Intangible Property and Transfer Pricing:
Minimizing Valuation Risks

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Agenda

- Introduction
- Definitions and Regulations
- Transaction-based Approaches
- Profit-based Approaches
- Other Key Elements to Valuation: Useful Life, Discount Rates
- Application: The Veritas Example

Introduction

- Transfer pricing for intellectual property ("IP") has a special set of regulations and considerations
- Determination of arm's length pricing for the transfer of IP can be a challenging task for complex transactions, for which there are typically no sufficiently comparable transactions that can be used as evidence of arm's length prices
- Often the most difficult, variable, and high-dollar-value related party transactions that tax departments have to deal with

Introduction (continued)

Some of the most prominent transfer pricing controversies recently:

- GlaxoSmithKline settled its 17-year-old dispute with the IRS regarding the value of its intellectual property – paid $3.4 billion to US government
- Merck settled transfer pricing / IP disputes with the IRS in 2007 – paid more than $2 billion to US government
- Symantec was recently in a high-profile dispute with the IRS about the acquired software firm Veritas
  - IRS claimed royalties paid by Irish sub were billions too low – proposed adjustment $2.5 billion
  - The IRS lost the case in 2011 – but interesting lessons were learned

What do these controversies all have in common?
The transfer pricing controversies all centered around IP

- **In general, the biggest dollar adjustments, as a result of transfer pricing audits, will be due to IP issues**

Definitions and Regulations: Some Important Distinctions

- Intangible assets vs. IP
- Routine vs. non-routine
- Legal ownership vs. economic ownership
- Valuation purposes vs. transfer pricing purposes

Where do US 482 Regulations fit with respect to these categories?

- “Intangible assets” vs. “intellectual property” – somewhere in between
- “Routine” vs. “non-routine” – typically non-routine only
- “Economic “vs. “legal” ownership – typically economic ownership

Definitions and Regulations:

Review of Transfer Pricing Regulations for Intangibles

United States Regulations:

Definition of intangible (1.482-4(b)): An intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual –

1. Patents, inventions, formulae, processes, designs, patterns, or know-how;
2. Copyrights and literary, musical, or artistic compositions;
3. Trademarks, trade names, or brand names;
4. Franchises, licenses, or contracts;
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
6. Other similar items. For purposes of section 482 [26 USCS § 482], an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties

Definitions and Regulations:

Review of Transfer Pricing Regulations for Intangibles (continued)

Implications:

- There is often no simple objective criterion that can determine whether something should be considered an intangible asset for tax purposes.
- It is important to be very precise about exactly what is included in a suite of intangible assets that is being traded, sold, or licensed to a related party.

Definitions and Regulations:

Review of Transfer Pricing Regulations for Intangibles (continued)

United States Regulations:

Applicable Methods:

- Comparable uncontrolled transaction ("CUT") method: Some guidance provided in the regulations regarding the application of the CUT method
- Comparable profits methods ("CPM") (which is functionally equivalent to the TNMM specified in the OECD guidelines): No specific guidance provided in the US regulations
- Profit Split method: No specific guidance provided in the US regulations
- Unspecified methods: (When economists get creative) The only regulatory guidance is that "an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction"

Definitions and Regulations:

Review of Transfer Pricing Regulations for Intangibles (continued)

United States Regulations:

The regulations also provide for:

1. possible periodic adjustments: "the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible"
2. specific rules to be applied when the controlled transfer is for a lump sum payment rather than a royalty: must treat the lump sum "as an advance payment of a stream of royalties over the useful life of the intangible"
3. a separate set of rules regarding cost sharing in the development of new intangibles
4. particular comparability factors, such as:
   - comparable industries
   - comparable profit potential

Definitions and Regulations: Methodologies

Similar methodologies are used for transfer pricing and valuation purposes

Methodologies used in transfer pricing:

Transaction-based approach

- CUT Method

Profit-based approaches

- Comparable profits method (CPM)
- Profit-split method

Methodologies used in valuation:

Transaction-based approach

- Market valuation method

Profit-based approaches

- Income method
- Cost approach

Polling Question #1

Your own organization has had to consider the tax treatment of related-party transactions involving intangible assets for:

A. Transfer pricing compliance purposes (e.g., royalty payments)

B. Sale/transfer of assets between affiliated legal entities

C. Both

D. It has not historically been an issue

Transaction-based Approaches:
The CUT Method

The CUT method is the most common method for verifying arm's length nature of royalties for transfer pricing purposes

Degree of comparability

- To be considered comparable to a controlled transaction, an uncontrolled transaction must be sufficiently similar that it provides a reliable measure of an arm's-length result
- The CUT method may be applied by reference to "inexact" comparables

Transaction-based Approaches:
The CUT Method (continued)

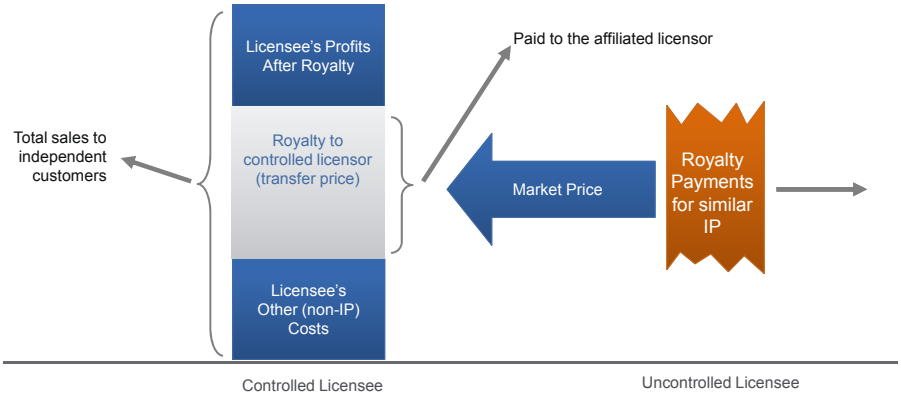
The CUT method is the most common method for verifying arm's length nature of royalties for transfer pricing purposes

Factors of comparability

- Identifying uncontrolled transactions that involve the same intangible property is often impossible (unless there are "internal" comparables)
- Under the regulations, to be "comparable," two potentially comparable intangibles must meet two tests:
  - Industry or market test – The two intangibles being compared must be used
    in connection with similar products or processes within the same general industry or market, and
  - Profit potential test – Comparability requires that the two intangibles being compared have a similar profit potential. Ordinarily the profit potential of an intangible is to be measured by calculating the net present value of the benefits to be realized through the use of the intangible

Transaction-based Approaches:
The CUT Method (continued)

CUT method is a common method for verifying arm's length nature of royalties …



… but comparability and disclosure problems make it unreliable in many instances

Transaction-based Approaches:
The CUT Method (continued)

Difficulties in Finding Comparable Uncontrolled Transactions:

- Intangible Property is (almost by definition) unique
- Judgments comparing the value of brand names, technology, etc. must necessarily be largely subjective. Is the trade name "Honda" worth more or less than the trade name "Volkswagen"? Why?
- Many types of IP simply are rarely (or never) sold or licensed in arm's length transactions. For example:
  - proprietary procedures
  - proprietary technologies or systems allowing vertical integration
  - proprietary marketing strategies
- Adjustments for differences in attributes are difficult, and therefore rarely done (unlike with CPM applications).
  - how much should a royalty rate be adjusted for exclusivity v. non-exclusivity?
  - for geographic differences?
  - for differences in profit potential?

Transaction-based Approaches:

The CUT Method (continued)

Difficulties in Finding Comparable Uncontrolled Transactions:

Implications:

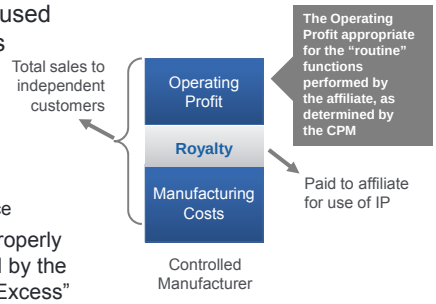
- "Internal" comparables solve many (though not necessarily all) comparability problems, if they are available. In particular, they eliminate the comparability issues around the uniqueness of each type of IP
- For other comparability issues, it may be possible to apply other techniques to make adjustments for differences

Profit-based Approaches:

Comparable Profits Method

CPM or TNMM method is another method used for verifying arm's length nature of royalties

- Generally, CPM/TNMM is applied when there is insufficient reliable data to establish CUT comparability
  - The degree of required functional comparability is less under CPM than CUT method
  - Product similarity may not be of critical importance
- Under the CPM/TNMM, the operating profit properly attributable to the routine functions performed by the controlled party is calculated. "Residual" or "Excess" profits can then be paid out as royalties for the use of intangibles



- CPM includes a number of variations based on different rate-of-return measures or profit level indicators such as return on capital employed, and financial ratios including return on sales, return on SG&A, and return on assets
- CPM may require a number of comparability and other adjustments, depending on the identified differences between the controlled party and the comparables

Profit-based Approaches:
Comparable Profits Method (continued)

Advantages and disadvantages of the CPM:

- CPM data may be available in cases where CUTs are not (i.e., looking under the street light)
- Analytically and conceptually simple

However:

- CPM may be overly simplistic
- CPM is easily misapplied
- Tax authorities may not accept it as the Best Method (especially if they don't like the results)
- Differences in the returns assigned to "routine" functions will result in different valuations and transfer prices for the intangible asset.

Profit-based Approaches:
Profit Split Method

Profit split method is an alternative method to CUT and CPM:

- Typically used in complex situations where other methods are not sufficient to price the functions performed
- Profit-split methods are appropriate when
  - Valuable, non-routine intangibles exist on both sides of the transaction
  - Significant differences between controlled and uncontrolled transactions are attributable to economies of vertical/horizontal integration
  - Adequate comparables are unavailable to set margins for either party
- Without adequate comparables, neither the CUT method nor CPM would produce the most reliable results; in such cases the regulations favor the use of the residual or comparable profit split method

Profit-based Approaches:

Residual Profit Split Method

Application of RPSM is a two-step process:

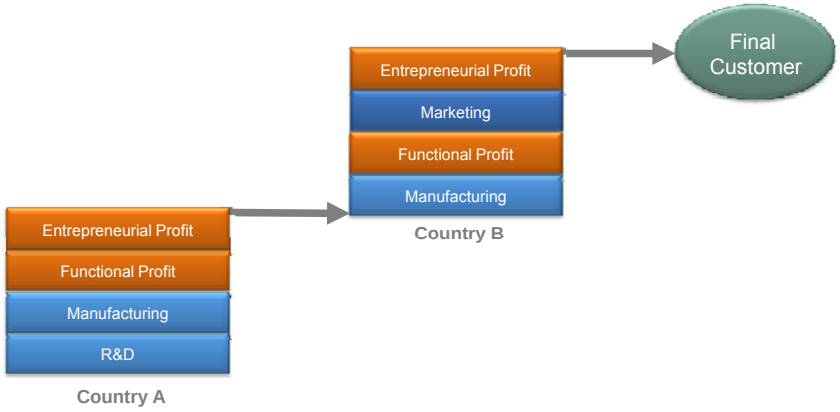
1. valuation of routine functions, and
2. distribution of residual profits attributable to non-routine intangible creating functions

- The first step is to price all of the routine functions performed by the affiliated entities at each stage of the value chain, using comparables data
- The method that will produce the most reliable results is selected to conduct an arm's length valuation of the routine functions, conforming with best method analysis. The CPM is the most commonly used method
- The "residual" profit is then calculated as the difference between the total profits earned and those attributable to the routine functions
- Finally, the residual profit is then split among affiliated entities in proportion to the levels of non-routine intangibles employed. Intangibles can be valued in terms of historic expenses, i.e., historical expenses capitalized over the estimated useful life of the intangible, for each affiliate engaged in functions that create non-routine intangibles

Profit-based Approaches:

Profit Split Method

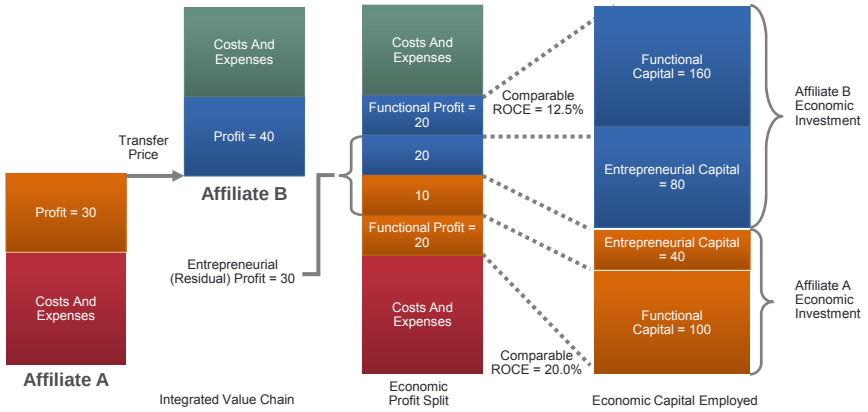
Appropriate when both parties possess valuable entrepreneurial intangibles



Profit-based Approaches:

Profit Split Method (continued)

Residual profit split method calculations determine the profit split rate of return r* on entrepreneurial capital



Polling Question #2

If your organization has ever had to prepare a transfer pricing analysis or valuation of intangible assets for tax purposes, the defensibility of the analysis is:

A. Extremely important, with significant tax implications

B. Moderately important, with some tax implications

C. A minor issue with minor tax implications

D. We have not had to prepare transfer pricing studies or valuations of intangible assets

Other Key Elements to Valuation:
Useful Life

Useful Life: Crucial to determining the total valuation

- The methods described above can be used to determine an annual income stream attributable to the IP, but in some situations we need the NPV of that income stream:
  - for valuation purposes (for example, in case of an outright sale)
  - to calculate total buy-in payments
  - for one-time tax assessments, e.g., Veritas

Obviously, the useful life of the IP is an extremely important ingredient to that calculation, so how is it determined?

- Internal company data
- External expert opinion

Other Key Elements to Valuation:
Discount Factor

Discount Factor: Also crucial to determining the total valuation

- The discount factor is the third crucial ingredient required. Typically:
  - Company's average cost of capital (WACC)
  - WACC = Cost of debt × w(1 − t) + Cost of equity × (1 − w)
- However, in some cases something different may be used:
  - Cost of equity only (for equity valuations)
  - Cost of debt only
  - Market rates on alternative comparable investments (i.e., with comparable risk)
- Need to use nominal rates if income stream is in nominal terms, real rates if real income stream
- Need to consider if discount rate should vary over time

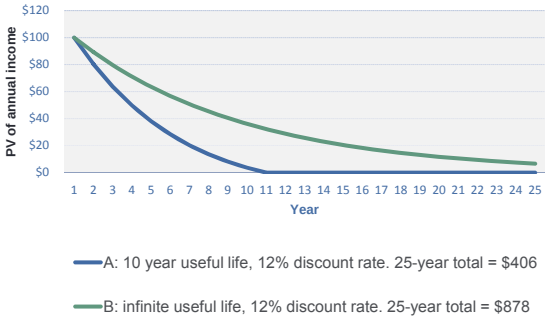
Other Key Elements to Valuation

Useful life + discount factor:
A powerful mix

Compare two valuations of the same income stream:

- A = $100 income in year 1 useful life = 10 years discount rate = 12%
- B = $100 income in year 1 infinite useful life discount rate = 12%

Importance of Useful Life in IP Valuation, with **12 percent discount rate**



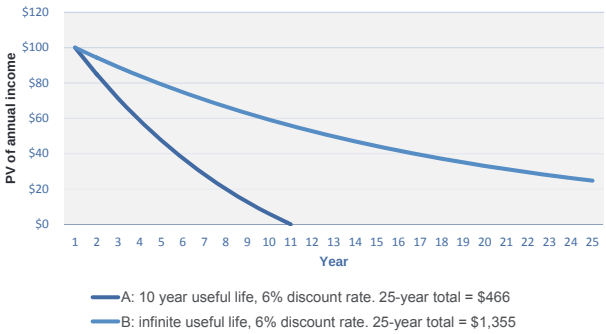
Other Key Elements to Valuation

Useful life + discount factor:
A powerful mix

Compare two valuations of the same income stream:

- A = $100 income in year 1 useful life = 10 years discount rate = 6%
- B = $100 income in year 1 infinite useful life discount rate = 6%

Importance of Useful Life in IP Valuation, with **6 percent discount rate**



The Veritas Example:
Veritas / Symantec

- Company position:
  - CUT method
  - Short useful life of IP
  - IP contributes profits after routine returns are carved out
  - WACC used as discount rate
- IRS position:
  - Income method
  - Infinite useful life of IP
  - IP responsible for all returns – no routine return carve-out
  - Calculated an alternative (significantly lower) discount rate
- Court ruling:
  - IRS position was “arbitrary, unreasonable, and capricious”

The Veritas Example:
Veritas / Symantec

IRS thinking, post-Veritas decision:

- The IRS says that they agree with the court’s decision given the court’s findings of fact (though they disagree with the findings of fact)
- New internal procedures being instituted within the IRS to more carefully review adjustments that go to litigation
- Implications?

Polling Question #3

Tax authorities and taxpayers can arrive at very different transfer prices or valuations of intangible assets for which of the following reasons:

A. They may use different analytical methods or approaches

B. They may make different assumptions about the useful life of the asset

C. They may assign different returns to “routine” functions

D. They may have different definitions of what is included in the intangible asset being transferred or licensed

E. All of the above

Questions?

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