforcement would be essential to a clear division of functions.\textsuperscript{206} When a fully-fledged distributor is converted into a limited-risk one, its functional profile and responsibilities may materially change, and transfer pricing policies should be evaluated and updated.\textsuperscript{207}

IPCo should assume decision-making functions related to its newly acquired marketing intangibles and should employ a Chief Marketing Officer who will be responsible for brand-building, marketing strategy, and control over detailed implementation of the strategy in the United States. To maintain the requisite financial capacity to assume the risks associated with the strategic development of the brand names, IPCo should be well-capitalized through capital contributions and continuous reimbursement by Company A.

\begin{footnotes}
\textsuperscript{204} \textit{Id.} at para. 9.82.
\textsuperscript{205} \textit{Id.} at para. 9.86.
\textsuperscript{206} Valoir \& Nijhof, \textit{supra} note 54, at 33.
\textsuperscript{207} Webber, \textit{supra} note 1, at 165.
\end{footnotes}
CONCLUSION

Complex transactions often give way to lack of clarity and perspectives driven by subjectivity. The OECD Guidelines provide a roadmap that would be indispensable to MNEs contemplating transactions that involve elements of a business restructuring implicating steep transfer pricing consequences. In broad strokes, the OECD Guidelines offer a grip on significant issues that may weigh on transfer pricing implications of business restructurings, illustrating common scenarios with specific examples.

Still, when planning for a conversion of a distributing entity that has long been engaged in advertising, marketing, and promotion on behalf of the global group, MNEs should consult actual domestic law for an in-depth perspective on considerations that may affect the planning and post-restructuring stages. While the U.S. regulations harmoniously reiterate the main principles of the OECD Guidelines, the regulations come with their own historical development reflected in case law at times elucidating the proper interpretation of U.S. transfer pricing law.

Identification of marketing intangibles and their valuation can be inherently uncertain, especially when economic ownership may be implicated. Transfer pricing planners should examine comprehensively the history of a U.S. distributor’s arrangement when undertaking a conversion. By using the OECD Guidelines as a compass to navigate the right direction and following closely the U.S. regulations, in combination with other guidance by the Service and the judgment of U.S. courts, a U.S. distributor will predictably weather any storms in uncovering and transferring marketing intangibles offshore. While reasonable minds may differ, being thoroughly inclusive when identifying individual marketing intangibles, before the Service does, and assigning them reasonably calculated and well-supported values will keep the transfer pricing doctor away.