The transfer pricing methods’ applicability when determining the transfer price of intangible property
- based on Swedish legislation and the OECD Transfer Pricing Guidelines.

Bachelor’s thesis within Commercial and Tax Law
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Bachelor’s Thesis in Commercial and Tax Law

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Abstract

Transfer pricing is the internationally accepted term for determining and adjusting the price for a transaction that has taken place between two related parties, i.e. affiliated companies, situated in different countries. These transactions most often regard goods and services, but also the use of intangible property.

There is no internationally accepted definition of what intangible property is and because of the fact that intangible property has rare and different characteristics and are all unique in some way, difficulties occur when attempting to determine the transfer price of intangible property in accordance to the arm’s length principle stated in chapter 14, section 19 of the Swedish Income Tax Act and in article 9 of the OECD Model Convention on Income and Capital.

When establishing the arm’s length transfer price of intangible property, there are five methods available to apply – the traditional transaction methods, which are the comparable uncontrolled price method, the resale price method and the cost plus method and then there are the transactional profit based methods, which are the profit split method and the transactional net margin method.

All methods have their strengths and weaknesses and in this bachelor’s thesis the different transfer pricing methods will be studied and analyzed in order to determine which method is the best applicable when establishing the transfer price of intangible property.
# Table of Contents

1 **Introduction** .................................................................................................................. 1  
1.1 Background .................................................................................................................... 1  
1.2 Purpose and approach ..................................................................................................... 2  
1.3 Method and material ....................................................................................................... 2  
1.4 Delimitations .................................................................................................................. 3  

2 **Transfer pricing** ............................................................................................................ 4  
2.1 The term ‘transfer pricing’ ............................................................................................. 4  
2.2 Background .................................................................................................................... 5  
2.3 The arm’s length principle .............................................................................................. 6  

3 **Intangible property** ........................................................................................................ 8  
3.1 General .......................................................................................................................... 8  
3.2 Definition - OECD ......................................................................................................... 8  
3.3 Definition - Sweden ....................................................................................................... 9  

4 **Transfer pricing methods** ............................................................................................. 10  
4.1 The traditional transaction methods ............................................................................... 10  
4.1.1 Comparable uncontrolled price method .................................................................... 10  
4.1.2 Resale price method ................................................................................................. 12  
4.1.3 Cost plus method ...................................................................................................... 14  
4.2 The transactional profit methods .................................................................................. 15  
4.2.1 Profit split method .................................................................................................... 15  
4.2.2 Transactional net margin method .............................................................................. 17  

5 **Analysis** ......................................................................................................................... 19  
5.1 Comparable uncontrolled price method ....................................................................... 19  
5.2 Resale price method ...................................................................................................... 20  
5.3 Cost plus method .......................................................................................................... 21  
5.4 Profit split method ........................................................................................................ 22  
5.5 Transactional net margin method .................................................................................. 23  

6 **Conclusion** .................................................................................................................... 24  

List of references .................................................................................................................... 25
### Abbreviation list

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>CUP</td>
<td>Comparable Uncontrolled Price</td>
</tr>
<tr>
<td>ITA</td>
<td>Income Tax Act</td>
</tr>
<tr>
<td>MNE</td>
<td>Multinational Enterprise</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>SSAC</td>
<td>Swedish Supreme Administrative Court</td>
</tr>
<tr>
<td>STA</td>
<td>Swedish Tax Authorities</td>
</tr>
<tr>
<td>TNMM</td>
<td>Transactional Net Margin Method</td>
</tr>
</tbody>
</table>
1 Introduction

1.1 Background

In Sweden’s current business environment, multinational enterprises (MNEs) are not regarded as an entity from a tax perspective. The Swedish tax authorities want to assess the part of the profit derived from their country. Since the MNEs taxable income is affected by the transfer price used within the enterprise, the determination of the accurate transfer price is of great importance considering the fact that, already in 2002, more than 60% of the world trade took place within MNEs.¹

For tax purposes, the correct transfer price between affiliated companies should be determined through the so-called ‘arm’s length principle’ found in article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Convention on Income and Capital. The arm’s length principle is also expressed in chapter 14, section 19 of the Swedish Income Tax Act (ITA)². The principle implicates that the transfer price should be compared to the price that would have been applied if the transaction had taken place between independent companies, “companies dealing at an arm’s length”, where the transaction and the conditions are similar to the ones between the affiliated companies.³ These comparisons between independent and affiliated companies are executed through various transfer pricing methods, where the most eligible method is determined by the circumstances in question.

The fact that the different transfer pricing methods require comparables is generally not an issue, except when it comes to intangible property such as trademarks or patents. Intangible property is frequently referred to as the most complex part of transfer pricing.⁴ The area is complicated mainly because of the absence of comparables, since intangible property often are rare and unique. This makes it difficult to determine the property’s value which consequently makes it difficult to establish an arm’s length price for the use or transfer of intangible property by applying the transfer pricing methods.⁵

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¹ Neighbour, John, OECD Centre for Tax Policy and Administration, OECD Observer, January 2002.
² Inkomstskattelag (1999:1229).
³ Hamaekers, Hubert. Introduction to transfer pricing, IBFD online transfer pricing database, 2001, p. 4.
⁴ Ibid., p. 69.
⁵ Ibid.
1.2 Purpose and approach

The purpose of this bachelor’s thesis is to study and analyze which of the various transfer pricing methods are applicable when determining the transfer price of intangible property. This study and analysis will be made from a Swedish point of view and from the OECD’s point of view, meaning that the Swedish ITA and Swedish case law will be studied, and in cases where these sources are not sufficient enough, the OECD Transfer Pricing Guidelines will be used as a complement.

1.3 Method and material

In this bachelor’s thesis both a comparative method and a descriptive method is applied.6 The descriptive method is used to clarify what transfer pricing and what intangible property is. The descriptive method is also used to describe the different transfer pricing methods and how they are applied. Here, Swedish legislation and Swedish case law will be used as the primary sources. The rules regarding transfer pricing within Sweden’s national legislation are few. Therefore the OECD Transfer Pricing Guidelines, which are the basis of the transfer pricing rules, will be used to complement the rules within Sweden’s national legislation. The Swedish Supreme Administrative Court (SSAC) has established that the OECD Transfer Pricing Guidelines, while not binding, can serve as guidance for the STA.7

The comparative method will be applied when analyzing the different transfer pricing methods in order to determine the best applicable methods on intangible property.

The descriptive method is used in chapter two, where an explanation of transfer pricing is given explaining the term, the background and also the underlying principle of transfer pricing – the arm’s length principle, as well as in chapter three where the OECD’s and Sweden’s definition of intangible property is given. In chapter four the different transfer pricing methods are presented and described, starting off with the three traditional transaction methods and then moving on to the two transactional profit methods. These methods are explained with basis in the OECD Transfer Pricing Guidelines, since the methods have


7 RÅ 1991 ref 107, para 5.3.
not been incorporated into Swedish legislation and since Sweden is to look at the OECD Transfer Pricing Guidelines for guidance when applying the methods.\(^8\)

In chapter five an analysis of each transfer pricing method is given. In this chapter the different methods applicability to intangible property will be discussed and compared and the conclusion regarding which transfer pricing method is best applicable to intangible property will be given in chapter six.

### 1.4 Delimitations

When studying the different transfer pricing methods, it is the traditional transaction methods and the transactional profit methods that will be studied. Alternative methods will not be taken into consideration, since these are not included in the OECD Transfer Pricing Guidelines or in Swedish legislation.

The facts presented in this thesis will be based on Swedish national legislation and the OECD Transfer Pricing Guidelines. The national legislation of other countries will not be considered.

Also, the study on transfer pricing in relation to intangible property is seen only through a tax point of view and is limited to examine the different methods only from a theoretical point of view.

\(^8\) Ibid.
2 Transfer pricing

2.1 The term ‘transfer pricing’

Transfer pricing is the internationally accepted term for determining and adjusting the price for a transaction that has taken place between two related parties, i.e. affiliated companies, situated in different countries.\(^9\) These transactions most often regard goods and services, but also the use of intangible property. In other words, the transfer price is the price at which goods, services or the use of intangible property are transferred from one part of an enterprise in a certain country to another part of the enterprise located in a different country.\(^10\) Since the transfer prices set, on these so-called intra-firm transactions, have an immediate effect on each entity’s taxable profit, the tax authorities of each country have a great interest in knowing what transfer pricing methods are used when setting the transfer prices.\(^11\)

Let us assume that a company within a MNE (Company A), located in a state with a high income tax rate, produces a certain item and then transfers this item to a different company within the same MNE (Company B), located in a state with a low income tax rate. Let us also assume that the item is worth 500,000 SEK. The companies can easily manipulate the transfer price set in this transaction in a manner that benefits the MNE simply by transferring the item to Company B at a very low cost, for example for 200,000 SEK. This will lead to an increased taxable profit for Company B, since they now own assets worth 500,000 SEK although they have only payed 200,000 SEK, and a decreased taxable profit for Company A since they now only have 200,000 SEK, when before the transaction they had assets worth 500,000 SEK. Consequently, Company A, located in a state with a high income tax rate pays less taxes and Company B, located in a state with a low income tax rate pays more taxes.

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\(^11\) KPMG International Cooperative, Global transfer pricing review, Publication number: 101031, February 2011.
Presuming that these assets are all the companies own, Company A’s taxable profit before the transaction would have been 500 000 SEK, while it after the transaction will be 200 000 SEK. Company B’s taxable profit before the transaction would have been 200 000 SEK, while it after the transaction is 500 000 SEK.

### 2.2 Background

Over the last two decades, the role of MNEs in world trade has increased significantly. This increment creates even greater taxation issues for both tax administrations and the MNEs themselves since the countries separate rules for taxation cannot be seen independently. Instead, the rules must be dealt with in a wider, international context.  

Each country’s taxing rights depends entirely on which system of taxation the specific country uses. The system is either source-based, residence-based or, in certain countries, both. A source-based tax system means that the country’s tax base includes income arising within that country’s tax jurisdiction, irrespective of the taxpayer’s residence. In a residence-based tax system the country includes in its tax base all or part of the income, as well as income from sources outside that country, of any person who is regarded as a resident of that jurisdiction. In Sweden, a residence-based tax system is applied and it is expressed in chapter 3, section 3 of the Swedish ITA.  

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12 OECD transfer pricing guidelines for multinational enterprises and tax administrations, preface, para. 1.  
13 Ibid., preface, para. 5.  
The member countries of the OECD, Sweden included, apply the so-called ‘separate entity approach’ when it comes to the taxation of MNEs. This means that each enterprise within a MNE group is seen as a separate entity from a tax point of view. Therefore the individual entities are subjected to tax only on income arising to that particular entity, either on a residence basis or on a source basis depending on what system is applied in the country in question. This approach has been chosen by the OECD member countries to minimize the risk of unrelieved double taxation.\(^\text{15}\) In other words, to minimize the risk of a MNE being subjected to tax in two, or more, countries in respect of the same subject matter and for identical periods.\(^\text{16}\)

If the member countries are to be able to apply this ‘separate entity approach’ and levy the taxes accordingly, the separate entities must act at arm’s length when performing intra-firm transactions.\(^\text{17}\)

### 2.3 The arm’s length principle

In Sweden, as well as in the other OECD member countries, the arm’s length principle is used as a general principle for the taxation of MNEs.\(^\text{18}\) The principle implies that when setting the price for transactions between enterprises within a MNE, the transfer price should derive from what would have been set in a transaction between independent enterprises. This of course presumes that the transactions and the conditions regarding the transactions are similar and therefore comparable.\(^\text{19}\)

The arm’s length principle is stated in chapter 14, section 19 of the Swedish ITA\(^\text{20}\) and is generally referred to as the ‘adjustment rule’\(^\text{21}\). When a transaction takes place between affiliated companies, i.e. a controlled transaction, there is a great possibility that the contract terms agreed, regarding the transaction, deviate from contract terms that would have been agreed if the transaction had taken place between independent enterprises. The adjustment

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\(^\text{15}\) OECD transfer pricing guidelines for multinational enterprises and tax administrations, preface, para. 5.


\(^\text{17}\) OECD transfer pricing guidelines for multinational enterprises and tax administrations, preface, para. 6.


\(^\text{19}\) Hamaekers, Hubert. Introduction to transfer pricing, IBFD online transfer pricing database, 2001 p. 4.

\(^\text{20}\) Chapter 14, section 19 of the Swedish Income Tax Act.

\(^\text{21}\) ‘Korrigeringsregeln’ in Swedish.
rule implies that, if the result of a business ends up being lower because of this fact, then the result shall be adjusted and considered to be what the result would have been if such conditions would not have been applied.\textsuperscript{22}

In order for the adjustment rule to be applicable, there are three conditions that need to be fulfilled, the first one being that the business receiving the higher result shall not be liable to tax in Sweden on the basis of that result.\textsuperscript{23} The second and third conditions are that there shall be reason to assume that the dealing enterprises have a mutual economic interest and that it is clear that these contract terms have arisen on the basis of this common interest.\textsuperscript{24} In other words, there must be a connection between the inaccurate transfer price and the dealing enterprises’ mutual economic interest for the adjustment rule to be applicable.\textsuperscript{25}

The arm’s length principle is also expressed in article 9 of the OECD Model Tax Convention on Income and Capital. When Swedish legislation is insufficient regarding how to establish the transfer price on transactions, the OECD Transfer Pricing Guidelines are available for further guidance.\textsuperscript{26}

One of the most recurrent criticisms regarding the arm’s length principle being used in transfer pricing transactions is the fact that there are not always transactions that are comparable. This problem is most relevant regarding transactions involving intangible property, since the arm’s length principle is rather complicated to apply in such cases.\textsuperscript{27} What makes the application difficult is the fact that intangible property often have a special and unique character which leads to difficulties in determining the exact value at the time of the transaction as well as leading to complications in finding comparable transactions.\textsuperscript{28}

\textsuperscript{22} Mattias Dahlberg, Internationell beskattning, Studentlitteratur AB, Lund 2007, p. 119.
\textsuperscript{23} Chapter 14, section 19, p. 1 of the Swedish Income Tax Act.
\textsuperscript{24} Chapter 14, section 19, p. 2-3 of the Swedish Income Tax Act.
\textsuperscript{25} Mattias Dahlberg, Internationell beskattning, Studentlitteratur AB, Lund 2007, p. 119.
\textsuperscript{26} RÅ 1991 ref 107, para 5.3.
\textsuperscript{28} Hamaekers, Hubert. Introduction to transfer pricing, IBFD online transfer pricing database, 2001 p. 40.
3  Intangible property

3.1  General
Within the transfer pricing area, intangible property is commonly known as the most complex part. The real cause for this fact is that intangible property has rare and different characteristics and that all intangible property are unique in some way. This in turn has lead to one of the main reasons for its complexity, namely the fact that there is no internationally accepted definition of what intangible property is. The differences that appear in different parts of the world concerning the definition is primarily ownership issues and the fact that it is not clear what transfer pricing methods to use when determining the transfer price for intangible property.

3.2  Definition - OECD
In the OECD Transfer Pricing Guidelines, there is no concrete definition of what intangible property is, it is only stated that “[…] the term “intangible property” includes rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as know-how and trade secrets.”

The OECD Transfer Pricing Guidelines also divides intangible property into two different sorts – trade intangibles and marketing intangibles. Trade intangibles are “[…] patents, know-how, designs and models that are used for the production of a good or the provision of a service, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of a business[…]” These kinds of intangible property are often created through research and development which can be very risky and expensive. Therefore the developer normally tries to recover the expenses through product sales as well as through license or service agreements.

29 Ibid., p. 69.
31 Hamaekers, Hubert. Introduction to transfer pricing, IBFD online transfer pricing database, 2001 p. 70.
32 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 6, para. 6.2.
33 Ibid., chapter 6, para. 6.3.
34 Ibid.
Marketing intangibles are “[…]trademarks and trade names that aid in the commercial exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned.”\textsuperscript{35} The value of these kinds of intangible property is based on many different aspects, such as the trade name’s reputation and credibility, the ongoing research and development and the degree of quality control.

### 3.3 Definition - Sweden

There is no Swedish definition of intangible property, there is only the fiscal definition of intellectual property stated in chapter 18, section 1 of the Swedish ITA.\textsuperscript{36} This provision may be used as some sort of direction.

In the first paragraph it is stated that the provision applies to equipment intended for permanent use\textsuperscript{37} and in the second paragraph it is stated that concessions, patents, licenses, trademarks, rental properties, goodwill and similar rights acquired by any other, also are included as equipment.\textsuperscript{38}

Because of the lack of a uniform definition of intangible property, the OECD member countries, Sweden included, generally rely on the OECD Transfer Pricing Guidelines and the definition mentioned above.\textsuperscript{39}

\textsuperscript{35} Ibid., chapter 6, para. 6.4.

\textsuperscript{36} Chapter 18, section 1 of the Swedish Income Tax Act.

\textsuperscript{37} Chapter 18, section 1, paragraph 1 of the Swedish Income Tax Act.

\textsuperscript{38} Chapter 18, section 1, paragraph 2 of the Swedish Income Tax Act.

4 Transfer pricing methods

4.1 The traditional transaction methods

To determine whether or not the transfer price set, and the conditions agreed by the affiliated companies in a transaction are at arm’s length, the most direct way is to compare the transfer price set in the controlled transaction to the transfer price set on comparable transactions carried out between independent enterprises.\(^{40}\)

These traditional transaction methods are the most direct, as long as there are comparable transactions. In that case, the difference in the transfer price set in the controlled and the uncontrolled transaction can usually be traced to the relations between the affiliated companies.\(^{41}\) Another reason is the fact that, if the arm’s length conditions are not met in a transaction, the conditions can be established by simply substituting the transfer price set in the controlled transaction with the transfer price set in a similar, uncontrolled transaction.\(^{42}\)

4.1.1 Comparable uncontrolled price method

The comparable uncontrolled price method (CUP) compares the transfer price for goods, services or property in a controlled transaction to the transfer price set for goods, services or property in a comparable uncontrolled transaction. If the transfer prices in the different transactions are not the same, this could mean that the conditions agreed between the affiliated companies are not in accordance with the arm’s length principle. In that case, the accurate arm’s length price can easily be determined by replacing the price set in the controlled transaction with the price set in the uncontrolled transaction.\(^{43}\)

If such comparisons are to be effective, the relevant economic features of the situations being compared must be sufficiently comparable.\(^{44}\) Although, the comparable transaction does not need to be identical to the controlled transaction. The only requirements are that, if there are any differences between the transactions compared, these do not materially af-

\(^{40}\) OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.5.

\(^{41}\) Ibid., Chapter 2, para. 2.5.

\(^{42}\) Report of the OECD Committee on Fiscal Affairs, transfer pricing guidelines for multinational enterprises and tax administrations, Part I: Principles and methods, 1994, p. 44.

\(^{43}\) OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.6.

fect the condition being examined or the transfer price. And that, if such differences as mentioned above does exist, a reasonable adjustments can be made to get rid of the material effects.

For example, if an independent enterprise sells Swiss chocolate of the similar sort and quality as chocolate sold between two affiliated companies and the different transactions, the controlled and the uncontrolled transaction, occur at about the same time and under similar conditions, the transaction would constitute a comparable uncontrolled transaction. But, if the only uncontrolled transaction available to comparison concerns Belgian chocolate, it would be appropriate to question whether or not the fact that the chocolates derive from different countries could have a material effect on the price and if this effect can be eliminated through reasonable adjustments.

In cases where a comparable uncontrolled transaction with similar circumstances exists, the CUP method is the most accurate and the most preferable method to use over all other. However, it can be difficult finding comparable transactions so similar that the differences do not have a material effect on the price. If that is the case, the best thing to do to get the most accurate transfer price in accordance with the arm’s length principle is to combine the CUP method with other transfer pricing methods or to simply not use the CUP method at all.

When using the CUP method, the most important factor is the similarity of the transactions compared and even a minor difference leads to a need for adjustments. This makes the CUP method unquestionably inappropriate when determining the arm’s length price of intangible property since, as explained, intangible property often are unique and rare and therefore it is difficult to find comparables. Although, it is possible to apply the CUP method when the case concerns the transfer or license of intangible property when it is the same owner that has sold or licensed comparable intangible property under comparable

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46 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.7.
47 Ibid., Chapter 2, paras. 2.7, 2.8.
49 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.8.
50 Ibid., chapter 6, para. 6.13.
It is also possible that the CUP method could, despite of its clear inapplicability to intangible property, be applied to routine intangibles. Routine intangibles are intangible property that are so common that a routine remuneration for the specific kind is already determined. But even these so called routine intangibles can be hard to compare to other intangible property because of the fact there can, for example, be goodwill attached to a specific brand name which makes it different from other intangibles.

4.1.2 Resale price method

The resale price method has its basis in the price at which a product, previously purchased from an affiliated company, is resold to an independent enterprise. This price is then decreased by a suitable gross margin. The gross margin represents the costs of the product sold and an appropriate profit and it is determined in the light of the functions performed, meaning that the assets used and the assumed risks concerning the transaction needs to be taken into account. Once the gross margin is subtracted, what is left is considered a price at arm’s length.

When applying the resale price method, it is the gross margin that is the fundamental factor. This gross margin can be established by comparing the margin of the reseller in a controlled transaction to the margin set by the same reseller in an uncontrolled transaction. The calculation of the arm’s length transfer price when applying the resale price method would look like this:

\[
(\text{Resale price}) - (\text{The costs of the product sold} + \text{An appropriate profit}) = \text{An arm’s length price}
\]

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51 Ibid., chapter 6, para. 6.23.
52 Ibid., chapter 6, para. 6.24.
54 Theeuwes, Ann, OECD Project on the Transfer Pricing aspects of Intangibles, 9 November 2010, p. 5.
56 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.14.
57 Ibid., chapter 2, para. 2.15.
For example, let us assume that a Swedish company sells a product through an independent distributor located in France. The independent distributor resells the product to a third party for 1000 SEK. The costs of the product that is sold is 500 SEK and the appropriate profit is determined to be 200 SEK. The calculation would in this case look like this:

\[(1000 \text{ SEK}) - (500 \text{ SEK} + 200 \text{ SEK}) = 300 \text{ SEK}\]

The arm’s length price in this uncontrolled transaction would be 300 SEK. If the Swedish company would have a subsidiary company located in Spain for example, distributing the same product as the independent company in France, then the gross margin in that controlled transaction would be established by comparing it to this calculation.

Just like the CUP method, the resale price method is based on a comparative study. When applying the resale price method there are two elements that need to be taken into consideration in order for an uncontrolled transaction to be comparable to a controlled transaction. The elements are identical regarding both methods, differences between either the compared transactions or the enterprises are not allowed to materially affect the price in the open market and if they do it is possible to make reasonable adjustments to get rid of the material effects. However, because of the fact that slight differences are less likely to have a material effect on the gross margins than on the actual price, fewer adjustments are necessary than under the CUP method.\(^58\)

Under the resale price method the comparison of functions, risks and the contract terms agreed are elements that need to be taken into consideration, as well as management efficiency and differences in business experience. The application can therefore be seen as difficult since complete accounting information is likely to be needed to identify the differences between the costs of sold goods and the operating costs.\(^59\)

An accurate gross margin is easiest to establish where the reseller does not add substantial value to the product. An example could be that the reseller adds components to the production or the maintenance of intangible property connected to the original product, such as a trademark, owned by an affiliated company. In cases like these, it can be hard to de-

\(^{58}\) Ibid., chapter 2, para. 2.16.

termine the value of the final product because of the additions made by the reseller to the original product.\textsuperscript{60}

Also, if the reseller is an enterprise that carries on commercial activities involving intangible property, difficulties in finding comparable uncontrolled transactions and in finding a reseller with similar intangible property are likely to occur.\textsuperscript{61}

4.1.3 Cost plus method

The basis of the cost plus method lies within the costs that the supplier has brought upon himself for products or services transferred to a related enterprise. In order for the supplier to make a reasonable profit, an appropriate cost plus mark up is then added to the costs. The result, after adding the cost plus mark up, is considered to be a price at arm’s length.\textsuperscript{62}

The cost plus mark up added by the supplier in a controlled transaction is determined by comparing the mark up that the supplier earns in comparable uncontrolled transactions.\textsuperscript{63} The profit that the supplier makes should be in relation to the functions performed and the current market conditions.\textsuperscript{64}

When applying the cost plus method to determine the arm’s length price, this is an example of what the calculation could look like:

\[
(Costs \text{ incurred by the supplier}) \times (1 + \text{ The mark up percentage}) = A \text{ price at arm’s length}
\]

Let us assume that the supplier’s costs amount to 100 SEK and that the appropriate mark up is 30 percent. The calculation will in that case look like this:

\[
(100 \text{ } SEK) \times (1 + 0.30) = 130 \text{ } SEK
\]

There may be difficulties in determining the costs when applying the cost plus method, since there are cases where there is a lack of a connection between the level of costs and the market price. These sorts of difficulties are most likely to occur when dealing with in-

\textsuperscript{60} OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.22.

\textsuperscript{61} Ibid., chapter 2, para. 2.25.

\textsuperscript{62} Ibid., chapter 2, para. 2.32.

\textsuperscript{63} Ibid., chapter 2, para. 2.33.

\textsuperscript{64} Ibid., chapter 2, para. 2.32.
tangible property. For example when the costs for producing a product are relatively small, the addition of a trade name to the product can make the market price a lot higher than the production costs.\textsuperscript{65}

Regardless of the complications when applying the cost plus method to intangible property, the OECD still conclude that the method is applicable when dealing with transactions concerning intangible property.\textsuperscript{66}

4.2 The transactional profit methods
When the traditional transactional methods cannot be trustworthy if applied by themselves or if they cannot be applied at all, the methods to use for determining the arm’s length price are known as the transactional profit methods.\textsuperscript{67} These methods examine the profits that arise from specific controlled transactions. This profit, if it is different than the profit that would have arisen in an uncontrolled transaction, could indicate that the conditions agreed also differ and consequently that the transfer price set in the controlled transaction is not at arm’s length.\textsuperscript{68}

4.2.1 Profit split method
The profit split method can be used when a transaction takes place between affiliated companies that are very interrelated\textsuperscript{69}. The first step when applying the method is to identify the profit that is to be split from the controlled transaction that has occurred between affiliated companies. Then, the profit is split between the affiliated companies on an economically legitimate basis that estimates the division of the profit that would have been probable in an agreement made in accordance to the arm’s length principle.

For example, if the profit arisen from a transaction is 100 000 SEK and the contribution made from one of the affiliated companies (Company A) involved in the transaction amounts up to 70 percent, leaving the other company (Company B) with the remaining 30 percent, the profit is split accordingly. Company A will be allocated 70 percent of the prof-

\textsuperscript{65} Ibid., chapter 2, para. 2.36.
\textsuperscript{66} Ibid., chapter 2, para. 2.48.
\textsuperscript{67} Ibid., chapter 3, para. 3.1
\textsuperscript{68} Ibid., chapter 3, para. 3.2.
\textsuperscript{69} Interrelated means that the affiliated companies are very much influenced and affected by each other.
it, in this case 70 000 SEK and Company B will be allocated 30 percent of the profit, in this case 30 000 SEK.

When determining the profit that is to be split it could be the total profit gained in the transaction, but it could also be a residual profit that cannot clearly be assigned to one of the companies. A residual profit could, for example, be the profit arisen from high-value, unique intangible property.\(^\text{70}\)

In cases where the profit that is to be split is the profit gained in the transaction, external data is used to provide an independent comparability measure.\(^\text{71}\) Where a residual profit is used the split takes place in two stages. In the first stage, the participants are allocated adequate profits providing a basic return that is appropriate for the specific type of transaction. In the second stage, any residual profit remaining after the first stage would receive as much as is appropriate, considering how the profit would have been divided between individual enterprises.\(^\text{72}\)

The profit split method can be applied where no closely comparable transaction between independent enterprises can be found, since the method does not usually rely on comparable transactions. The distribution of the profit is based on the division of functions between the affiliated companies themselves. The method takes specific, sometimes unique, facts and circumstances of the affiliated companies into account, and these circumstances are often not at hand within independent enterprises. But the profit split method is still consistent with the arm’s length principle to the extent that it reflects what independent enterprises logically would have done if faced with the same circumstances.\(^\text{73}\)

Also, when using the profit split method it is less likely that one of the companies will be left with an excessive and questionable profit, since both companies involved in the transaction are evaluated. This part can be of great importance when determining the contributions made by the companies in transactions regarding intangible property.\(^\text{74}\)

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70 Bakker, Anuschka and Obuoforibo, Belema, Transfer Pricing and Customs Valuation: Two worlds tax as one, International Bureau of Fiscal Documentation, 2009, p. 44.

71 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 3, para. 3.16.

72 Ibid., chapter 3, para. 3.19.

73 Ibid., chapter 3, para. 3.6.

74 Ibid., chapter 3, para. 3.7.
But the method has its weaknesses as well. One of them could be the fact that it may be difficult for affiliated companies and tax administrations to access information from foreign affiliates and another one is that independent enterprises do not generally apply the profit split method when determining the transfer price. This could of course obstruct the application of the method.\textsuperscript{75}

Since it is difficult to find comparable uncontrolled transactions in cases that involve intangible property, it can therefore be difficult to use the traditional transactional methods, especially in cases where both parties of a transaction own valuable intangible property. Although such cases are extremely rare, the profit split method may be the most relevant to apply when such cases in fact occur.\textsuperscript{76}

4.2.2 Transactional net margin method

The transactional net margin method (TNMM) examines the net profit margin from a controlled transaction in relation to an appropriate base that consists of, among other things, costs, sales and assets. The net profit is equal to the profit before interest and before taxes have been levied.

The TNMM is rather similar to the CUP method and to the resale price method considering the way the methods operate and must therefore be applied in a manner that is consistent with the way the CUP method and the resale price method is applied. This means that the net margin of a controlled transaction is to be determined by reference to the net margin that the same company earns in comparable uncontrolled transactions and if this is not possible, the net margin earned by an independent enterprise can serve as guidance. This, of course, is only possible where the transaction made by an independent enterprise is comparable to the controlled transaction. To determine whether or not it is comparable, and to determine what adjustments may be necessary, a functional analysis of the affiliated company or, in some cases, the independent enterprise is required.\textsuperscript{77}

The TNMMs strength lies within the fact that it uses the net margin instead of using the price, as the CUP method does. This because the net margin is less effected by transactional differences and may also be more lenient to functional differences between the con-

\textsuperscript{75} Ibid., chapter 3, para. 3.9.

\textsuperscript{76} Ibid., chapter 6, para. 6.26.

\textsuperscript{77} Ibid., chapter 3, para. 3.26.
trolled and the uncontrolled transactions if there should be any, than if the gross margin was used, as is the case when applying the resale price method. It is possible that the controlled and the uncontrolled transactions may have a rather large difference of gross margins but the net margins can still be on a rather similar level.\textsuperscript{78}

Although, the fact that the TNMM can be influenced by factors that does not, or has a very small effect on the price and the gross margins makes it difficult to make an accurate and reliable determination of a net margin that is consistent with the arm’s length principle.\textsuperscript{79}

When applying this method to establish the arm’s length transfer price it requires information on uncontrolled transactions that may not be available when the controlled transaction is taking place. Also, the companies may not have access to enough information regarding the profits in uncontrolled transactions to be able to make a reliable application of the method.\textsuperscript{80}

Just like the CUP method and the resale price method, the TNMM is a method that is generally only applied to one of the affiliated companies in the controlled transaction. Because of the fact that there are many factors irrelevant to the price that can affect the net margin and that the application is one-sided, this could potentially lead to one of the affiliated companies being attributed with a profit leaving the other companies within the MNE with questionably high or low profit levels.\textsuperscript{81}

\textsuperscript{78} Ibid., chapter 3, para. 3.27.
\textsuperscript{79} Ibid., chapter 3, para. 3.29.
\textsuperscript{80} Ibid., chapter 3, para. 3.30.
\textsuperscript{81} Ibid., chapter 3, para. 3.31.
5 Analysis

5.1 Comparable uncontrolled price method

The CUP method is the method that gives the most reliable results when there are uncontrolled comparable transactions available. The key factor when applying the CUP method is similarity. This can easily be translated into the fact that it might not be the most reliable method to use when dealing with intangible property because of their unique and rare qualities.

However, since the method can be applied when establishing the arm’s length price in the case of selling or licensing intangible property where it is the same owner that has transferred or licensed the property to an independent enterprise under comparable circumstances, the CUP method is not entirely useless regarding intangible property. In such cases, it is the price set for the transfer and for the license in the uncontrolled transaction that will serve as guidance for the transfer price to be set in the controlled transaction.82

The most logical reason as to why the CUP method is unfit to be applied to transactions involving intangible property is presumably the fact that MNEs might be unwilling to share their intangible property with unrelated, independent enterprises.83 This reluctance to share will probably only increase as the value of the property increases. In other words it is rather safe to assume that intangible property with high value, owned by an MNE, will most likely not be transferred or licensed to an independent enterprise. It does not seem meaningful in any way for an enterprise to go through with such a transaction when this will lead to losing the advantages of being the sole owner of high-value intangible property. The likelihood of an MNE deliberately getting rid of such a rare and unique asset is practically non-existent.

This of course becomes a big problem when trying to apply the CUP method on intangible property since this leads to an absence of comparable uncontrolled transactions which is the main requirement if the method is to be applicable.

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82 Ibid., chapter 6, para. 6.24.
5.2 Resale price method

Since the resale price method focuses more on the functions of a product than on the price, the method seems to be more suitable for MNEs that have small operating costs. Factors that may have very little effect on the price such as management efficiency and differences in business experience\(^{84}\) must, when applying the resale price method, be taken into consideration.

Because of the fact that the amount of the resale price commonly refers to the contributions made by the reseller, in cases where a part of the operation is acquired as a service performed in favor of, for example a trade mark, the margin can be unusually high. Therefore, the resale price method does not seem to be appropriate to apply where the reseller has added substantial value to the product by using or adding intangible property.

Since intangible property owned by an MNE are not likely to be sold or licensed to an independent enterprise, because of the fact that the MNEs want to keep the advantages that comes with being the sole owner of high-value intangible property, the market for this kind of property is probably not that wide, if not completely absent. The basis of the resale price method can presumably be that the remuneration should be equal to the functions performed in a transaction. This in turn requires a market for intangible property, so that the remuneration in a controlled transaction can be compared to the remuneration in an uncontrolled transaction, in order to determine whether or not it is equal to the functions performed. As stated, this kind of market is practically non-existent. Therefore, finding comparable transactions to make a comparison seems to be very difficult.

Despite of these difficulties in applying the resale price method in transactions regarding intangible property, the OECD still states that the method is possible to use to analyze the terms of the controlled transaction when an affiliated company sub-licenses the intangible property to independent enterprises.\(^{85}\) To compare the selling or licensing of high-value intangible property to the sub-licensing of intangible property to a third party does not seem to be a very reliable way of reaching an arm’s length transfer price. What seems more likely is that no MNE would sub-license high-value, intangible property used within the enterprise. Consequently, the intangible property that in fact are being sub-licensed to indepen-

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\(^{85}\) OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 6, para. 6.23.
dent enterprises are probably of low value and not used by the MNE itself. To compare these kinds of intangible property to the high-valued ones being sold or licensed would therefore not give an accurate transfer price.

5.3 Cost plus method

When applying the cost plus method the reseller’s costs are used as a basis for determining the arm’s length price. The costs are then added with an appropriate profit. The problem with the method is that it can sometimes be difficult to determine the costs. Profits are generally determined by competitive prices on the market, but in some cases it can be hard to find a connection between the costs incurred and the market price.\(^8\) This is most likely to be the case when it comes to applying the cost plus method in transactions involving intangible property. An example of such cases is where the owner’s costs for making a new, highly valuable product are very small and this scenario seems to almost only apply on intangible property.

The thing about intangible property is that the production itself need not to be expensive and frankly, the quality of the product does not have to be better than any other product, especially not when intangible property such as trademarks or trade names are incorporated into a product. If we take a pair of shoes for example, the quality and production costs of two different pairs of shoes produced by two different unrelated enterprises could be exactly the same. The only thing that separates them is the fact that one pair has a trademark attached to it, making that pair of shoes more expensive to purchase than the pair without a trademark attached to it. It is presumably in cases like these that the connection between the production costs and the market price can be difficult, making the cost plus method inappropriate to apply to most cases involving intangible property.

The cost plus method is despite of its difficulties, according to the OECD, applicable to transactions involving intangible property.\(^8\) This can be seen as odd, since the cost plus method and the resale price method are generally seen as not being applicable on intangible property transactions.\(^8\) This bottom line here is that, in order to reach a transfer price con-

\(^8\) Ibid., chapter 2, para. 2.36.

\(^8\) Ibid., chapter 2, para. 2.48.

sistent to the arm’s length principle through the cost plus method, there is a cost plus mark up that should be added to the costs and this mark up is to be determined by comparison to the mark up in comparable uncontrolled transactions. In the area of intangible property where there is no concrete market, trying to find an appropriate, comparable cost plus mark up is virtually impossible.

### 5.4 Profit split method

The profit split method establishes and then, in accordance to the arm’s length principle, divides the combined profit among the affiliated companies involved in the controlled transaction. Since the method does not rely on comparisons to uncontrolled transactions it is presumably more fit to be applied in transactions regarding intangible property than the traditional transaction methods.

The fact that there is no need for comparable uncontrolled transactions when applying the profit split method gives it a great advantage over the CUP method, the resale price method and the cost plus method when determining the transfer price of intangible property. However, this does not mean that applying the profit split method can be done without difficulties.

The main issue with the profit split method seems to be the allocation of the profit. At first hand, it seems very reasonable to take the entire profit earned in a controlled transaction and simply divide this profit between the affiliated companies. Both companies involved in the transaction are evaluated and the profit is split between the affiliated companies on an economically valid basis, which logically makes it less likely that one of the companies will be allocated with an excessive and doubtful result. But it cannot always be easy determining exactly how much each company has contributed to a certain transaction in order to split the profit accordingly.

Regarding MNEs, the affiliated companies are located in different countries. It is rather safe to say that some of the countries, where one of the affiliated companies might be located, might not be willing to hand out as much information as needed for the STA to establish that company’s contribution to a specific transaction. Since the profit split method is based on the detailed, and sometimes even unique, facts and circumstances of the affiliated companies, it is of great importance that these will be taken into account when determining the transfer price of intangible property. This of course cannot be accomplished
if all the facts and circumstances are not available to the STA in some way and this clearly decreases the profit split method’s reliability.

### 5.5 Transactional net margin method

The TNMM, like the traditional transaction methods, is in need of comparable uncontrolled transactions in order for the method to be applicable. This causes the fact that the TNMM has similar issues when being applied to intangible property as the three other methods. The market for intangible property is, as already explained, practically non-existent making comparable uncontrolled transactions hard to find.

According to the OECD, the positive thing about the TNMM is that it uses the net margin instead of the price or the gross margin, since these are more likely to be affected by transactional and functional differences than the net margin is. This however cannot be seen as a positive factor when dealing with intangible property. It is not likely that this fact has any influence regarding intangible property transactions where even the slightest transactional difference may decrease the comparability. Factors that might not have an effect on the price or the gross margin can have a vast effect on the net margin, for example if the production is self-financed or financed from loans.

Also, it seems rather inappropriate that the transfer price of intangible property is set using a net margin in relation to a base that consists of all costs, sales and assets within the enterprise. These factors might not have anything to do with the real value of the intangible property, but they are still taken into consideration when determining the arm’s length transfer price. Consequently, the TNMM might not be the most appropriate method to use in transactions involving intangible property.

The OECD states in the Transfer Pricing Guidelines that the TNMM, as well as the profit split method, is inferior to the traditional transaction methods. This can possibly cause reluctances within the OECD member countries, Sweden included, to apply the TNMM. Since the method is one-sided, this could probably lead to unrelieved double taxation if the tax authorities in the other state do not accept the application.

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89 OECD transfer pricing guidelines for multinational enterprises and tax administrations, chapter 2, para. 2.49.
6 Conclusion

Determining the transfer price of intangible property has proven to be rather difficult. When applying the traditional transaction methods there is always a need to find comparable uncontrolled transactions in order to establish the correct transfer price in accordance to the arm’s length principle, something that is very difficult when dealing with rare and unique intangible property. If comparable uncontrolled transactions cannot be identified, which is most often the case since the market for intangible property is pretty much non-existent, the traditional transaction methods, meaning the CUP method, the resale price method and the cost plus method, are clearly not applicable to intangible property.

The transactional profit methods, that are the profit split method and the TNMM, are more suitable to apply to transactions involving intangible property. The TNMM is more suitable since the method does not rely on the price of the property but on the net margin. But the method still requires comparable uncontrolled transactions to compare the net margin in the controlled transaction. This makes the TNMM, just like the traditional transaction methods, in most cases inapplicable to intangible property because of the difficulties in finding comparables.

The profit split method is the only method that does not rely on there being uncontrolled transactions available for comparison which is what makes it the most applicable method when dealing with intangible property. That means that the profit split method is the method most consistent with the arm’s length principle when determining the transfer price of intangible property.
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