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Intangibles and Transfer Pricing Regulation in Nigeria: An Exposition

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Abstract

Intangibles play an important role in the processes of many business enterprises. They facilitate value creation and enhance the profitability of businesses that deploy them. They are also valuable assets that can be traded in themselves, although their appropriate values are often difficult to ascertain. As such, studies show that transactions in intangibles also provide opportunities for profit shifting by multinational enterprises through transfer (mis)pricing; a situation that deprives source states of due and sometimes significant tax revenue. This situation has over time triggered both unilateral and concerted responses by states anxious to cauterize this conduit of revenue bleeding. Through analysis of relevant legislation, case law, policy documents and opinions, this paper examines the recent measures applied by Nigeria to regulate the transfer pricing of intangibles, evaluating the legal and administrative challenges confronting Nigeria as a developing country seeking to enforce the complex arm's length principle of transfer pricing. Because the subject is of global character, the author relies on both Nigerian and foreign sources, including various OECD/UN initiatives.

1. Introduction

Such is the character of a village, or, since electric media, such is also the character of global village. And it is the advertising and PR community that is most aware of this basic new dimension of global interdependence.[1]

When Marshall McLuhan penned those famous words, he was not writing about taxation, in any sense. Rather he was acknowledging the burgeoning power of the 'new media,' its stupendous capacity to shape the world as a closely interactive unit and to influence life in a global sense. The advertising and PR community, apparently, were the first to truly appreciate this emergent power, and, thus, to deploy it to their advantage. McLuhan's words may in another sense be used to conceptualize the inherent potential of intangible property and how Multinational enterprises (MNEs) play a prominent role, not just in their development, but also in using these kinds of hard-to-understand and hard-to-value property to artificially determine their commercial fortunes or bottom-line. Put differently, McLuhan's words may illustrate the way MNEs operate and the cross-border impact of their operations. Such impact may be economic, social, political, environmental and, of course, fiscal. From a fiscal perspective, it may be used to reflect the notion that MNEs *paper-shift* revenue across country lines to influence their tax obligations, a practice that has placed MNEs under a microscope of deepening suspicion, if not contempt. Worldwide, there is a growing concern that governments are losing substantial corporate tax revenue because of tax planning by MNEs (taking advantage of weak international tax rules and processes) aimed at shifting profits

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[1] Marshall McLuhan, *The Gutenberg Galaxy: The Making of Typographic Man* (Toronto: University of Toronto Press, 1962) at 21.

in ways that erode the taxable base to locations where they are subject to a more favourable tax treatment.[2] Tax havens and profit shifting by MNEs have, thus, been receiving increasing attention from researchers, policymakers and the media alike, as documented by recent studies.[3] This greater attention is in part because it has become rather easy for MNEs to avoid paying corporate tax, but also, in part thanks to recent leaks of confidential documents and thorough investigative case studies.[4] In 2016, for instance, a study by the European Parliamentary Research Service revealed that various powerful MNEs, including Google, Amazon, Apple, Ikea, Gap, Microsoft and Starbucks, were involved in corporate tax-dodging, costing the EU between US$54.5 billion and US$76.4 billion a year. Companies allegedly achieved this tax avoidance by artificially allocating their profits economically derived in Europe to low-tax countries like Ireland and Luxembourg.[5] According to a 2013 research study conducted by the African Development Bank and Global Financial Integrity (GFI), between 1980 and 2009, African economies lost between US$597 billion and US$1.4 trillion in net resources.[6] This monumental bleeding was primarily effected through transfer mispricing.[7]According to a 2015 report by the United Nations Economic Commission for Africa, Africa is losing approximately US$50 billion per year in illicit financial flows (IFFs). Transfer mispricing is one of the primary sources of these losses.[8] The report specifically identifies the "misinvoicing" of services and intangibles as widespread means to effect IFFs from Africa and

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[2] Dirk Schindler & Guttorm Schjelderup, "Transfer Pricing and Debt Shifting in Multinationals" (2013) Norwegian School of Economics CESifo Working Paper No. 4381, online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2319873, at 2. See also Allison Christians, "Drawing the Boundaries of Tax Justice," in Kim Brooks, ed, *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) 53; Kimberly A Clausing "The Effect Of Profit Shifting On The Corporate Tax Base In The United States And Beyond," (2016) 69:4 National Tax J 905; Annet Wanyana Oguttu, "Tax Base Erosion and Profit Shifting in Africa – Part 1: What Should Africa's Response be to the OECD BEPS Action Plan?" (2015) 48:3 The Comp & Intl LJ of Southern Africa 516; Allison Christians & Laurens van Apeldoorn, "Taxing Income Where Value Is Created," (2018) 22:1 Florida Tax Rev 1; Tarcisio Diniz Magalhães, "What Is Really Wrong with Global Tax Governance and How to Properly Fix It," 10:4 (2018) WTJ 499; Aguguom Theophilus Anaekenwa & Olaoye Samuel, "A Tax Base Erosion and Profit Shifting through Transfer Pricing: Evidence from Nigeria," (2017) 6:1 Apex J Business Administration and Management Sciences Research 1; Antony Ting and Sidney J Gray, "The Rise of the Digital Economy: Rethinking the Taxation of Multinational Enterprises" (2019) J Intl Business Studies 1; Thomas Rixen, "Tax Competition and Inequality: The Case for Global Tax Governance" (2011) 17:4 Global Governance 447.

[3] See Petr Janský & Miroslav Palanský, "Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment," 26:5 Intl Tax and Public Finance J 1048.

[4] *Ibid* at 1049.

[5] Jonathan Chew, "7 Corporate Giants Accused of Evading Billions in Taxes," Fortune Magazine (11 March, 2016), online: https://fortune.com/2016/03/11/apple-google-taxes-eu/

[6] African Development Bank and Global Financial Integrity, "Illicit Financial Flows and the Problem of Net Resource Transfers from Africa: 1980-2009" (2013), online:https://secureservercdn.net/45.40.149.159/34n.8bd.myftpupload.com/wp-content/uploads/2014/05/gfi_afdb_iffs_and_the_problem_of_net_resource_transfers_from_africa_1980-2009-highres.pdf?time=1571932270

[7] Shafi'U Abubakar Kurfi et al, "Transfer Pricing and the Regulations in Nigerian Milieu" (2017) 1:1 Indian J Finance and Banking 33 at 35.

[8] Africa, AUC/UNECA Conference of Ministers of Finance, Planning and Economic Development, High Level Panel on Illicit Financial Flows from Africa, *Illicit Financial Flows* (2015), online: https://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf

acknowledges that while there is increasing awareness of the use of intangibles for IFFs, existing tools do not seem to provide the required solutions.[9] Available data report that over-invoicing of imports and under-invoicing of exports represents a substantial source of transfer pricing and capital flight in Nigeria, with an average annual outflow of capital running to the tune of US$386 million and cumulative total of US$13.5 billion over the 1970-2004 period.[10] Between the periods of 2005 and2007, Nigeria lost £502 million in transfer pricing via trade 'misinvoicing.'[11] The role of transfer mispricing, in the gargantuan revenue leaks highlighted above cannot be overstated. Moreover, even where there is no intention to misprice, arriving at an appropriate transfer price may be a complex task particularly because of the difficulty in identifying and valuing intangibles transferred and/or services provided.[12] This state of affairs makes it an absolute necessity for tax authorities to keep a close eye on controlled transactions. The global disaffection with the egregious revenue haemorrhage and the need for an effective legal and policy framework to address these shortfalls have been some of the drivers of 21st Century international tax reform efforts. A key coordinating forum for these efforts has been the Organisation for Economic Cooperation and Development (OECD), which has attempted to develop functional legal and policy frameworks through its Base Erosion and Profit Shifting (BEPS) project. For instance, Action 8 of the OECD's Action Plan on BEPS, published in July 2013, specifically addresses transfer pricing issues relating to controlled transactions involving intangibles.[13]

Nigeria is a member of the OECD Inclusive Framework on BEPS and has participated in the multilateral anti-BEPS project, including the adoption/domestication of rules and procedures developed at that forum, such as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations[14] and the OECD Guidance on the Implementation of Country-by-Country Reporting.[15] In March 2018 Nigeria's Federal Inland Revenue Service (FIRS) issued the Income Tax (Transfer Pricing) Regulations 2018 (TPR18 or the TP Regulations).[16] TPR18 repealed and replaced the Income Tax (Transfer Pricing) Regulations 2012

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[9] *Ibid* at 31.

[10] Taiwo Ajilore, "An Economic Analysis of Capital Flight from Nigeria" (2010) 2:4 Intl J Economics and Finance 89 at 92.

[11] Christian Aid, "False Profits: Robbing the Poor to Keep the Rich Tax Free" (2009),online: https://www.christianaid.org.uk/sites/default/files/2017-08/false-profits-robbing-the-poor-to-keep-rich-tax-free-march-2009.pdf at 5.

[12] UN Tax Committee's Subcommittee on Practical Transfer Pricing Issues, *Background Paper,* Working Draft, online: https://www.un.org/esa/ffd/wp-content/uploads/2011/06/20110607_TP_Chapter1_Introduction.pdf, at 4, para 1.9 [UN Tax Committee].

[13] OECD, "Action Plan on Base Erosion and Profit Shifting" (2013), online: https://www.oecd.org/ctp/BEPSActionPlan.pdf

[14] OECD, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (2017), online: https://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations_20769717. [OECD TP Guidelines]

[15] OECD, "Guidance on the Implementation of Country-by-Country Reporting" (2018), online: http://www.oecd.org/tax/guidance-on-the-implementation-of-country-by-country-reporting-beps-action-13.pdf

[16] The FIRS also issued the Income Tax (Country-by-Country Reporting) Regulations 2018 (CBCR) to try to address the problem of information asymmetry between the tax authority and taxpayers by requiring MNEs in Nigeria to declare their group capital, labour, revenue and tax statuses on a yearly basis. This Regulation serves to provide the

(TPR12), introducing some notable updates to the transfer pricing regulatory framework in Nigeria. The pricing of intangibles is one of the key areas of reform. In the segments that follow, I examine the provisions of TPR18 that I consider relevant to the pricing of intangibles and the challenges that Nigeria may encounter in trying to effect these reforms; and also reflect on what Nigeria may to do try to enhance the workability of the rules. The remaining part of this paper is divided into two. In section 2, I discuss the concept of transfer pricing and distinguish it from transfer mispricing. In section 3 I discuss the regulation of transfer pricing through the arm's length principle and the challenges of applying the existing rules to transactions in intangibles.

2. Transfer Pricing: Overview

Transfer pricing is the general term for the pricing of cross-border, intra-firm transactions between related parties.[17] It refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services. These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that are not associated and can be assumed to operate independently ("on an arm's length basis") in setting terms for such transactions.[18] Such term setting is in itself not necessarily illegal or abusive. What is illegal or abusive is transfer mispricing, which is also known as transfer pricing manipulation or abusive transfer pricing.[19] In other words, transfer pricing does not necessarily involve tax avoidance, as the need to set prices is a normal aspect of how MNEs must operate.[20] Broadly speaking, the two possible objectives of transfer pricing are: performance evaluation and cost minimization.[21] Performance evaluation means evaluating the performance of both parties on an intercompany transaction. That is to say, the transfer should be made at a price acceptable to both parties. This could be determined by reference to outside market prices or by negotiation between the parties to the transaction.[22] Regarding cost minimization, differences between countries in respect of intercompany transactions across national borders might give an MNE the desire to control costs through the discretionary determination of transfer prices by the headquarters.[23]

A significant volume of global trade consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called "intra-group transactions." There is evidence that intra-group trade is growing steadily and arguably accounts for more than 30 percent of all international transactions. In

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FIRS relevant information for transfer pricing purposes, although the information cannot be used as a basis for making transfer pricing adjustments. See regulations 3, 4, 8-10 of the CBCR.

17 United Nations, "Transfer Pricing Manual for Developing Countries" (2017) at 2, para B.1.1.6 [UN TP Manual].

18 *Ibid.*

19 Lee Sheppard, "Transfer Pricing" *Tax Justice Network* (2012), online: https://www.taxjustice.net/topics/corporate-tax/transfer-pricing/

20 UN TP Manual *supra* note 17, para B.1.1.7.

21 Timothy Doupnik & Hector Perera, *International Accounting,* 3rd ed (New York, Mc-Graw Hill, 2012) at 591.

22 *Ibid* at 593.

23 *Ibid.* Other cost minimization objectives might include avoidance of withholding taxes, minimization of import duties, circumvention of profit repatriation restrictions, protection of cash flows from currency devaluation and improvement of competitive position of foreign operations. See Doupnik & Perera *ibid* at 595.

addition, transactions involving intangibles and multi-tiered services constitute a rapidly growing proportion of an MNE's commercial transactions and have greatly increased the complexities involved in analyzing and understanding such transactions.[24] These complexities can be categorized into jurisdiction, allocation and valuation.[25] Jurisdictional issues border on which country should tax the MNE's income and the resolution of that question especially where more than one country claims that right.[26] Allocation issues require the consideration of two conflicting perspectives: the MNE's perspective and the government's perspective. The MNEs aim to allocate their resources, especially taxable profits, with maximum efficiency, whereas for the government, the allocation of costs and income from the MNEs resources needs to be addressed to compute the tax judiciously.[27] Sometimes these diverse perspectives result in a tug-of-war between the countries in the allocation of costs and resources in the hope towards maximizing the tax base in their respective states.[28] The third issue deals with the valuation of intra-firm transfers. This simply means that the mere allocation of income and expenses to one or more members of the MNEs group is insufficient. The income and expenses must also be valued.[29] Where the pricing does not accord with internationally applicable norms or with the arm's length principle under domestic law, the tax administration may consider this to be "mis-pricing", "incorrect pricing", "unjustified pricing" or non-arm's length pricing, and issues of tax avoidance and evasion may potentially arise.[30] It is in this negative context that transfer pricing connotes the artificial manipulation of internal prices within an MNE, with the intention of creating a tax advantage.[31] This brings us to the subject of combating transfer mispricing.

3. Tackling Transfer Mispricing (in Nigeria)

Nigeria did not have a comprehensive legal framework to combat transfer mispricing until 2012.[32] Neither was there guidance on how taxpayers could comply with or demonstrate that their related-party transactions complied with the arm's-length principle.[33] Prior to the issuance of the Income Tax (Transfer Pricing Regulations 2012 ('TPR12') the most that taxpayers and tax administrators could refer to were general anti-avoidance rules (GAARs) contained in various statutes and Double

[24] UN Tax Committee *supra* note 12, paras 1.3–1.4
[25] *Ibid*, para 2.
[26] *Ibid.*
[27] Kurfi et al, *supra* note 7 at 35.
[28] *Ibid*, para 35
[29] UN TP Manual *supra* note 17, para B.1.2.11.
[30] *Ibid*, para B.1.1.7.
[31] Lynne Oats, Angharad Miller & Emer Mulligan, *Principles of International Taxation*, 6th ed (London: Bloomsbury, 2017) at 412.
[32] This delayed arrival may, in theory, be traced to two factors. First, for decades, Nigeria relied heavily on revenue from her oil and gas sector, with little effort to mobilise the tools of taxation to source alternative revenue. In the past decade or so – mostly in the last half-a-decade – there has been far greater emphasis on tax revenue, especially given the global fall in oil prices. Nigeria's Federal Inland Revenue Service regularly posts huge revenue collection targets. Second, it cannot be ignored that the period around 2012 is also noted for the prominence of the global BEPS awakening which has spurred many countries to try to reshape their international tax mechanisms.
[33] Joshua Bamfo, Amaka Samuel-Onyeani & Abisola Agboola, "Understanding the Transfer Pricing Audit Process in Nigeria," (2016) 84 Tax Notes Intl 501 [Bamfo, Samuel-Onyeani & Agboola]

Taxation Treaties.[34] For instance, paragraph 13(2)(d) of the Companies Income Tax Act (CITA),[35] provides that:

> The profits of a company other than a Nigerian company from any trade or business shall be deemed to be derived from Nigeria where the trade or business or activities is between the company and another person controlled by it or which has a controlling interest in it and conditions are made or imposed between the company and such person in their commercial or financial relations which in the opinion of the Board is deemed to be artificial or fictitious, so much of the profit adjusted by the Board to reflect the arm's length transaction.[36]

This situation changed in 2012 with the issuance of TPR12 which was subsequently replaced by TPR18. The TP Regulations seek to, *inter alia,* ensure that Nigeria is able to tax on an appropriate taxable basis corresponding economic activities deployed by taxable persons in Nigeria, including their transactions and dealing with related persons; and provide the Nigerian tax authorities with the tools to fight tax evasion that may arise through over or under pricing of transactions between related persons.[37] The Regulations govern transactions between "connected persons" including the transfer, purchase, license or use of intangible assets.[38]

3.1 The Arm's Length Principle

The TP Regulations require that transactions between connected persons be conducted in a manner that is consistent with the arm's length standard (ALS) or arm's length principle (ALP).[39] A controlled transaction is at arm's length if the conditions of the transaction do not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances.[40] Where a connected person fails to comply with the ALP, the tax authority may make adjustments to bring the transaction in compliance therewith.[41] Basically, the ALS attempts to impose the realities of similar transactions amongst unrelated parties on intra-group transactions.[42] As such, the ALS was conceived as a system that requires connected persons to set the prices of their transactions in a similar manner as independent parties in comparable transactions. ALS, therefore, consists of comparing intra-group transactions to open market transactions and taxing them accordingly. Transfer pricing leads to various adjustments in

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[34] See Lolade Ososami, Joseph Eimunjeze & Mojisola Jawando, "Nigeria" in Steve Edge & Dominic Robertson, eds, *The Transfer Pricing Reviews*, 3rd ed (London: Law Business Research, 2019) 195.
[35] Companies Income Tax Act 1961, Cap C21, Laws of the Federation of Nigeria 2004, as amended [CITA].
[36] For a similar DTA provision, see Article 9 of the *Nigeria-Canada Income Tax Treaty*, 4 August 1992, E102399 - CTS 1999 No. 48. For a relevant GAAR prescription, see section 22 of the CITA *ibid*.
[37] See regulation 2 of TPR18.
[38] See paragraph 3(1)(c) of TPR18. Regulation 12 specifies that persons are deemed 'connected' where one person has the ability to control or influence the other person in making financial, commercial or operational decisions.
[39] These acronyms are used interchangeably in this paper.
[40] Sub-regulation 4(2).
[41] Sub-regulation 4(3).
[42] Zachée Pouga Tinhaga, "From Avoiding 'Double Taxation' Yesterday to Avoiding 'Double Non-Taxation' Today: The Urgent Need for an International Tax Regime Based on Unitary Tax Principles" (SJD Dissertation, University of Michigan Law, 2006), online: https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1005&context=sjd, at 129.

the event the intra-group pricing does not agree with the independent parties' open market transactions.[43]

The ALP is contained in both the OECD and UN Transfer Pricing models and its methods are enshrined in Nigerian law by TPR18. The Regulations incorporate five methods for attaining an arm's length pricing. Sub-regulation 5(1) provides that:

> In determining whether the result of a transaction or series of transactions are consistent with the arm's length principle, one of the following transfer pricing methods shall be applied-
> (i) the Comparable Uncontrolled Price ('CUP') method;
> (ii) the Resale Price method;
> (iii) the Cost Plus method;
> (iv) the Transactional Net Margin method;
> (v) the Transactional Profit Split method; or
> (vi) any other method which may be prescribed by Regulations made by the Service from time to time.

I briefly discuss these methods below.

3.1.1 Comparable Uncontrolled Price Method

The first transfer pricing method prescribed in TPR18 is the Comparable Uncontrolled Price ("CUP").[44] Under this method, the transaction between the related parties is compared to a transaction in the same good or service, in the same market, under similar conditions, but between unrelated parties. The CUP method is only useful if the goods or services are standard enough that they can be found in the open market.[45] There is a requirement that the comparable be close to the actual transaction if not identical to the actual transaction except that it is occurring between unrelated parties unlike the actual transaction which is between related parties.[46] CUP is reliable where none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or reasonably accurate adjustments can be made to eliminate the material effects of such differences.[47] If such comparable is found, the transfer price is adjusted to the price in the comparable transaction and taxed accordingly.

3.1.2 Resale Price method

The Resale Price Method ("RPM") evaluates whether the amount charged in a controlled transaction is at arm's length, by reference to the gross margin realized in comparable uncontrolled

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[43] *Ibid*, 129
[44] Regarded, alongside the resale price method and the cost plus method, as one of the three traditional methods is (one of three the traditional methods). See Tinhaga *ibid*.
[45] *Ibid.*
[46] *Ibid.*
[47] See Mbiki Kamanjiri, "Welcome to Transfer Pricing," *Grant Thornton* (2017) online: https://www.icpak.com/wp-content/uploads/2017/06/Welcome-to-Transfer-Pricing-by-Mbiki-Kamanjiri.pdf

transactions.[48] Under this method, the arm's length price is measured by subtracting an appropriate gross profit from the applicable resale price of the property involved in the controlled transaction. RPM uses comparable profitability, and comparable profitability is determined by calculating the ratio of the initial purchase price of comparable tangible goods to their resale price to an unrelated party. This ratio (expressed as a percentage) is then used to calculate the value of the goods in a related-party transaction.

3.1.3 Cost Plus Method

The cost-plus method compares gross margins of controlled and uncontrolled transactions. Under this method, the arm's length price is measured by adding an "appropriate" gross profit to the controlled taxpayer's cost of producing the property involved in the controlled transaction. Under Cost Plus, the amount needed to produce is added to the prevalent profit margin (from uncontrolled transactions) to determine the arm's length transfer price.[49]

3.1.4 Transactional Net Margin Method

The fourth transfer pricing method is the Comparable Profits Method ("CPM") which is also known as the Transactional Net Margin Method ("TNMM"). This method evaluates whether the amount charged in a controlled transaction is at arm's length by comparing the profitability of one of the parties to the controlled transaction (the "tested party") to that of companies that are similar to the tested party.[50] Application of this method entails assembling a sample of standalone companies that are similar to the tested party principally in terms of resources employed and risks assumed. Unaffiliated firms need only perform broadly similar functions and operate in broadly similar product markets as the tested party.[51] The analysis of the reasonably similar industries provides a range of prices allowing for a curve where the bottom 25% and the top 25% of the curve are excluded. If the profits realized on the controlled transaction fall within the middle 50%, no further analysis is required. However, if the related parties' transaction does not fall within the middle 50%, then the tax authority can make adjustments.[52]

3.1.5 Transactional Profit Split Method (TPSM)

The TPSM allocates operating profits or losses from controlled transactions in proportion to the relative contributions made by each party in creating the combined profits or losses. Relative contributions must be determined in a manner that reflects the functions performed, risks assumed, resources employed, and costs incurred by each party to the controlled transaction.[53] A strength of the transactional profit split method is that all relevant parties to the transaction are directly evaluated as part of the pricing of the transaction; that is, the contributions of each party to the

[48] Tinhaga *supra* note 42 at 131.
[49] *Ibid* at 130.
[50] *Ibid* at 132.
[51] Elizabeth King, *Transfer Pricing and Corporate Taxation: Problems, Practical Implications and Proposed Solutions*, (New York: Springer, 2009) at 12.
[52] Tinhaga, *supra* note 42 at 132.
[53] *Ibid.*

transaction are specifically identified and their relative values measured in order to determine an arm's length compensation for each party in relation to the transaction.[54] A profit split method is particularly appropriate where there are significant intangibles being transferred between related corporations.[55]

The transfer pricing methods that I have discussed here are alternatives that may, depending on the facts, be applied to the various forms of transaction (goods, services and intangibles). A taxpayer is at liberty to select any of these methods that it deems appropriate. The FIRS can, however, accept or reject the taxpayer's method if it deems that another method is more appropriate for the transaction.[56] I now focus on the subject of intangibles and the transfer pricing issues around them, including the transfer pricing methods and valuation methods that may be applied to them.

3.2 Transfer Pricing and Intangibles

The relevance of intangibles to business success has been increasing since the 1970s.[57] Intangibles affect nearly every aspect of economic activity in the twenty-first century. They have become a major source of sustainable competitive advantage for many firms.[58] They are seen as the main driver of value creation and a major source of sustainable competitive advantage for a majority of multinationals, now more so than ever.[59] In context, the five largest U.S. public companies in 2016 by market capitalization were Apple, Alphabet (Google), Microsoft, Exxon-Mobil, and Amazon (companies that rely heavily on intellectual property); whereas, fifty years earlier, the top five by the same measure were AT&T, IBM, General Motors, ExxonMobil, and Kodak.[60] The information and communication technology (ICT) revolution has made some technologies cheaper and more powerful, enabling improvement of business processes and boosting innovation across virtually all sectors of the economy.[61] Depending on the structure and strategies of their businesses, MNEs often share ideas, innovations, formulas, and so forth – some of which qualify as intangibles – that are pertinent to the development of products or the furtherance of the business processes of the

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[54] See OECD, "Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10, OECD/G20 Base Erosion and Profit Shifting Project 2018," online: www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf, para 2.122,

[55] See Anita Anand & Kimberley Brooks, "The Allocation of Profits between Related Entities and the Oppression Remedy: An Analysis of Ford Motor Co. V Omers," (2004) 36:1 Ottawa L Rev 127 at 147.

[56] See *Prime Plastichem Nigeria Limited v Federal Inland Revenue Service* [unreported] Appeal No. TAT/LZ/CIT/015/2017: decided on 19 February 2020. (on file with the author).

[57] Martin Lagarden, "Intangibles in a Transfer Pricing Context: Where Does the Road Lead?" (2014) 21:5 Intl Transfer Pricing J 331.

[58] United Nations, Committee of Experts on International Cooperation in Tax Matters, "Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries. Coordinator's Report on Work of the Subcommittee on Transfer Pricing", *United Nations*, (7 October 2016), online: https://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP2_TransferPricing.pdf [UN TP Manual Update Report]

[59] Mohamed Serokh, "Intangibles: Tax Risks and Opportunities for Multinational Groups," *PwC* (9 April 2018), online: https://www.pwc.com/m1/en/blog/intangibles-tax-risks-opportunities-multinational-groups-serokh.html

[60] Alan J Auerbach, "Demystifying the Destination-Based Cash-Flow Tax", (2017) 2017:2 Brookings Papers on Economic Activity 409, online: https://muse-jhu-edu.ezproxy.library.dal.ca/article/688910/pdf, at 413.

[61] UN TP Manual Update Report *supra* note 58.

MNE. These intangible assets may include technical knowhow, patents, brand names, trademarks, and goodwill.[62] The increasing interconnectedness of the global economy underscores the need for MNEs to deploy their intangible assets on a global scale to ensure that their subsidiaries' operations are aligned with those of the group, including the use of the headquarters' technologies to boost productivity of the local core activities.[63] It also underscores the onus on tax authorities to ensure that the inter-deployment of intangibles by MNEs is not used to mastermind unwholesome tax avoidance. This is because given the high value often attached to intangibles, their use can induce damaging outflows – from a tax perspective – if left unchecked.[64] A case in point is *GlaxoSmithKline Holdings (Americas) Inc. v Commissioner of Internal Revenue.*[65] In this case, a pharmaceutical company and the US Internal Revenue Service (IRS) reached a 3.4 billion United States dollars (USD) settlement[66] after more than a decade of legal battle over the correct transfer prices the company paid to its UK parent for several drugs. The battle was mainly over the value of R&D versus marketing and selling expenses.

In *Norway v Cytec Norway KS v Norway,*[67] the court was asked to determine whether Cytec Norway KS (now Allnex Norway A/S) had paid an arm's length price for an intra-group transfer of intangibles (goodwill) in 2010. Cytec Norway KS had determined the price for the acquired intangibles to be NOK210 million which it deemed deductible from its taxable income. The Norwegian tax authorities found that no intangibles had been transferred and disallowed the deduction. The Tax Appeals Committee determined that intangibles had been transferred but only at a total value of NOK45 million. The Court of Appeal upheld the decision of the Tax Appeals Committee.

In an earlier case, *Cytec Norge GP AS v Norway,*[68] the appellant transferred certain intangibles (customer portfolio, technology, trademarks and goodwill) to a related entity, Cytec Industries Europe (the Netherlands), apparently without compensation. The court found that Cytec Norge AS held intellectual property rights of considerable value prior to is restructuring in 1999, and that the Norwegian entity should have received an arm's length compensation when these rights were transferred to the related Dutch entity. The court, thus, upheld the Norwegian tax authorities' calculation of remuneration and the increase of taxable income. An appeal to the Supreme Court was dismissed in 2008.

Nigeria is one of many states trying to catch-up with the regulation of the transfer pricing of intangibles. Neither TPR18 nor the statutes which it seeks to supplement defines the term

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[62] Victor Adegite & Nwakaego Ogueri-Onyeukwu, "Transfer Pricing and the Right to Use Intangibles in Nigeria: Is the Arm's-Length Principle at Risk?" (2019) Tax Notes Intl 137 at 138.
[63] *Ibid.*
[64] See *Nestle Holdings Inc. v C.I.R.* 152 F.3d 83 (1998); *Medieval Attractions N.V v Commissioner* 1996-455 (RIA) 3277.
[65] 117 T.C. No. 1 (2001).
[66] Robert Guy Matthews & Jeanne Whalen, "Glaxo to Settle Tax Dispute with IRS Over U.S. Unit for $3.4 Billion," *The Wall Street Journal* (12 September 2006), online: https://www.wsj.com/articles/SB115798715531459461
[67] LB 2017-90184.
[68] LRD-2007-1400.

"intangible."[69] Thus, recourse must be had to external sources. The Oxford Advanced Learner's Dictionary of English Language defines the term "intangible" as "(business) that does not exist as a physical thing but is still valuable to a company."[70] The same dictionary further describes intangible as something "that exists but that is difficult to describe, understand or measure."[71] This description, perhaps, best epitomizes the volatile character of intangibles and the special challenges that they pose in the context of transfer pricing. Indeed, the OECD acknowledges that difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. If an overly narrow definition is applied, either taxpayers or governments may argue that certain items fall outside the definition and may therefore be transferred or used without separate compensation, even though such use or transfer would give rise to compensation in transactions between independent enterprises. If too broad a definition is applied, either taxpayers or governments may argue that the use or transfer of an item in transactions between associated enterprises should require compensation in circumstances where no such compensation would be provided in transactions between independent enterprises.[72] A case in point is *Amazon Inc. & ors. v Commissioner of Internal Revenue.*[73] In this case, Amazon, a US-based online retailer with highly profitable intangible assets, restructured its European businesses in a way that would shift a substantial amount of its income from US-based entities to newly created European subsidiaries between 2005 and 2006. Because the restructuring would allow the European entities to generate income using Amazon's pre-existing intangible assets developed in the US, the US tax code and corresponding regulations required that the European entities compensate Amazon for the use of assets that meet the regulatory definition of an "intangible." The compensation was provided through a cost sharing arrangement, whereby Amazon and a holding company for the European subsidiaries would be treated as co-owners of the intangibles. Under the arrangement, the holding company was required to make a "buy-in" payment for the pre-existing intangibles Amazon contributed to the arrangement and to make cost sharing payments going forward for its share of future research and development (R&D) efforts. The buy-in payment was taxable income to Amazon, and the holding company's cost sharing payments would reduce Amazon's US tax deductions for R&D costs. To guard against manipulation by jointly controlled entities, the regulations required that the buy-in payment reflect the fair market value of the pre-existing intangibles made available under a cost sharing

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[69] TPR18 seeks to regulate transfer pricing as contemplated in the Companies Income Tax Act, Cap C21 Laws of the Federation of Nigeria 2004 (as amended); the Petroleum Profits Tax Act, Cap P13, Laws of the Federation of Nigeria 2004 (as amended); the Personal Income Tax Act, Cap P8, Laws of the Federation of Nigeria 2004 (as amended), the Capital Gains Tax Act, Cap C1 Laws of the Federation of Nigeria 2004; and the Value Added Tax Act, Cap V1 Laws of the Federation of Nigeria 2004. See regulation 1.

[70] Oxford Advanced Learner's Dictionary of English Language, online: https://www.oxfordlearnersdictionaries.com/definition/english/intangible_2

[71] *Ibid.*

[72] OECD, "Guidance on Transfer Pricing Aspects of Intangibles, OECD/G20 Base Erosion and Profit Shifting Project" (2014), online: https://read.oecd-ilibrary.org/taxation/guidance-on-transfer-pricing-aspects-of-intangibles_9789264219212-en#page20 [OECD Guidance on TP Aspects of Intangibles], para 6.5.

[73] (2019) No. 17-72922.

arrangement. Amazon initially reported a buy-in payment of about US$255 million. The Internal Revenue Service (IRS) concluded that the buy-in payment had not been determined at arm's length and so performed its own calculation, valuing the buy-in at about US$3.6 billion. Amazon filed a petition in the United States Tax Court challenging the IRS's valuation. In the tax court proceedings, Amazon and the Commissioner offered competing methods for valuing Amazon's pre-existing intangibles. While Amazon's method isolated and valued only the specific intangibles that it transferred to the European holding company under the cost sharing arrangement, including website technology, trademarks, and customer lists, the IRS essentially valued the entire European business, minus pre-existing tangible assets. The IRS's method necessarily swept into the calculation all contributions of value, including those that are more "nebulous and inseparable from the business itself," like the value of employees' experience, education, and training (known as "workforce in place"), going concern value, goodwill, and other unique business attributes and expectancies (which the parties refer to as "growth options"). The tax court sided primarily with Amazon, and the Commissioner appealed. The case required the Court of Appeal to interpret the meaning of an "intangible" in the then applicable transfer pricing regulations. It was a question of whether, as the Commissioner argued, the regulatory definition was broad enough to include all intangible assets of value, even the more nebulous ones that the Commissioner referred to as "residual-business assets" (i.e., Amazon's culture of innovation, the value of workforce in place, going concern value, goodwill, and growth options). The Court concluded that the definition did not include residual-business assets. Although the language of the definition was ambiguous, the drafting history of the regulations, according to the Court, showed that "intangible" was understood to be limited to independently transferrable assets. The U.S. Court of Appeal for the 9th Circuit, thus, affirmed the decision of the U.S. Tax Court to the effect that the definition of "intangible", as it then was, did not include residual-business assets, and that the definition was limited to independently transferrable assets.[74]

The OECD Guidance on Transfer Pricing Aspects of Intangibles defines an intangible as "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances."[75] This

[74] This case was governed by regulations promulgated in 1994 and 1995. In 2009, more than three years after the tax years at issue here, the Department of Treasury issued temporary regulations broadening the scope of contributions for which compensation must be made as part of the buy-in payment. *See* 74 Fed. Reg. 340 (Jan. 5, 2009). In 2017, the US Congress amended the definition of "intangible property" in 26 U.S.C. § 936(h)(3)(B) (which is incorporated by reference in 26 U.S.C. § 482). Tax Cuts and Jobs Act of 2017, Pub. L. 115-97, § 14221(a), 131 Stat. 2054, 2218 (2017). The Court noted that if this case were governed by the 2009 regulations or by the 2017 statutory amendment, there was no doubt that the Commissioner's position would be correct. In other words, the case would have been decided differently.

[75] OECD Guidance on TP Aspects of Intangibles *supra* note 72, para 6.6. I take the view that by virtue of regulation 18 of TPR18 this definition could be the operative definition in Nigeria. Regulation 18 permits the FIRS to apply transfer pricing guidance formulated by the UN and the OECD. So, in theory at least, this guidance may be deployed by the tax authority even though it was subsequent to the TP Regulations. In *Prime Plastichem Nigeria Limited v FIRS supra* note 44 – Nigeria's first TP case – both parties, as well as the court, recognized the application of the OECD/UN Guidelines in Nigeria.

definition attempts to be all-encompassing, and it tries to allow room for the different tax rules and interpretations in different countries.[76] Broken down, the definition connotes that an intangible is something which (1) is not a physical or financial asset; (2) is capable of being owned or controlled for use in commercial activities; and (3) the use or transfer would be compensated had it occurred in a transaction between independent parties under comparable circumstances.[77] Lagarden has identified certain qualities that can be used to identify intangibles. These include a lack of physical substance (i.e. separation from tangible goods); non-monetary character (i.e. separation from financial assets); identifiability (i.e. precondition for transfer); separability (i.e. precondition for transfer); controllability (e.g. in contrast to certain local market features); future economic relevance/utility (i.e. basic value criterion); and different conceivable forms of ownership.[78]

The OECD Guidance on Transfer Pricing Aspects of Intangibles states that intangibles that are important to consider for transfer pricing purposes are not always recognised as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalized for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may nevertheless be used to generate significant economic value and may need to be considered for transfer pricing purposes. Furthermore, the enhancement to value that may arise from the complementary nature of a collection of intangibles when exploited together is not always reflected on the balance sheet. Accordingly, whether an item should be considered an intangible for transfer pricing purposes under Article 9 of the OECD Model Tax Convention can be informed by its characterization for accounting purposes but will not be determined by such characterization only. Also, the determination that an item should be regarded as an intangible for transfer pricing purposes does not determine or follow from its characterization for general tax purposes, as, for example, an expense or an amortizable asset.[79] It is also, perhaps, necessary to iterate that intangibles are different from services (and vice versa) and should not be confused as such.

In *Vodacom Business Nigeria Limited (Vodacom) v Federal Inland Revenue Service,*[80] the Nigerian Court of Appeal upheld a decision of the Federal High Court[81] to the effect that the supply of satellite bandwidth capacities from a nonresident company to Vodacom, a Nigerian company, was subject to Value Added Tax (VAT) in Nigeria. The court determined that the "service" was supplied to a destination in Nigeria, thus taxable in Nigeria. Of course, the question of whether bandwidth is indeed a service (or an intangible) was neither argued nor determined. However, by the courts' holding, it seems clear that bandwidth was subsumed as a service without the requisite

[76] Adegite *supra* note 62 at 137.
[77] See Margaret Critzer et al, "DEMPE – Development, Enhancement, Maintenance, Protection & Exploitation of Intangibles." (Paper presented at the Global TP Conference, Amsterdam, The Netherlands, 29-30 November 2018), online: http://www.taxand.com/wp-content/uploads/2018/11/DEMPE-of-Intagibles-November-2018.pdf
[78] Lagarden, *supra* note 57 at 335.
[79] OECD Guidance on TP Aspects of Intangibles *supra* note 72, para 6.7.
[80] (2019) LPELR-47865(CA).
[81] *Vodacom Business Nigeria Limited v Federal Inland Revenue Service* [unreported] Suit No. FHC/L/4A/2016.

consideration or distinction. The need for clarity is important because such characterisations can have tax implications. For instance, in the Vodacom case, aforementioned, if the bandwidth supplied was determined to be an intangible – as distinguished from a service – then perhaps, the Value Added Tax Act would not have applied, since the Act only taxes the supply of "goods and services." It has been remarked, in response to the earlier Federal High Court decision in the *Vodacom* case, that "*Bandwidth is synonym for data transfer rate; it is the amount of data that can be carried from one point to another in a given time. Greater bandwidth indicates greater capacity. Bandwidth is invisible and so, is not goods. However, it is not human exertion, but data transfer capacity, and so, would not qualify as service*."[82] Incidentally, this argument was not under consideration, so there is no knowing whether it would have affected the outcome. The case does, however, reflect the importance of drawing those lines to avert unintended tax consequences. Indeed, if comparisons are to be drawn, intangibles have all the salient economic characteristics of goods and nothing in common with services.[83] In the global economy their production and distribution are organized in patently different ways from services. Treating them as services not only obscures the real nature and economic significance of intangibles but also causes confusion about the true characteristics of services.[84]

3.2.1 Classification of Intangibles

TPR18 does not classify intangibles, but intangibles are sometimes classed between trade intangibles and marketing intangibles, between "soft" intangibles and "hard" intangibles, between routine and non-routine intangibles, and between other classes and categories of intangibles.[85] Moreover, intangibles (and IP) may be categorized with reference to contrasting terms, such as "ground breaking (or break through)" as opposed to "me too" on one hand, or alternatively "ground breaking (or break through)" versus "incremental", on the other.[86] This broad characterization gains importance when companies are looking for relevant comparable data to assess and document the arm's length character of transactions involving their intangibles and IP, respective prices or other conditions negotiated; the timing within the lifecycle of the intangibles when a valuation is actually conducted; or the selection of an applicable valuation method "fit for the purpose".[87] For the purpose of this paper, I will not dwell on such categorizations. I would,

[82] Kingsley N Amaefule, "Vodacom v FIRS - Are intangibles goods, services or neither?" *Ajumogobia & Okeke* (18 March 2018), online: http://www.ajumogobiaokeke.com/wp-content/uploads/2018/03/pdf-Newsletter-on-Intangibles-Goods-services-or-neither.pdf
[83] Peter Hill, "Tangibles, Intangibles and Services: A New Taxonomy for the Classification of Output," (1999) 32:2 Canadian J Economics 426.
[84] *Ibid*. It seems that this confusion has now been put to bed by the recently enacted Finance Act 2019. Section 46 of the Finance Act, which amends section 46 of the VAT Act provides that "goods" means… "(b) any intangible product, asset or property over which a person has ownership or rights, or from which he derives benefits, and which can be transferred from one person to another excluding interest in land."
[85] See, for instance, Margaret M Blair & Steven H Wallman, *Unseen wealth: Report of the Brookings task force on understanding intangibles sources of value* (Washington DC: The Brookings Institution Press, 2000).
[86] Lagarden *supra* note 57 at 335.
[87] John Henshall & Roy Donegan, *Global Transfer Pricing: Principles and Practice,* 2nd ed., (London: Bloomsbury Professional, 2013) at 97.

however, note that intangibles are common in Nigeria and various forms are traded on the Nigerian market, including the kinds listed by the OECD.[88] The modes of trading in intangibles are discussed in the next sub-paragraph.

3.2.2 Categories of Transactions

Cross-border transactions within multinational enterprises involving intangibles may be grouped into three major categories, namely (i) acquisition or sale, (ii) licensing and (iii) R&D cost sharing.[89]

a. Licensing

Licensing involves the contractual right to use certain intangible, but without a transfer of ownership in the intangible. Consequently, the licensor continues to be the legal owner of the licensed intangible.[90]

b. Research and Development (R&D) Cost Sharing

R&D cost sharing deals with the joint development and/or utilization of IP (and/or intangibles).[91] This rather complex set-up creates several challenges, such as the valuation and pricing of pre-existing relevant IP (and/or intangibles) when an R&D pool is formed for the first time, the pricing of entry or exit fees for (potentially additional) pool participants over time, the establishment of (an) arm' s length allocation key(s) for ongoing R&D expenses incurred by pool members and also the question of ownership of the IP that is newly created in the pool.[92]

c. Acquisition or Sale

In an acquisition or sale, a transfer of *ownership* takes place. Before concluding the transaction, an arm's length price will be established, including a valuation or some kind of value estimation, and be negotiated between the parties to the transaction.[93]

3.2.3 Determining Appropriate Remuneration for Intangibles

In determining the appropriate remuneration that is payable for a transaction in intangibles, TPR18 prescribes a guide that must be used by taxpayers and tax administrators. Sub-regulation 7(2) of the Regulations provides as follows:

> 7(1) The determination of arm's length conditions for controlled transactions involving the exploitation of an intangible <u>shall take into account the contractual arrangements</u> and the

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[88] Intangibles mentioned by the OECD for transfer pricing purposes include patents; know-how and trade secret; trademark, trade names and brand; Rights under contracts and government licenses; licenses and similar limited rights in intangibles; and goodwill and ongoing concern value. See <u>OECD Guidance on TP Aspects of Intangibles</u> *supra* note 72, paras 6.19–6.31.

[89] Lagarden *supra* note 57 at 333. TPR18 makes "consistent references to license, sale or other transfer", which put together, does not appear to differ from the grouping herein.

[90] *Ibid.*

[91] *Ibid.*

[92] *Ibid.*

[93] *Ibid.*

following factors with regard to the development, enhancement, maintenance, protection and exploitation of the intangible asset, the-

(a) Functions performed by the person;
(b) Management and control of those functions;
(c) Contribution by the person of assets, including financial assets;
(d) Management and control regarding the contribution of assets including financial assets;
(e) Risks assumed by that person; and
(f) Management and control of those risks.

The above provisions mirror the OECD's recommendation that an analysis of cases involving the use or transfer of intangibles should begin with a thorough comparability analysis, including a functional analysis.[94] The functional analysis should identify the *functions* performed, *assets* used, and *risks* assumed by each relevant member of the MNE group; and in cases involving the use or transfer of intangibles, it is *especially important to ground the comparability and functional analysis on an understanding of the MNE to add or create value across the entire supply chain*.[95] In other words, in order to determine arm's length conditions for the use or transfer of intangibles it is important to consider as part of the comparability and functional analysis: (i) the identification of specific intangibles; (ii) the legal ownership of intangibles; (iii) the contributions of MNE group members to their development, enhancement, maintenance, protection and exploitation; and (iv) the nature of the controlled transactions involving intangibles including the manner in which such transactions contribute to the creation of value, including the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.[96]. On that foundation, it is then necessary to consider the remuneration that would be paid between independent parties in transactions involving intangibles.[97] While it may be appropriate to aggregate intangibles for the purpose of determining arm's length conditions for the use or transfer of the intangibles in certain cases, it is not sufficient to suggest that vaguely specified or undifferentiated intangibles have an effect on arm's length prices or other conditions. A thorough functional analysis, including an analysis of the importance of identified relevant intangibles in the MNE's global business, should support the determination of arm's length conditions.[98] A good functional analysis must also: fully understand the economics of the particular business and its markets; aim to highlight the distinctiveness of the goods/services produced and the sensitivity of demand to price; recognise invisible factors not evident from the accounts; and identify the relative level of risk carried by the various group companies.[99] The functional analysis is important as it provides an overview of value creation within the supply chain in general and the related party

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[94] OECD Guidance on TP Aspects of Intangibles *supra* note 72 at 27.
[95] *Ibid*, para 6.3.
[96] OECD Guidance on TP Aspects of Intangibles *supra* note 72 at 6.12.
[97] *Ibid*, para 6.4
[98] *Ibid*, para 6.12
[99] Lynn Oats *et al supra* note 31 at 420.

transaction in particular.[100] It provides an understanding of the relative contributions of the parties to the transaction and their roles in overall value creation.[101] It is not the volume of functions an entity performs that is important for the analysis – it is the economic significance of those functions in terms of their frequency, nature and value to the respective parties to the transactions. The functions and their significance should be viewed in light of the value drivers of the business.[102]

The place of an efficient functional evaluation is highlighted by the US Court of Appeal's decision in *Medtronic Inc. & Consolidated Subsidiaries v Commissioner of Internal Revenue*.[103] In this case, the US Court of Appeal for the 8th Circuit vacated a decision of the Tax Court that had applied the Comparable Uncontrolled Price method to a transfer pricing arrangement involving intercompany licences between a US company and its Puerto Rico-based subsidiary. The IRS argued that the Comparable Profit Method (similar to the Transactional Net Margin Method) was applicable, while the appellant advocated the CUP. The Tax Court had held for the taxpayer, albeit with modifications on the price. The Court of Appeal did not take a position on the best applicable method, but based its decision to vacate and remand the case for further consideration on the ground that the decision of the lower court was not founded on sufficient functional and comparability analysis to determine the best method to be applied and the appropriate comparability adjustments.

In another U.S. case, *DHL Incorporated and Subsidiaries v Commissioner of Internal Revenue,*[104] involving the sale of intellectual property (DHL's trademark) by DHL to DHL International (DHLI), the IRS disagreed with DHL's evaluation of the arms-length price of the intellectual property and reallocated income to DHL. DHL's appeal to the Tax Court was dismissed. On further appeal to the US Court of Appeals for the Ninth Circuit, the court partly affirmed the Tax Court's decision but reversed that part of it that rejected a $50million value of the foreign trademark rights, as asserted by DHL. The court found that DHLI, formed shortly after DHL began operations, was the only entity that moved packages out of the United States, and between all foreign points; and that DHLI thus developed both the trademark in foreign countries and the service network that was the foundation for the trademark. DHLI undertook the registration of the "DHL" trademark in numerous foreign countries and bore essentially all related costs. Furthermore, DHLI paid for all the overseas marketing campaigns with the "DHL" trademark. According to the court, since developing a trademark includes advertising that mark, it does not make sense to distinguish between typical marketing activity and development. On the basis of these functions performed by DHLI, the court held that DHLI was the developer of the "international trademark," in which case no allocation to DHL for the value of the foreign

[100] Kestutis Rudzika, "What is functional analysis?" *RoyaltyRange* (October 2017), online: https://www.royaltyrange.com/home/blog/what-is-functional-analysis
[101] *Ibid.*
[102] *Ibid.*
[103] (2018) No. 17-1866.
[104] (2002) Nos. 99-71580, 00-70008, 99-71592 and 99-71675.

trademark rights was appropriate, or, alternatively, that DHLI provided assistance to DHL's development, thereby entitling DHL to a complete set-off against the $50 million allocated to DHLI.

A well-conducted functional analysis can enable both the tax authority and the court – in the case of litigation – obtain a clear picture of who did what and who deserves to be compensated for what. In the case of *Switzerland vs S SA*,[105] the Swiss Federal Supreme Court upheld the disallowance of intercompany royalty payments made by a Swiss company to its offshore parent company. The Court agreed with the tax authority that the payments were not commercially justified because, as the analysis showed, the offshore parent did not have the required substance to perform the functions that would entitle it to any royalty payments. The parent company was not involved in the group's R&D activity and had no/very few employees. The parent company was not even the legal owner of the assets as the patents were registered in the name of another group member, based in France. This subsidiary (S SA) had 60 employees and made all the strategic decisions over the R&D functions.

The functions considered under a functional analysis are development, enhancement, maintenance, protection and exploitation (DEMPE).[106] Development entails everything associated with coming up with ideas for intangibles, and putting plans and strategies in place for their creation; enhancement refers to continuing to work on aspects of intangibles to make sure they can perform well at all times and continue to be improved; maintenance consists of actions that ensure intangibles continue to perform well and generate revenue; protection entails ensuring that the value of the intangible remains strong; and exploitation refers to the way in which intangibles are used to generate profits.[107] Performing or exercising control over the functions that contribute most to value drivers has the biggest impact on overall value creation and, ultimately, profits from the transaction.[108] The functions performed and especially risks assumed can significantly affect the profitability of the entity that performs the functions and assumes the risks.[109] Further, it is typically the case that the functions correlate with the risks and also impact the assets used. A functional analysis is usually performed during a functional analysis interview meeting or call.[110] Interviews and meetings provide a description of the material controlled transactions and the context in which they take place.[111] It also documents the functions performed, risks assumed and assets used with respect to these transactions. The functional analysis provides the factual

[105] 2C_11/2018.
[106] Margaret Critzer *et al*, *supra* note 77.
[107] *Ibid*
[108] Rudzika *supra* note 100.
[109] *Ibid*
[110] *Ibid*
[111] *Ibid.* With the potentially greater information availability intended by the mandatory TP filings, Country-by-Country reporting and cooperative information exchanges between tax authorities, it may be more tenable for tax officers to perform such analyses on the basis of information and documentation at their disposal. However, meetings and interviews would remain crucial to clarify positions and also, maybe, reduce the risk of conflict.

background and is used to establish the transfer pricing methodology based on the OECD's transfer pricing guidance.[112]

3.2.4 Selecting the Appropriate Pricing Method

After performing the functional analysis to determine the parties' functional profiles, the application of a transfer pricing method, with the associated evaluation of comparable transactions, may be considered.[113] This entails a selection of the transfer pricing methods – from those specified in sub-regulation 5(1) TPR18 – that is most suitable in allocating remuneration to the ascertained functions/risks. The selection/determination must take into account four factors. These are:

a) The strengths and weaknesses of the respective transfer pricing method in circumstances of the case at hand;
b) The nature of the controlled transaction determined through an analysis of the functions, assets and risk profiles of a party to the controlled transaction;
c) The availability of reliable information; and
d) The degree of comparability between controlled and uncontrolled transactions, including the reliability of adjustments if any, that may be required to eliminate any differences between comparable transactions.[114]

It should be noted that a taxpayer may, however, apply a method that is not listed in the TP Regulations provided it can establish to the satisfaction of the tax authority that none of the listed methods is workable in the circumstances; that the method used gives a result that is consistent with the ALP; and that reliable information needed to apply the chosen method exists.[115] These conditions are cumulative; and whist a taxpayer has agency over what method to apply, the end results must apportion remunerated on a function/asset/risk = reward basis. This means that a party must not only nominally perform/bear, but actually control and be able to manage the function/asset/risk for which it is compensated. More so, considering the provision of regulation 8 of TPR18, it is inferable that a capital rich low function entity that merely finances the development of an intangible would only earn a risk-free return rather than the return from the exploitation of the intangible.[116] The tax authority has a duty to ensure that the a method overrule is predicated on solid grounds and not on the basis of arbitrary exercise of administrative power. As an illustration, in the U.S. case of *Veritas Software Corp. v Commissioner*,[117] the plaintiff entered into a cost-sharing transaction with its foreign subsidiary to develop and manufacture storage management software products. Pursuant to this arrangement, the plaintiff granted the

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[112] *Ibid.*
[113] UN TP Manual 2017 *supra* note 17, para B.3.1.2.8.
[114] Sub-regulation 5(2) of TPR18.
[115] See sub-regulation 5(4) of TPR18.
[116] Regulation 8 of TPR18 provides that "a capital rich, low function company that does not control the financial risks associated with its funding activities, for tax purposes, shall not be allocated the profits associated with those risks and will be entitled to no more than a risk-free return. The profits or losses associated with the financial risks would be allocated to the entity (or entities) that mange those risks and have the capacity to bear them."
[117] 133 TC 297 (2009).

subsidiary the right to use certain preexisting intangibles overseas. As consideration for the transfer of preexisting intangibles, the subsidiary made a $166 million buy-in payment to the plaintiff. The plaintiff reached this outcome on the CUP method. The respondent rejected the sum received by the plaintiff and employed an income method to determine the sum of $2.5 billion as the arm's length buy-in payment. This was subsequently revised to $1.675 billion by the respondent. The respondent further determined that the requisite buy-in payment must take into account access to the plaintiff's team and the plaintiff's distribution channels, customer lists, trademarks, trade names, brand names and sales agreements. The United States Tax Court upheld the plaintiff's contention that the respondent's determinations were arbitrary, capricious, and unreasonable and that the CUP method was the best method to calculate the requisite buy-in payment. The Court also determined that in calculating the $1.675 billion allocation, the plaintiff relied on an inapplicable law, used the wrong useful life for the products and the wrong discount rate and, admittedly, did not know precisely which items were valued.

Sub-regulation 7(3) of TPR18 provides that "*the determination of arm's length conditions for controlled transactions involving licenses, sales or transfers of intangible property between connected persons shall take into account both the perspective of the transferor of the property and the perspective of the transferee, including in particular the pricing at which a comparable independent person would be willing to transfer the property and the value and usefulness of the intangible property to the transferee in its business*." It seems, from the wording used, that there is noticeable emphasis on comparability here.[118] This supposes that the CUP method is the starting point in deciding how to apportion remuneration from intangibles under TPR18. Essentially, the reward to be received by a connected person for its ascertained function, asset and risk (FAR) contribution to the development, enhancement, maintenance, protection and/or exploitation of an intangible should be ascertained with recourse to what a person who makes similar contributions in an uncontrolled transaction would ordinarily be entitled to. This requirement reflects the arm's length standard's assumption that one can find market comparables as a benchmark against which to measure the transfer price. While this may be achievable with tangible products (and even with tangibles products there are difficulties), with intangible assets, arm's length transactions occur much less frequently or may simply not exist at all.[119] The inherent weakness of the application of the CUP method is the fact that most valuable intangibles are unique and might not meet the high comparability standards, so some statistical adjustments to the benchmark might be needed to improve the reliability of the results.[120] More so a comparability test is not complete without reference to sub-regulation 7(4) of TPR18 which provides that:

[118] There is also an emphasis on what would seem reasonable from the perspective of the respective parties.
[119] Monica Boos, *International Transfer Pricing. The Valuation of Intangibles* (The Hague: Kluwer Law International, 2003) at 11.
[120] Josh Bamfo & Yewande Akinsulire, "Reviewing the Implications of the Revised Transfer Pricing Regulations on Intangibles for Businesses," *Andersen Tax LP* (16 July 2019), online: https://drive.google.com/file/d/1z7XjPdWnsTQhTNjTMt-UTkcun0EFCGNw/view [Bamfo & Akinsulire]

> in applying the provisions of sub-regulation (3)… to a transaction involving the license, sale or other transfer of intangible property, consideration shall be given to any special factors relevant to the comparability of the controlled transactions, including – (a) the expected benefits from the intangible property; (b) the commercial alternatives otherwise available to the acquirer or licensee derived from the intangible property; (c) any geographic limitations on the exercise of rights to the intangible property; (d) the exclusive or non-exclusive character of the rights transferred; and (e) whether the transferee has rights to participate in further developments of the intangible property by the transferor.

The inclusion of the "special factors" consideration is a recognition of the fact that the pricing of an intangible at a given time or place may be altered by peculiar circumstances surrounding the transaction. They show that comparability is not determined only by reference to the intangible property itself, but that regard must in each case be had to the surrounding circumstances.[121] Differences in the surrounding circumstances between the controlled and uncontrolled transactions may, therefore, limit the applicability of the CUP method notwithstanding that the intangibles themselves appear to be similar or comparable *ab initio.* This situation further shrinks the usability of the CUP, because of the difficulty of finding comparables that are *that* close. It also implies that, for a country like Nigeria, it may be untenable to rely on "comparable" data from other jurisdictions since the circumstantial differences may produce more of a grapes-versus-oranges situation.

Like the CUP method, the RPM also suffers from overreliance on the availability of actual comparables; which, as observed, are very difficult, if not impossible, to find. Further, the working of this method gives it a relatively limited scope as the RPM is most often used for distributors that resell products without physically altering them or adding substantial value to them. Current economies, as indicated above rely as much on intangibles and alterations in the chain are common practice.[122] The Cost-Plus method is also limited in scope.[123] The method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties. Cost Plus is most appropriate for the manufacturing and assembly industries.[124] The method also suffers from the malaise of overreliance on comparables since, like CUP, it is only useful if there are comparables.[125] If one is looking for actual references for transactions involving intangibles as a valid reflection of the arm's length principle, those examples should ideally be derived from an observation of comparable transactions between independent parties in the marketplace. This reservoir, however, provides scarce information and data, as intangibles are rarely traded as such in active markets. Instead, these assets are much more often subject to

[121] See *Medtronic, supra* note 103. See also *Canada v GlaxoSmithKline Inc* (2012) SCC 52.
[122] Tinhaga *supra* note 42 at 31.
[123] *Ibid.*
[124] *Ibid.*
[125] *Ibid.*

transactions involving their combination with other tangible goods or services, between independent and/or affiliated market participants.[126]

Doctoral scholar, Zachée Tinhaga, asserts that the main weakness of the TNMM is that it requires a tremendous amount of available information in order to examine a wide range of reasonably similar transactions for a reliable curve. Tax authorities have difficulties assembling this information and big four accounting firms have established a de facto monopoly for these analysis and charge a considerable amount for their services.[127] Neither can small companies (since they cannot afford the services of the accounting firms) and tax authorities do not have all the necessary information to potentially challenge the position taken by MNEs of a transfer price reasonably comparable to the open market price.[128] These weaknesses are recognised by the OECD which has admonished that one-sided methods such as the resale price method and the TNMM, are generally not reliable methods for directly valuing intangibles as they usually allocate all residual profit, after a limited return to those providing the relevant functions, to the owner of intangibles.[129]

It has been suggested, as a robust alternative to the CUP method, that an economic valuation approach called Discounted Cash Flow (DCF) method can be used.[130] This method seeks to project the contribution of intangibles to the excess profits of the licensee over the useful life or the license period and discount it to the present value. That will result in a lump sum amount more useful for outright sale of intangibles as opposed to license arrangements.[131] Bamfo & Akinsulire, Nigerian tax consultants, opine that although this approach has strong technical merits, it faces practical challenges such as reasonableness of key input parameters such as the growth rates used in the projections, the discount rate and the useful life of the intangibles.[132] These could all be contentious points between the taxpayer and the tax authority.

The OECD, through its Guidance for Tax Administration on the Application of the Approach to Hard-to-Value Intangibles (the HTVI Guidance), presents an alternative way of pricing intangibles in the absence of comparables. The HTVI Guidance was issued in June 2018 shortly after the birth of TPR18 and further to Action 8 of the Action Plan on Base Erosion and Profit Shifting.[133] The HTVI Guidance defines the term "Hard-to-value Intangibles" as those intangibles for which (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the

[126] Lagarden *supra* note 57 at 335.
[127] Tinhaga *supra* note 42 at 132.
[128] *Ibid.*
[129] Such an approach would appear to contradict the spirit of the TP Regulations which regards function, asset and risk contributions, rather than mere ownership or risk-free funding, as the basis of reward.
[130] Bamfo & Akinsulire *supra* note 120.
[131] *Ibid.*
[132] *Ibid.*
[133] Action 8 of the BEPS Action Plan mandated the development of transfer pricing rules or special measures for transfers of HTVIs aimed at preventing base erosion and profit shifting by moving intangibles among group members.

level of ultimate success of the intangible at the time of the transfer.[134] It has been observed that this definition can be construed as being overly broad and may comprehend almost any intangible.[135] Examples of an HTVI include an intangible that is partially developed at the time of the transfer or an intangible that is used or developed under a cost contribution arrangement.[136] The solution presented by the HTVI Guidance is that in the above circumstances the tax authority may consider "ex post outcomes" as presumptive evidence about the appropriateness of the ex-ante pricing arrangements.[137] This process allows the tax authority to re-characterize transfers of intangibles using presumptions based upon alternative – even hypothetical – ex post pricing arrangements to determine ex ante value.[138] Put differently, in a case like this, the tax authority may use the actual results (i.e. profit or loss) obtained from exploiting the relevant intangible in assessing the arm's-length price at the time the transaction occurred.[139] If there is a major deviation between the realized results (i.e. profit or loss) and the expectations (and resulting prognosis) that formed the basis for the determination of the price of the HTVI at the moment of the license or transfer and this deviation cannot be explained on the basis of facts and circumstances occurring after the date of the price determination, the tax authority can question the price as determined at the time of the transaction with a reference to the actually realized results.[140] This is, perhaps, the most far-reaching tool in the hand of the tax authority as far as readjusting the price of intangibles is concerned. It appears, however, that this approach is meant to be a last resort which may not be invoked where the taxpayer can satisfactorily demonstrate what was foreseeable at the time of the transaction and reflected in the pricing assumptions, and that the developments leading to the difference between projections and outcomes arose from unforeseeable or extraordinary events. Where this is the case, the HTVI Guidance "takes away" the power of tax administrations to adjust the *ex ante* pricing arrangements based on ex post outcomes.[141] Further, the HTVI approach may

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[134] See regulation 18 of TPR18 for the applicability of this Guidance in Nigeria.

[135] PWC, "OECD releases guidance for tax administrations on hard-to-value intangibles," *Tax Insights from Transfer Pricing Tax Policy Bulletin* (7 August 2018), online: https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-oecd-htvi.pdf. This observation is instructive especially when viewed in the general context of the OECD's own observation that difficulties can arise in a transfer pricing analysis as a result of definitions of the term intangible that are either too narrow or too broad. An overly broad definition of HTVIs may likewise allow the tax authority to apply the HTVI approach to nearly every transaction in intangibles, even though this appears not to be the intent of the framers of the guidance. The problem, perhaps, is where to make the delineations.

[136] See Clive Jie-A-Joen, Liu Lu & Fan Bai, "Transfer Pricing Valuation by Tax Authorities" *Bloomberg Tax* (1 August 2018), online: https://news.bloombergtax.com/transfer-pricing/insight-transfer-pricing-valuation-by-tax-authorities

[137] "Ex-post is another word for actual returns and is Latin for "after the fact." The use of historical returns has customarily been the most well-known approach to forecast the probability of incurring a loss on an investment on any given day. Ex-post is the opposite of ex-ante, which means "before the event." See *Investopedia* (10 May 2019), online: https://www.investopedia.com/terms/e/expost.asp. On the other hand, "Ex-ante refers to future events, such as the potential returns of a particular security, or the returns of a company. Transcribed from Latin, it means "before the event." See, *Investopedia* (11 April 2019), online: https://www.investopedia.com/terms/e/exante.asp

[138] PWC *supra* note 135.

[139] See Jie-A-Joen, Liu Lu & Bai, *supra* note 136.

[140] *Ibid.*

[141] It must be emphasised that the HTVI Guidance is meant to protect tax administrations from the negative effects of information asymmetry. Thus, in a situation where the taxpayer, much like the tax authority, could not have foreseen

not be applied where: the transaction is covered by a bilateral or a multilateral advance pricing agreement (APA); the difference between the *ex ante* projections and the *ex post* outcomes is less than 20%; or five years of commercialization have elapsed since the year in which the HTVI first generated third-party revenue for the transferee.[142] The HTVI approach allows tax authorities to make appropriate adjustments – including adopting alternative or different pricing structures for the transaction, such as milestone payments, running royalties, price adjustment clauses, or a combination of pricing structures.[143] Because no reliable comparable intangibles exist in case of HTVI, references to pricing structures used in transactions between unrelated parties likely will not be available.[144] The Guidance stops short, however, in indicating how and on what basis a tax authority should make such pricing adjustment and therefore could be subject to subjective interpretation and to arbitrariness.[145] A major criticism of the HTVI approach is that it can, in practice, lead to uncertainty and unpredictability, particularly for taxpayers.[146] At the same time, it will open up avenues for disputes between taxpayers and tax authorities or between tax authorities when called upon to give relief under a corresponding transfer pricing adjustment. This is in particular a concern as the Guidance does not delineate clear boundaries of what could be considered satisfactory evidence, nor does it clarify the subjective terminology and language used in the Guidance such as 'unforeseeable' or 'extraordinary.'[147] Also, there is a risk that the tax authority may take the 'easy' option of always hinging on the outcomes whenever favourable, even if those outcomes may appear to result from unforeseen or unexpected events. After all, the onus to prove – to the satisfaction of the tax authority – that the outcomes were unforeseen or unexpected rests on the taxpayer. The approach, thus, becomes the go-to option rather than the (intended) exceptional option. MNEs that do not want the valuation of their transactions to be open for ex-post adjustments must therefore provide evidence that they have properly considered ex-ante uncertainties.[148] When these uncertainties are reflected in the original valuation, ex-post adjustment should simply not be justified, since deviations were then already accounted for.[149]

One method to reflect the uncertainties and improve ex-ante valuations are scenario building techniques that go beyond ordinary discount cash-flows.[150] Such methods that may be used to deal

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the difference between the ex post outcome and the ex-ante pricing arrangement, it can be said that there was no information asymmetry.

[142] The limitation period is only a recommendation and is not intended to override a state's limitation laws. See OECD HTVI Guidance, para 15.

[143] PWC *supra* note 135.

[144] *Ibid.*

[145] *Ibid.*

[146] *Ibid*

[147] *Ibid*

[148] Philip de Homont & Yves Hervé, "Germany: A practical solution for hard to value intangibles" *International Tax Review* (8 May 2019), online: https://www.internationaltaxreview.com/article/b1fm4hh89sx970/germany-a-practical-solution-for-hard-to-value-intangibles

[149] *Ibid.*

[150] *Ibid*. For more on these alternative methods, please see Emmanuel Llinares & Ralph Meghames, "Hard to Value Intangibles," in Lang et al, eds, *Transfer Pricing and Intangibles. Current Developments, Relevant Issues and Possible Solutions* (Vienna: Linde Verlag, 2019) 113. See also European Union, European Commission: *EU Joint Transfer*

with the specific risks related to the development of HTVI include real option pricing, which is supported by Monte Carlo simulations, and the binomial tree analysis. All these methods are based on not just assuming a single prediction of a future income, but explicitly looking at different scenarios, which range from failure to better-than-expected.[151] MNEs may also make their contracts subject to actual income basis, although this may not necessarily take care of the potential exposure to double taxation of at least one party to the transaction.

3.2.5 Other Government Agencies Price Approvals?

Perhaps another way that the FIRS could ascertain arm's length pricing for intangibles would be to rely on technology transfer prices approved by other agencies of government for the transfer of intangibles between related Nigerian and foreign entities. Incidentally, the FIRS' approach in this regard has proved somewhat controversial. Prior to the introduction of TPR12, now TPR18, the National Office for Technology Acquisition and Promotion (NOTAP) had specific guidelines for recognizing technology transfer agreements between foreign licensors and Nigerian licensees.[152] NOTAP also has approved a range of fees/royalties Nigerian licensees were permitted to pay the foreign owners and licensors for use of the licensed commercial and industrial intangible property rights (IP rights).[153] The FIRS has in the past (before the establishment of the transfer pricing regulations) relied on NOTAP approved rates to demonstrate that the pricing of these related-party transactions was reasonable.[154] Thus, taxpayers have often sought NOTAP approvals for certainty in the FIRS's treatment of the reasonableness of the approved rates for tax purposes. Since the era of TPR12, however, the FIRS has questioned the validity of payments made to related parties, especially for imported items, including intangibles, despite NOTAP approval.[155] The tax authority requires a taxpayer to adduce proof of valuation methods used and analysis performed in determining royalty rates, fees and commissions being paid for licensed IP rights.[156] If a taxpayer is unable to demonstrate that a connected transaction has been concluded and executed in accordance with the arm's length principle, the tax authority may opt to disallow the expense for tax purposes despite the prior approval and certification by NOTAP.[157] The FIRS's view is that NOTAP does not apply standard transfer pricing principles to determine the fees approved and

Pricing Forum Report on the Use of Economic Valuation Techniques In Transfer Pricing (Brussels: Directorate-General for Taxation And Customs Union, 2017).

[151] Homont & Hervé *supra* note 148.

[152] Deloitte, "Pricing of Intangible Property ("IP") rights in Nigeria – Why commercial, fiscal and currency control interests must align" *Deloitte* (2015), https://www2.deloitte.com/content/dam/Deloitte/ng/Documents/tax/inside-tax/ng-pricing-of-intangible-property-rights-in-nigeria.pdf.

[153] *Ibid.*

[154] Joshua Bamfo, Amaka Samuel-Onyeani & Emmanuel Onasami, "Nigerian Transfer Pricing Audit Challenges: Arm's-Length Rates vs. NOTAP-Approved Rates," (2017) Tax Notes Intl 181.

[155] Tayo Ogungbenro, Amaka Samuel-Onyeani & Olanrewaju Alabi, "Transfer Pricing in Nigeria - the Journey So Far," (2016) 84 Tax Notes Intl 789, online: https://www.taxnotes.com/news-documents/transfer-pricing/transfer-pricing-nigeria-journey-so-far/2016/12/09/jwcl?highlight=Nigeria

[156] Deloitte *supra* note 152.

[157] Ogungbenro, Samuel-Onyeani & Alabi, *supra* note 155.

thus can approve fees that are not arm's length.[158] This stance is not altogether surprising since the NOTAP (and Central Bank of Nigeria) guidelines were seen as focused on imposing foreign currency control and restrictions on sourcing of foreign exchange from the government.[159] There are, however, concerns with this administrative approach. Firstly, it has been claimed that where the government agencies such as NOTAP's approved rate will result in less tax being paid, the FIRS will rely more on the arm's length principle, and vice versa.[160] This policy of inconsistency leaves the taxpayer in a perpetual guessing game which does not make for good tax planning or tax administration. Moreover the uncertainty induced by this approach runs contrary to Nigeria's National Tax Policy.[161] One way of mitigating or eliminating the ambiguity problem is to ensure that both government agencies – the FIRS and NOTAP – use the arm's length principle in determining appropriate prices or rates for related-party transactions.[162] Alternatively, the FIRS may consider revising the safe harbor provision in the transfer pricing regulations to state that approved rates by other government regulatory agencies should suffice and need not meet the arm's length principle.[163] Rather unfortunately this issue has been on since TPR12 but remains unattended despite the issuance of TPR18.

3.2.6 Contributory Development

The OECD's *Revised Guidance on the Application of the Transactional Profit Split Method* ("the TPSM Guidance") posits that the TPSM is the ideal profit allocation method in a transaction between connected persons where one or more of the following indicators exists:

1) Each party makes unique and valuable contributions;
2) The business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other;
3) The parties share the assumption of economically significant risks, or separately assume closely related risks.[164]

The TPSM is particularly useful when the compensation to the associated enterprises can be more reliably valued by reference to the *relative* shares of their contributions to the profits arising in relation to the transaction(s) than by a more direct estimation of the value of those contributions.[165] The OECD asserts that *in some cases,* the TPSM may be the *most appropriate* method for a transfer of fully or partially developed intangibles where it is not possible to identify reliable comparable

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[158] Seun Audu, "Nigeria's Approach to Transfer Pricing Audits of Technical and Management Services," (2018) Tax Notes Intl 171.
[159] Deloitte *supra* note 152.
[160] Bamfo, Samuel-Onyeani & Onasami *supra* note 154.
[161] See Nigeria, Federal Ministry of Finance, *National Tax Policy*, (Abuja, Nigeria: FMF, 2017), para 2.1.
[162] Deloitte *supra* note 152.
[163] *Ibid.*
[164] See OECD, "Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10, OECD/G20 Base Erosion and Profit Shifting Project 2018," online: www.oecd.org/tax/beps/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf
[165] *Ibid*, para 2.114.

uncontrolled transactions.[166] The main strength of the TPSM is that it can offer a solution for cases where both parties to a transaction make unique and valuable contributions (*e.g.* contribute unique and valuable intangibles) to the transaction. In such a case independent parties might effectively price the transaction in proportion to their respective contributions, making a two-sided method more appropriate.[167] Further, since those contributions are unique and valuable there will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method. In such cases, the allocation of profits under the TPSM may be based on the contributions made by the associated enterprises, by reference to the relative values of their respective functions, assets and risks.[168]

Despite its perceived strengths as a method, the OECD cautions that TPSM should not be used where there are comparables, albeit limited.[169] The TPSM Guidance also makes clear that while a lack of comparables is, by itself, insufficient to warrant the use of the profit split method, if, conversely, reliable comparables are available it is less likely that the method will be the most appropriate.[170] It would seem therefore that in some cases that even a limited scope of comparable uncontrolled data may be a more reliable option for meeting the arm's length standard than the TPSM.[171] This raises significant doubts about the reliability of this method and presents it more as a makeshift solution to a complex problem. Also, the TPSM relies on internal data of the companies in the controlled transaction.[172] This could prove problematic, especially to the tax authority, where "sufficient" internal data is not readily available. Perhaps such paucity may be ameliorated – but to what extent – with the stricter information filing requirements now prescribed especially under the Country-by-Country Reporting Regulations. It seems also that even with available information, identifying the appropriate profit splitting factors can also be challenging.[173]

3.2.7 The 5% Expense Deductibility Rule

TPR18 adopts the African Tax Administrators Forum (ATAF) Approach, that seeks to provide African countries with simplified policy measures to address capacity constraints that make it difficult to price complex controlled transactions, such as those involving the transfer of rights relating to intangibles.[174] One of such simplification measures is contained in sub-regulation 7(5). It provides that:

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[166] *Ibid*, para 2.132.
[167] *Ibid*, para 2.119.
[168] *Ibid*.
[169] The TPSM Guidance also suggests that while the transactional profit split method can be applied in cases where there are no uncontrolled comparables, information from transactions between independent parties may still be relevant to the application of the method, for example to guide the splitting of relevant profits, or where a residual analysis approach is used. See para 2.144.
[170] *Ibid*, para 2.143
[171] See *ibid*, para 2.128.
[172] Such data will frequently be extracted from the taxpayers' cost accounting or financial accounting. See the OECD TPSM Guidance *ibid*, para 2.174.
[173] Ibid, para 2.123.
[174] See Ososami, Eimunjeze & Jawando, *supra* note 34 at 199.

> Notwithstanding any other provision of these Regulations, where a person engages in any transaction *with a related person* that involves the transfer of rights in an intangible, other than the alienation of an intangible, the consideration payable in that transaction that is allowable for deduction for tax purposes shall not exceed 5% of the earnings before the interest, tax, depreciation, amortisation and that consideration, derived from the commercial activity conducted by the person in which the rights transferred are exploited.

It is not unusual for MNEs to vest legal ownership of an intangible in a subsidiary resident in a low tax jurisdiction and then license the use of the intangible to another subsidiary or parent resident in a high tax jurisdiction. This way profit is shifted from the high tax jurisdiction to the low tax jurisdiction through huge royalty payments.[175] It would seem that the above provision seeks to curb profit shifting through licensing and payment of royalties by "arbitrarily" limiting the incentive to pay huge compensations to a nonresident related company for the exploitation of an intangible in a case other than an outright alienation. Although the provision does not preclude a Nigerian taxpayer from paying more than 5% of its earnings before interest, tax, depreciation and amortization (EBITDA) to, for instance, the licensor of an intangible, if the amount paid does exceed 5% of the income earned from the relevant commercial activity, the Nigerian taxpayer would not be allowed to deduct more than a sum equal to the specified percentage as an expense in computing its tax liabilities in Nigeria. This looks like a strong anti-avoidance provision; and also one that makes for administrative simplicity. In terms of administrative simplicity, a provision such as this offers the Nigerian tax authority, which is, presumably, in a weaker position to determine appropriate arm's length royalty payments, a way to forestall the potential revenue losses that may otherwise arise from such payments. There are, however, some issues with the provision. When the TPR was issued, the 5% deductibility limit appeared to be at variance with the provisions of superior legislation or statute. For instance, the corporate expense deductibility rule as prescribed under section 24 of CITA provides that:

> Save where the provisions of subsection (2) or (3) of section 14 or 16 of this Act apply, for the purpose of ascertaining the profits or loss of any company of any period from any source chargeable with tax under this Act, <u>there shall be deducted all expenses for that period by that company wholly, exclusively, necessarily and reasonably incurred in the production of those profits including, but without otherwise expanding or limiting the generality of the foregoing</u>…

The above provision goes on to outline certain specific expenses that may be deducted, and in specific cases prescribes deductibility caps. The established position of the law is that any expense that is wholly, exclusively, necessarily and reasonably incurred in producing income qualifies for

[175] See Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," (2003) 56:1 National Tax J 221. See also the case of *Netherlands v Shoe Corp.* (2007) (Case 05/1352) where the Dutch District Court disallowed royalty payments made to an offshore related company in a sale and license back arrangement of company trademarks on the basis that the transaction was not at arm's length and not intended for any business reasons, but just for tax reasons.

deduction and the courts have traditionally upheld this position.[176] There was nothing in CITA, for instance, that placed a quantitative limit on the deductibility of expenses incurred as payments for intangibles. The test of deductibility, traditionally, rests on whether the sum sought to be deducted was expended on an (intangible) asset that aided the taxpayer to generate the profit sought to be taxed.[177] Based on this rule, if the expense directly or indirectly contributes to the generation of profits for the company, then it should be allowable in its entirety as a tax expense.[178] It was questionable, therefore, whether TPR18, a subsidiary legislation, could impose such a limit, especially as Nigerian courts have consistently taken the position that a subsidiary legislation cannot override the provision of a primary legislation.[179] In *Mobil Producing (Nig.) Unltd v Johnson*, for instance, the Supreme Court of Nigeria made this point as follows:

> A subsidiary or subordinate legislation and its provisions must be consistent with the principal legislation from which it derives its life. Where the substantive legislation is not complied with, there is no basis to consider the subordinate legislation on the issue because any subordinate legislation which is inconsistent with the principal legislation, is a nullity to the extent of its inconsistency. The Force Administrative Instruction/Force order is a subsidiary legislation which derives its validity from the Police Act, its provisions and directives, therefore, must be in conformity with the terms of its enabling law in order to make it valid.[180]

In the light of these authorities, the validity of sub-regulation 7(5) was questionable, although one could argue that with this provision the FIRS was merely exercising its broad power to take anti-avoidance measures, as authorised by the relevant anti-avoidance rules.[181] Thus, the provision only seeks to forestall profit shifting perpetrated by overpaying royalty to subsidiaries in tax favourable jurisdictions. Such an assertion is not without counterarguments, however.[182] The Nigerian policy makers moved to cure this lacuna through the recently enacted Finance Act 2019.[183] Section 11 of the Finance Act has amended section 27(1) of CITA by inserting a new paragraph (g) that disallows "*any expense incurred within or outside Nigeria involving related parties as defined under the*

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[176] See *Shell Petroleum Development Company Limited v F.B.I.R.* (1996) 8 NWLR (Pt 466) 256*; Nigerian Agip Oil Company Limited v FIRS* (1993) 7 NWLR (Pt 303) 49 at 102.
[177] Adegite, *supra* note 62 at 139.
[178] *Ibid.*
[179] See *Olanrewaju v Oyeyemi & ors.* (2000) LPELR-6045(CA)*; Din v A.G., Federation* (1988) 4 NWLR (Pt.87) 147*; Gov, Oyo State v Folayan* (1995) 8 NWLR (pt.413) 292 at 327; *Ishola v Ajiboye* (1994) 6 NWLR (Pt.352) 506*; Ebebi & ors v Denwigwe & ors* (2011) LPELR-4909(CA)*; NNPC v Famfa Oil Ltd* (2012) 17 NWLR (Pt. 1328) 148.
[180] (2018) 14 NWLR (Pt. 1639) 329 at 361 D-F.
[181] See, for instance, section 22 of CITA.
[182] (1) it may be argued that anti-avoidance rules are to be applied on a case by case basis (when it is apparent that the transaction is 'artificial' or 'fictitious') and not in every case; (2) it could be argued that the GAAR provision, being a general provision, cannot override the more specific provision that deals with deductibility… unless it is specifically shown that the transaction qualifies for invocation of the GAAR; (3) it could be argued that in a transfer pricing arrangement – especially with the TP Regulations in place – the FIRS cannot whimsically disallow any payments made in a controlled transaction but must demonstrate that it has conducted its own analysis to show that the payment does not reflect what would be expected in an uncontrolled transaction.
[183] Act No. 14 of 2019.

Transfer Pricing Regulations, except to the extent that it is consistent with the Transfer Pricing Regulations." With this amendment, the validity of sub-regulation 7(5) of TPR18 vis-à-vis CITA now appears unquestionable.

There is a subsisting concern that sub-regulation 7(5) of TPR18 creates a discriminatory tax system where taxpayers are treated differently on the basis of whom they do business with. Given that the deductibility cap only applies to taxpayers in controlled transactions, an inequity may be created in "favour" of taxpayers in uncontrolled transactions. In that sense, taxpayers who license intangibles from connected parties would be arbitrarily restricted in deducting their expenses irrespective of whether they trade at arm's length. On the other hand, taxpayers who license intangibles as independents can deduct their full expenses even if in excess of 5% of EBITDA.

Critics also criticize the use of EBITDA as a deduction benchmark. One commentator observes that in transactions involving the transfer of intangibles between independent parties, the base over which the pricing is calculated is usually revenue, turnover, or profit before tax. This is largely because intangibles often drive revenue; and it is, therefore, questionable to use EBITDA as a base reference in regulation 7(5), especially because the value it attributes to the intangibles would be significantly distorted.[184] EBITDA, it is opined, is susceptible to major fluctuations and thus poses a problem year-over-year because it would not adequately portray the value that the intangible brings to the company.[185] Deductibility should, ideally, be determined by actual contribution of an intangible to the bottomline.

The preceding segments of this paper showcase the difficulties that confront method selection and pricing determination for intangibles under arm's length pricing. It is noted that while the tax authority is at liberty to question a pricing method chosen by the taxpayer and to make a re-selection and/or readjustment accordingly, the tax authority must also be ready to demonstrate that whatever method it chooses is the appropriate method. In other words, the tax authority cannot choose arbitrarily or capriciously simply because it does not agree with the outcome produced by the method selected by the taxpayer. Failure to abide by these principles may have severe repercussions for the bottom line, as some of the cases herein have demonstrated.[186]

4. Conclusion

"Today, after more than a century of electric technology, we have extended our central nervous system itself in a global embrace, abolishing both space and time as far as our planet is concerned."[187]

[184] Adegite *supra* note 62 at 138.
[185] *Ibid*.
[186] See *Veritas Software Corp*. *supra* note 117.
[187] Marshall McLuhan, *Understanding Media: The Extensions of Man*, (Canada: McGraw-Hill, 1964) at 3.

Taxing MNEs has always been a difficult and complex task. Globalization is making it more so.[188] This complexity is only heightened by the ever-increasing integration of intangibles in the business of MNEs and the risk of unwholesome outflows in controlled transactions. States are left with no choice but to initiate proactive measures to ensure that intangibles and other inter-company assets are traded in a fiscal compliant manner. Despite its obvious, if not brazen, imperfections, and numerous calls for its replacement, it does not seem that the arm's length principle is anywhere near demise and may remain the anchor of international tax regulation for the foreseeable future. For developing countries like Nigeria, the burden of dealing with the web of abstraction that is transfer pricing rules is heavier. There is a recognised dearth of publicly available data from which local comparables can be drawn for benchmarking analysis because of the lack of a centralized database. Thus, taxpayers and the FIRS have, generally, had to rely on comparables from other jurisdictions in Africa, Asia, Europe and America.[189] Of course, even where seemingly comparable data can be found, they must also be put through the acid tests of *circumstanciality*.[190] This is apart from the general capacity constraints which make it difficult to price complex transactions.[191] Even for taxpayers, the transfer pricing audit process is extremely tedious and cumbersome. The volume of documents requested by the tax authority to enable it to understand the facts of each case is enormous;[192] and the tax authority may also conduct strenuous interviews and document reviews.[193] This is neither ideal for the taxpayer nor for a tax authority with limited competent tools. More so when there are no guarantees that the most diligent TP audit process would produce the most accurate of results.

There is a discernible consensus that the international tax order is flawed and requires some surgical reconfiguration. These flaws are not limited to transfer pricing. Neither are they constrained to the specific problem of pricing intangibles. Issues dominating the international tax debate include the suitability/viability of present tax treaty models[194] and the migraine of digital

[188] See Eden Lorraine, "Taxes, Transfer Pricing, And the Multinational Enterprise," AM Rugman, ed, *The Oxford Handbook of International Business*, 2nd ed (Oxford: Oxford University Press, 2009) 591 at 615.
[189] See Ososami, Eimunjeze & Jawando, *supra* note 34 at 198.
[190] The complex functionality, comparability and valuation requirements of the ALP may also weigh heavily against a relatively low-capacity tax authority like Nigeria's in litigation, especially since the evidential onus would likely be on the tax authority to establish that its own approach, at any given stage, better reflects the ALP. [See section 135 of the Evidence Act 2011 which deals with the burden of proof in civil case]. Even in jurisdictions where tax administrations are relatively more formidable, judicial decisions show that this is seldom an easy task. See for instance See *Netherlands v Restructuring BV* (2017) Rechtbank ZWB, No BRE 15/5683.
[191] See Ososami, Eimunjeze & Jawando, *supra* note 34 at 205
[192] Tayo Ogungbenro, Amaka Samuel-Onyeani & Olanrewaju Alabi, "Transfer Pricing in Nigeria - the Journey So Far," (2016) 84 Tax Notes Intl 789.
[193] *Ibid.*
[194] See, for instance, Kimberly Brooks, "Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Policy Objective" in JG Head & R Krever, eds, *Tax Reform in the 21st Century* (New York: Wolters Kluwer Law & Business, 2009) 471; Tsilly Dagan, "The Tax Treaties Myth" (2000) 32:4 NYUJ Intl L & Pol 939; Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" (2006) 43:8 J Development Studies 1501; Richard J Vann, "Tax Treaties: the Secret Agent's Secrets" (2006) 2006:3 BTR 345; Allison D Christians, "Tax Treaties for Investment and Aid to Sub-Saharan Africa – A Case Study" (2005) 71:2

taxation.[195] In nearly all cases the contention is wrapped around the forms and degrees of reconfiguration. In terms of the specific issues discussed in this paper, while some favour a tweaking of the existing order, some favour an overhaul. So far, most of the concrete actions taken – led by the OECD – appear to favour the former. A reasonable solution is not simple, especially as increased efforts by governmental units to impose restrictions are immediately countered by increased efforts by tax planners to reduce taxes by circumventing those restrictions.[196] For those who favour an overhaul, there has been no shortage of suggestions. From formulary apportionment[197] to destination-based cash flow tax[198] to minimum taxation to intellectual property rights approaches.[199] While the debate persists, Nigeria – unable to act unilaterally – must adopt and develop rules, institutions and actors under the incumbent ALP framework to tackle transfer mispricing. From a legal perspective, Nigeria's tax statutes should be updated, where need be, to match the trends of combating transfer mispricing. It is comforting to see that CITA has been amended to legitimize some of the seemingly *ultra vires* provisions in the TP regulations. From an institutional angle, significant investment in revenue collection expertise and facilities is advocated. Facilities would include databases that identify royalty percentages and sale prices, for (near) comparability purposes. Of course, recruitment and training of a wider array of competent TP specialist personnel is a *sine qua non*. There must also be collaborative engagement with other cooperative states. Having regard to the uniqueness of the intangibles problem, highlighted in this paper, just how far these measures can go is hard to tell. What is easier to tell is that intangibles will continue to be integral to the way life is lived and the globalization of business. Such

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Brooklyn L Rev 639; Kimberly Brooks & Richard Krever, "The Troubling Role of Tax Treaties" in G Michielse & V Thuronyi, eds, *Tax Design Issues Worldwide* (The Netherlands: Kluwer Law International, 2015) 159.

[195] See, for instance, Pasquale Pistone, João Félix Pinto Nogueira & Betty Andrade, "The 2019 OECD Proposals for Addressing the Tax Challenges of the Digitalization of the Economy: An Assessment," (2019) 2:2 Intl Tax Stud. 1; David R Agrawal & William F Fox, "Taxes in an E-Commerce Generation," (2017) 24:5 Int Tax Public Finance 903; Rifat Azam, "Global Taxation of Cross-Border E-Commerce Income" (2012) 31:4 Va Tax Rev 639; Arthur J Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85:5 Minnesota L Rev 1171; Monica Gianni, "The OECD's Flawed and Dated Approach to Computer Servers Creating Permanent Establishments," (2014) 17 Vand. J Ent. & Tech L 1; Francois Chadwick, "International Tax Rules for the Digital Era," (2019) Tax Notes Intl 709; Orly Mazur, "Taxing the Cloud" (2015) 103:1 Cal L Rev 1; Gianni, Monica, "OECD BEPS (In) Action 1: Factor Presence as a Solution to Tax Issues of the Digital Economy" (2018) 72:1 The Tax Lawyer 255; Raffi Melanson, "Sales Taxes and the Shadow of Cloud Computing: Searching the Horizon for a Workable, National Solution" (2012) 65:4 The Tax Lawyer 871; Maarten Floris de Wilde, "Tax Jurisdiction in a Digitalizing Economy; Why 'Online Profits' are so Hard to Pin Down," (2015) 43:12 Intertax, 796; Itai Grinberg, "International Taxation in an Era of Digital Disruption: Analyzing the Current Debate. Taxes," (2019) 97:3 Taxes 73.

[196] Sharon Burnett & Darlene Pulliam, "Transfer Pricing Seven Years After GlaxoSmithKline," (2014) 41:1 Southwestern Economic Rev 99 at 107.

[197] See, for instance, François Vincent, "Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)" (2005) 53:2 Canadian Tax J 409; Tinhaga *supra* note 42; Reuven S Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15:1 Va Tax Rev 89.

[198] See Agrawal, *supra* note 195; Michael Devereux & Rita de la Feria, "Designing and implementing a destination-based corporate tax" (2014) Oxford University Centre for Business Taxation Working Paper No. 14/07. Online: http://eureka.sbs.ox.ac.uk/5081/1/WP1407.pdf; William B Barker, "A Common Sense Corporate Tax: The Case for a Destination-Based, Cash Flow Tax on Corporations" (2012) 61:4 Cath UL Rev 955.

[199] See Andrew Blair-Stanek, "Intellectual Property Law Solutions to Tax Avoidance," (2015) 62 UCLA L Rev 2; See also Linda M. Beale, "Reining in Intellectual Property Tax Avoidance" (2017) 155 Tax Notes 1877.

developments can only further blur the inter-state lines that exist between related corporations in the context of cross-border business. They will, perhaps, demystify the "illusion" that MNEs are separate in their legal and economic identities. As Professors Avi-Yonah and Benshalom observe, there is already a noticeable integration of formulary apportionment elements into transfer pricing regulation.[200] Perhaps this is indicative of a march towards a more globe-centric tax future; a global (tax) village through the lenses of Marshall McLuhan. Perhaps not.

[200] See, generally, Reuven S Avi-Yonah & Ilan Benshalom "Formulary Apportionment: Myths and Prospects - Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative" (2011) 3:3 WTJ 371. See also Heinz-Klaus Kroppen, Roman Dawid & Richard Schmidtke, "Profit Split, the Future of Transfer Pricing? Arm's Length Principle and Formulary Apportionment Revisited from a Theoretical and a Practical Perspective," in KA Konrad & W Schön, eds, *Fundamentals of International Transfer Pricing in Law and Economics* (Berlin: Springer, 2012) 267.