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INSIGHT: Marketing Intangibles—Should the Trigger Point be SG&A or AMP Expenses of the Selling Entity ?

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"Marketing intangible" means an intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, or has an important promotional value for the product concerned, as per the Organization for Economic Cooperation and Development's (OECD's) revised transfer pricing guidelines on Chapter VI, which were released as part of base erosion and profit shifting (BEPS) Actions 8 to 10. Depending on the context, a marketing intangible may include trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling of goods or services to customers.

Thus, the concept of a marketing intangible goes far beyond mere advertising, marketing, and promotional (AMP) expenses, which is contrary to the general position taken by revenue authorities across the world. The critical aspect to be considered in the context of a marketing intangible is the strategic or significant functions involved in the activities of marketing and distribution of products. The issue is whether the licensor or licensee of the trademark economically owns the same, so as to determine the proper allocation of financial results, namely profits or losses, between the said two parties by applying proper transfer pricing methods.

One needs to appreciate that incurring of AMP expenses cannot by itself be a trigger for the revenue officer to impute a standalone transfer pricing adjustment in the hands of the selling entity on the mere pretext that the taxpayer's AMP expenses as a percentage of turnover exceeds the average of those of comparable companies.

The level of AMP expenses, alongside the site of strategic decision making regarding marketing and distribution activities may, at best, provide an indicator of whether the licensee (selling entity) economically owns the marketing intangible. It may be borne in mind that marketing intangible is an asset to be taken into consideration in conducting the functional, asset, and risk (FAR) analysis and the resultant characterisation of the licensee for the purpose of applying proper transfer pricing methods.

Both the OECD and UN transfer pricing guidelines have made it amply clear that for an intangible asset (in this case, marketing intangible) to have any relevance in the context of transfer pricing, the said intangible needs to be "unique" or "non-routine"; and non-existent within comparable companies that are selected the purpose of transfer pricing analysis.

Global Supply Chain Analysis

A global supply chain analysis of a multinational group needs to be the starting point to ascertain whether a selling entity within the MNC group can be said to possess unique marketing intangibles. This scenario would typically arise in the case of branded products, which are not overly superior in terms of patents or technology; and whose success depends more on selling and distribution functions, rather than manufacturing and research and development (R&D) functions performed by the manufacturer of the products; or the selling and distribution functions are at least as important as the manufacturing and R&D functions. This is typically the case with branded generic products in the pharmaceutical sector and for some of the products in the retail and consumer sector.

Such an analysis of a global supply chain needs to be corroborated by a comparison with the local comparable companies in the country of the selling entity. While there is no doubt that a qualitative analysis of the

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functions performed around marketing and distribution of products, both by the licensee taxpayer and comparable companies, is the best way to decide whether the taxpayer has any unique or non-routine ''marketing intangibles,'' in practice such qualitative analysis is never possible with respect to comparable companies. Thus, it is necessary to resort to quantitative analysis with reference to the financials of both the taxpayer and the comparable companies to deduce the aforesaid result.

There is a question of whether the filter of AMP expenses to turnover ratio is the only and best way to determine whether the licensee taxpayer carries a unique or non-routine ''marketing intangible'', in a case where such ratio or percentage in the case of the taxpayer exceeds the average of comparable companies. A high ratio of AMP expenses to turnover in the case of the taxpayer, as opposed to the comparable companies, does not automatically lead to the conclusion that the taxpayer has a unique or non-routine ''marketing intangible.'' The converse is also true. Without spending a significant amount on AMP as compared to comparable companies, a licensee taxpayer may still create a unique or non-routine ''marketing intangible''.

As discussed earlier, a marketing intangible is a combination of several aspects relating to marketing and distribution of products. It does not only constitute a trademark, brand, trade name, etc. It also takes within its sweep, customer lists, customer relationships, proprietary market and customer data, distribution channels, dealership networks, etc., that are used or aid in marketing and selling goods or services to customers.

A pharmaceutical product that is not sold over the counter but through prescriptions drawn up by doctors and hospitals, particularly generic drugs, would not need any advertisement for promoting its sale, since the target customers are not the end-use consumers, i.e. patients, but doctors and hospitals, who would prescribe the medicine to the patients. The company entrusted with the responsibility of distributing the products would need to focus heavily on reaching out to hospitals and doctors through dealers, medical representatives, etc., and through unique selling strategies.

Depending upon the successful implementation of such selling strategies, a particular pharmaceutical company may be able to garner a much larger market share with respect to a particular type of drug, as compared to a similar drug sold by a competing company. In that case, the former or more successful company may be said to have created unique or non-routine marketing intangible in the form of distribution channels and dealership networks, relationships with customers, namely doctors and hospitals, etc., which may yield premium profits for the company as compared to its competitors. Thus, such unique marketing intangible can be created even without actual advertisement or brand-building expenses, *per se*. In such a case, the indicator of the existence of a unique marketing intangible would ideally be the overall selling and general administrative (SG&A) expenses relating to distribution, rather than only AMP expenses.

Branded Products

Branded products, particularly in the segments of retail and consumer, automobiles, etc., which require direct contact with end customers, would typically need significant advertising to promote the brands, and accordingly, sales. Now, when one deals with the case of a licensee taxpayer, who is a distributor of high-end branded products, it is important to first understand the nature or type of comparable companies that may be selected for the purpose of comparability analysis. It is extremely difficult to obtain comparable, uncontrolled distributors of high-end branded products matching the status of the taxpayer's products. The comparable, uncontrolled distributors would typically deal with products that are either non-branded or relatively low in brand value as compared to the taxpayer's products. Obviously, as in the case of generic pharmaceutical products, as discussed above, such uncontrolled distributors would need to devote additional efforts in creating dealership networks and distribution channels, maintaining relationships with retail stores, etc., to push the sales of their products.

Thus, what a distributor of high-end brand products may achieve in terms of promotion or increase of sales through significant advertising campaigns, a similar distributor of unbranded products may be able to achieve through other selling functions, as discussed above. Thus, a higher ratio of AMP expenses to turnover in the case of the former would not automatically lead to the conclusion that such distributor has a unique or non-routine ''marketing intangible'' as compared to the latter.

In order to better compare two classes of distributors to ascertain which (if any) has a unique ''marketing intangible,'' it would be prudent to consider an overall indicator that is likely to even out such differences — namely the overall ratio of SG&A expenses to turnover. This ratio indicates the intensity of selling functions, which include all attributes and facets of selling and distribution functions, namely AMP, creation of distribution channels and dealership networks, maintenance of customer relationships, provision of after-sales services, etc., instead of considering only the filter of AMP expenses to turnover, which, as discussed above, is only a subset of overall marketing and selling functions.

It is empirically proven, with the help of statistical analyses, that there is a much greater positive correlation between gross profits, being the far superior profit level indicator (PLI) than net profits in the case of normal risk taking distributors, and overall intensity of selling functions, namely SG&A/turnover, than between gross profits and AMP/turnover. This correlation justifies the fact that the overall intensity of selling functions has a greater positive impact on profits relating to distribution functions, as compared to standalone functions relating to AMP, which, as stated above, is a mere sub-set of the overall intensity of selling functions.

Thus, care should be taken that comparable companies with a more or less similar level of intensity of functions, namely SG&A expenses/turnover, to that of the licensee taxpayer should be selected for testing the results of distribution functions.

In case the taxpayer's intensity of functions is much higher than the comparable distributors, then it may be concluded that the taxpayer might indeed have a unique or non-routine ''marketing intangible,'' in which case, one would need to consider whether reasonable adjustments can be made to the margins of comparable companies through the application of regression analysis in order to determine the arm's-length profit margin for the taxpayer. Else, as a more classical or purist approach, the case may demand application of the residual profit split method (RPSM) on the grounds that the case of the licensee taxpayer would fall outside the realm of comparability analysis due the presence of a unique or non-routine marketing intangible.

It goes without saying that the RPSM needs to be applied only with reference to the results, i.e. profits or losses, in the system of the overseas manufacturer and the local distributor relating to the products sold in the local country. The RPSM may be worked out in a manner that, after providing for routine returns to the overseas manufacturer and local distributor for the manufacturing and distribution functions respectively, the residual profits/ losses may be split in favour of the overseas manufacturer and local distributor in the ratio of R&D expenses of the manufacturer, as duly prorated to the level of the turnover of the distributor, and AMP expenses of the distributor in excess of the level of expenses of the comparable companies selected for providing routine distribution returns, as above, respectively.

Entrepreneurial Licensed Manufacturers

Now, let me deal with the issue of entrepreneurial licensed manufacturers, who generally take significant strategic decisions, both for manufacturing and distribution functions, while exploiting the intangibles, in the form of technology and trademark, which are taken on license from the overseas licensor. The relevance of a marketing intangible in the context of an entrepreneurial licensed manufacturer (given the intensity of its overall selling functions, including AMP functions), depends on whether the licensed manufacturer passed on to the foreign licensor of the trademark, the profits related to the economic ownership of the marketing intangible through transactions with manufacturer's overseas related parties, particularly the trademark licensor. Those transactions would ideally be the importation of raw materials or components; and payment of royalties for technology and brand.

The answer lies in a stand-alone testing of the two primary transactions : (1) the import of raw materials and components, *ideally under a cost-plus method, using the foreign supplier as the ''tested party,'' being the less complex of the two entities, vis-à-vis the transaction of supply of raw materials and components*; and (2) payment of royalties for technology and brand *under a comparable uncontrolled price/transaction method and corroborated by RPSM, in case reliable third party license agreements are not available in global databases for the relevant industry*. The overall transactional net margin method should not be applied to the results of the entrepreneurial licensed manufacturer, because as per the fundamentals of transfer pricing, an entrepreneurial entity should not be selected as the ''tested party.''

To apply RPSM for testing the arm's-length nature of a royalty, as above, one should initially provide routine returns for the manufacturing and distribution functions carried out by the licensed manufacturer, by selecting comparable companies engaged in routine manufacturing and distribution functions, which do not carry any significant intangible assets, whether trade or marketing intangibles.

The residual profit may then be split between the licensee and overseas licensor in proportion to contribution of unique intangibles, i.e. excess of SG&A expenses of the licensee, as a percentage of turnover, over the average of those of comparable companies selected for computing routine returns, as above, being the contribution of the marketing intangible by the licensee; and global R&D expenses of the licensor adjusted to the level of the turnover of the local licensee, being the contribution of ''trade intangible'' by the licensor.

If the facts of the case suggest that distribution strategies, including brand-building of the licensor at the global level, have positive impact on sales in the country of the licensee, then expenses incurred by the licensor for such functions, again being prorated to the level of turnover of the licensee, may be added as a contribution of a unique intangible by the licensor.

If the above transactions are found to be at arm's-length on the above approach, it would lead to the automatic conclusion that the entrepreneurial licensed manufacturer had not diverted any portion of the profits related to the economic ownership of marketing intangible in favour of the foreign licensor of the trademark. Accordingly, no transfer pricing adjustment on account of the marketing intangible would arise in the hands of the taxpayer. Any contrary result may call for transfer pricing adjustment with respect to royalties, as a fallout of the issue around marketing intangibles.

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