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Using Internal Agreements to Price Intangibles Transfers

While the Organization for Economic Cooperation and Development's latest draft on intangibles questions the general availability of comparable uncontrolled transactions, the author points to several factors that support use of the CUT method, noting that internal comparables often may be found in the licensing portfolios of multinational companies that are active participants in the marketplace for similar intangibles.



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For many years, intangible assets have been a large part of the economic landscape, and that growth continues today—arguably it has accelerated. Not surprisingly, transfer pricing issues related to intangible assets also continue to grow. Most recently, the Organization for Economic Cooperation and Development issued its Action Plan on Base Erosion and Profit Shifting (BEPS) and a revised discussion draft on transfer pricing aspects of intangibles. These documents have generated a great deal of controversy, with more than 1,000 pages received from 70 commenters on the revised draft. In particular, the OECD suggests in the intangibles draft that it may be difficult to find a comparable uncontrolled transaction¹ and, even if a potential CUT is found, it may be difficult to make reliable adjust-

ments for differences.² This view is not unique to the OECD. Indeed, it can be found among other tax authorities (including the U.S. Internal Revenue Service) and practitioners alike.

This article addresses the issues of comparability and adjustments for potential CUTs, and how they can be used to reliably apply the comparable uncontrolled price method.³ In particular, multinational firms that are active participants in the marketplace for similar intangibles are likely to have potential CUTs in their licensing portfolios. Moreover, firms that are active in licensing and out-licensing these technologies often prepare financial analyses that are useful for determining profit potential and making reliable adjustments where necessary. This article discusses how these analyses can be performed and provides an example

¹ See, for example, the revised OECD intangibles draft, p. 34, para. 134, Example 13, para. 274, and Example 14, para. 278. The draft is available at 22 *Transfer Pricing Report* 441, 8/8/13.

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² Revised intangibles draft, p. 37, para. 147. Some of the issues raised in support of this view in the draft relate to the OECD's position that functions and control are more important for assigning premium returns than risks and capital.

³ The comparable uncontrolled price method in the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* is analogous to the CUT method in the U.S. Section 482 regulations.

based on a hypothetical intercompany transaction involving intangible property.

Why the CUP method?

There are at least three prongs of support for the use of the CUP method if sufficient reliable data and information are available. The first is from the regulatory standpoint, where both the OECD guidelines and, arguably, the U.S. rules express a preference for the CUP or CUT method if the available data and information support its use. Second, from a practical standpoint, a potential readily available source for CUTs is the taxpayer's own agreements with third parties involving similar intangible property. Such agreements are likely to provide a rich source of information that can be used to assess (and adjust for differences in) comparability. Finally, there is judicial support for using CUTs even when substantial adjustments are required.⁴

Regulatory support

The OECD's intangibles draft cautions, "It should be recognised that the identification of reliable comparables in many cases involving intangibles may be difficult or impossible."⁵ However, if it can be applied, the OECD transfer pricing guidelines state, "the CUP method is the most direct and reliable way to apply the arm's length principle."⁶ Moreover, where "the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred."⁷ Similarly, the CUT method is cited in the U.S. Section 482 regulations as the method that "will generally be the most direct and reliable measure of the arm's length result."⁸ This substantial support for the CUP or CUT method suggests that multinationals would do well to consider carefully whether CUTs exist.

Practical support

Though it may apply only in select circumstances, there are several industries where companies are likely to find CUTs for intangible property. These are industries where companies engage in substantial licensing of intangible property, such as pharmaceuticals, high-technology, and media. In such cases, the firm is likely to have access to detailed information about the structure of the agreement, the functions performed by the parties, the financial consideration to each party and the expected market potential of the products embodying the technology. In addition, when companies engage in such transactions with third parties, they frequently prepare, for management review, financial or commercial analyses that reflect this detailed information in the financial projections for the use of the technology. This information can be used not only to identify potential CUTs, but also to make necessary adjustments. The quality of this information, including detailed information on the size, timing and riskiness of

cash flows, is likely to exceed that available from publicly available license agreements, and is more directly targeted to the intangible property than public data on the overall performance of companies.

Judicial support

Support also exists for the use of CUTs in court. For example, in *Veritas Software Corp. v. Comr.*,⁹ the taxpayer used as comparables its own licenses with third parties for similar intangibles. The U.S. Tax Court found that the CUT method, using the taxpayer's own transactions with third parties, was the best method even though adjustments were required. The court stated that although these "agreements are certainly not identical to the controlled transaction," they were "sufficiently comparable" and only required "certain adjustments" to enhance the reliability.

Evaluating the available data, best method

The U.S. Section 482 regulations require taxpayers to identify the best method for analyzing the controlled transaction. While not explicitly required for the OECD, a similar evaluation of the available data and methods is advisable. The best method depends critically on the available data.

What data are available?

If a company is active in the marketplace for similar intangible property, it is likely to have license agreements with third parties and these agreements may be useful. However, for these agreements to be useful the company will need more than just the agreement itself. Specifically, detailed information on how the licensor and licensee expected to share in the returns from the intangible property will be most useful. Fortunately, many companies that regularly engage in licensing activities do so only after preparing a rigorous financial analysis, such as a net present value (NPV) analysis, for management review. Such financial analyses reflect the expected revenue and costs of entering into the transaction as well as the specific circumstances surrounding it. If sufficient reliable, detailed information is available, these data provide a rich source of information for assessing comparability and making adjustments using the CUP or CUT method.

Another potential source of information is public data on license agreements. Sources such as RoyaltyStat or ktMINE provide publicly available information on license agreements. The information available often includes summaries of the financial terms of the transaction and a description of the transferred technology. While this information may be the best available in some cases, these sources lack detailed information on cash flows, risk assessment and the transferred technology itself.

Finally, taxpayers may be permitted to use public data on comparable companies. However, company-level data does not reflect the cash flows associated with a single technology. Rather, these data reflect all the functions performed and risks assumed by a company, making it difficult to focus on comparability in relation to the intangibles in the controlled transaction.

⁹ See note 4, above.

⁴ See, for example, *Veritas Software Corp. v. Comr.*, 133 T.C. No. 14, 18 *Transfer Pricing Report* 890 (decision), 843 (coverage).

⁵ Revised intangibles draft, para. 164.

⁶ OECD guidelines, para. 2.14.

⁷ OECD guidelines, para. 2.3.

⁸ U.S. Regs. § 1.482-3(b)(2)(ii).

Do the available data support using CUP or CUT?

The OECD's revised intangibles draft states that when "the CUP method is used in connection with transfers of intangibles, particular consideration must be given to the comparability of the intangibles or rights in intangibles transferred in the controlled transaction and in the potential comparable uncontrolled transactions."¹⁰ Under the OECD guidelines, comparability factors to consider are characteristics of property or services, functions, contractual terms, economic circumstances, and business strategies. The U.S. Section 482 regulations note that to apply the CUT method, uncontrolled transactions must be for comparable intangible property under comparable circumstances.¹¹ Although there are some differences in terminology, the comparability criteria under the OECD guidelines and the Section 482 regulations align closely.

OECD Guidelines	Section 482 Regulations
Form of transaction and type of property	Similar products or processes within the same general industry
Duration and degree of protection	Degree and duration of protection
Process of production and value added	Similar profit potential
Anticipated benefits	
Geographic location	
Size of markets	
Structure of markets	
Costs of inputs	
Business strategies: innovation, diversification, risk aversion, political climate, and labor laws	
Start-up expenses and development costs	Functions performed by the licensor and licensee
Assets used	
Product and environmental risks assumed	Economic and product liability risks
Limitations on geographic area of rights	Geographic limitations
Exclusivity	Exclusivity/uniqueness of property
Sublicensing rights	Rights granted/restrictions on use
Rights to further developments	Rights to receive updates
Government policies	Governmental approvals/authorizations
Degree of vertical integration	Existence/extent of collateral transactions
Timing of the transaction	Stage of development

Under the Section 482 regulations, comparable intangible property requires that the uncontrolled transactions have similar profit potential and be for similar products or processes within the same general industry. Comparable circumstances include terms of transfer, stage of development, rights to receive updates, unique-

¹⁰ Revised Intangibles Draft, para. 164.

¹¹ Regs. § 1.482-4(c)(2)(iii)(B)(1). The OECD also notes that the arm's-length principle may be "difficult to apply to controlled transactions involving intangible property." See OECD guidelines, para. 6.13.

ness of property, duration of license, economic or product liability risks assumed, existence of collateral transactions and functions to be performed by the parties.

The difficulty of meeting comparability criteria and making adjustments often is cited as an obstacle to reliably applying the CUP or CUT method. However, a firm that is actively in-licensing and out-licensing similar technologies already has a particular advantage in that it is licensing similar technology in the same industry (patented technologies embodied in, for example, a pharmaceutical product or computer chip). These license agreements typically include information on the terms of transfer, stage of development, rights to receive updates, duration of license, uniqueness of the property and degree of protection, allocation of risks, collateral transactions and functions performed by each party. Moreover, if the company has prepared NPV analyses when evaluating potential licensing transactions, these analyses can be used to assess comparability under the OECD guidelines or evaluate profit potential and adjust for differences in comparable circumstances under the Section 482 regulations. Specifically, under the regulations, profit potential and comparable circumstances are reflected in a rigorous NPV analysis as follows.¹²

■ **Profit potential:** NPV analysis estimates the profit potential by considering all relevant cash flows associated with the license, including net sales, cost of goods sold, royalties, marketing, research and development and other operating cash flows.

■ **Terms of transfer:** The terms of transfer may include, for example, geographic limitations, the degree of exclusivity and field of use. The ability to sell the product in wider and more lucrative geographic areas and fields of use would, other things equal, increase the net sales and the total NPV of entering into the agreement. Similarly, obtaining exclusive rights would reduce the risk of competition and provide more certainty that the expected cash flows would be realized. Because cash flows are discounted to reflect the time value of money and the risk associated with realizing the cash flows, the discount rate associated with the transaction would be lower with exclusive rights than without them. A lower discount rate, other things equal, increases the value of entering into the agreement.

■ **Stage of development:** Cash flows that are further in the future are less certain, and this fact is captured in an NPV analysis by applying a discount rate. As a result, a license at an earlier stage of development will have more distant cash flows and a lower value than the same license would have at a later stage of development.

■ **Rights to receive updates, revisions or modifications:** The right to participate in updates, revisions, or modifications to the intangible would, other things equal, likely increase the net sales and reduce the risk of obsolescence. Both factors would enhance the value of entering into the license agreement.

■ **Duration of the license:** The longer the term of the license, other things equal, the greater the profits and the higher the value of entering into the agreement.

■ **Uniqueness of property and degree and duration of protection:** The more unique the intangible, the less likely

¹² The discussion relating to how NPV analysis addresses each of the comparability factors under the OECD guidelines follows closely that for the Section 482 regulations.

there will be good substitutes for it and the more valuable it will be. Also, the greater the duration of protection (length of patent protection), other things equal, the more valuable the rights to use the intangible. For example, particularly unique intangibles with many years of protection may enjoy relatively high levels of net sales for an extended period.

■ **Economic and product liability risks assumed by transferee:**

A taxpayer using its own agreements with third parties as comparables is likely to bear similar economic and product liability risks in the controlled and uncontrolled transactions. These risks typically would be reflected in the projected cash flows or discount rate applied to the agreement.

■ **Existence of collateral transactions:** In some cases, agreements include additional components, such as use or sale of a plant or other assets. To the extent they affect the value of the transfer of the relevant intangible property, collateral transactions would affect the cash flows and potentially the risk associated with the project. However, if the value these collateral transactions add is substantial, comparability may be reduced despite the ability to make adjustments.

■ **Functions performed by licensor and licensee:** The functions that the licensor and licensee agree to perform will affect their respective costs. If a party performs additional functions and bears the associated costs, other things equal, the value of the project to that party will decrease.

Applying the CUT method using a company's own license agreements

The example below, which involves Elixir, an internally developed pharmaceutical product for the hypothetical firm PharmaTech, illustrates this approach to applying the CUT method to a taxpayer's own transactions with third parties.¹³ The example assumes that Elixir was discovered in the U.S. and will be manufactured and marketed outside the U.S. by the company's subsidiary in Singapore. To manufacture and sell the product outside the U.S., the Singapore subsidiary will require a license from the research facility in the U.S. (the licensor). PharmaTech first began specific development of Elixir in 2008, and expenses incurred since then are included in the NPV analysis. Patent protection for Elixir expires in 2017.

A review of PharmaTech's license agreements with third parties yields four agreements for licensing the intangible property embodied in a pharmaceutical product. For each of these agreements, the NPV of net income for the licensor is calculated as the present value of all the royalty and lump sum payments from the li-

censee. The NPV of net income for the licensee is calculated as the present value of the cash flows (annual revenue less costs). The present values are calculated using discount rates established by the taxpayer when evaluating transactions with third parties. For example, many companies use a standard discount rate when evaluating similar projects. Applying this same approach in the controlled and uncontrolled transactions effectively addresses the OECD's concerns regarding the sensitivity of the NPV to changes in the discount rate, as the approach is used by the taxpayer in evaluating arm's-length agreements.¹⁴

The sum of the NPV of net income for the licensor and licensee equals the total NPV of net income, or profit potential, for the product. The shares of the total NPV of net income to the licensor and licensee represent the behavior of the parties in dividing the present value of the profits from the product. See Table 1. These four agreements provide the basis for identifying CUTs.

Table 1: Database of PharmaTech's Third-Party License Agreements

Product	Licensor	Total NPV of	Share of Total NPV	
		Net Income (Millions)	Licensor —(%)—	Licensee —(%)—
[a]	[b]	[c]	[d]	[e]
Healing	Health Inc.	\$188.2	25.5%	74.5%
Cure	Medicines Inc	\$418.1	33.0%	67.0%
Miracle	MedChems	\$501.6	18.0%	82.0%
FluGone	Cures Ltd.	\$844.8	22.0%	78.0%

In PharmaTech's arm's-length agreements with third parties, the share of the total NPV of net income to the licensor ranges from 18 percent to 33 percent. This represents the consideration paid for the rights to use the intangible property.

A financial analysis then is prepared for Elixir, relying on projections used by management when making decisions regarding the product and including relevant costs. Relying on the projections used by management effectively addresses the OECD's concern regarding the "source and purpose of the projections."¹⁵ Moreover, the types of revenue and costs associated with the uncontrolled transaction for Elixir should be the same types of revenue and costs considered in the uncontrolled transactions. "Standardizing" the framework ensures a consistent method and should reduce the OECD's concerns around the financial projections.¹⁶ In this case, the total NPV of net income from non-U.S. sales of Elixir equals \$843.1 million. See Table 2.

¹⁴ Revised intangibles discussion draft, para. 176.

¹⁵ Revised intangibles discussion draft, paras. 179-182.

¹⁶ Revised intangibles discussion draft, paras. 181-186.

Table 2: Total NPV of Net Income Earned by PharmaTech from Non-U.S. Sales of Elixir

Year	Net Sales (Millions)	COGS (Millions)	Gross Margin (Millions)	Marketing -(Millions)-	R&D Expenses -(Millions)-	Net Income before Taxes -(Millions)-	Net Income -(Millions)-	Discount Factor (at 10%)	NPV of Net Income -(Millions)-
[a]	[b]	[c]	[d] = [b]-[c]	[e]	[f]	[g] = [d]-[e]-[f]	[h] = [g]*0.65	[i]	[j] = [h]*[i]
2008	\$-	\$-	\$	\$12.0	\$20.8	\$(32.8)	\$(21.32)	1	\$(21.3)
2009	\$-	\$-	\$	\$33.0	\$20.8	\$(53.8)	\$(34.97)	0.9091	\$(31.8)

Year	Net Sales (Millions)	COGS (Millions)	Gross Margin (Millions)	Marketing (Millions)	R&D Expenses (Millions)	Net Income before Taxes (Millions)	Net Income (Millions)	Discount Factor (at 10%)	NPV of Net Income (Millions)
[a]	[b]	[c]	[d] = [b]-[c]	[e]	[f]	[g] = [d]-[e]-[f]	[h] = [g]*0.65	[i]	[j] = [h]*[i]
2010	\$ 95.1	\$14.4	\$ 81.3	\$60.0	\$20.8	\$ 0.5	\$ 0.34	0.8264	\$0.3
2011	\$171.6	\$25.8	\$145.8	\$63.0	\$20.8	\$ 62.0	\$ 40.31	0.7513	\$30.3
2012	\$265.2	\$39.8	\$225.4	\$63.0	\$15.6	\$146.8	\$ 95.40	0.6830	\$65.2
2013	\$360.9	\$54.2	\$306.7	\$60.0	\$15.6	\$231.1	\$150.21	0.6209	\$93.3
2014	\$460.7	\$69.2	\$391.6	\$60.0	\$15.6	\$316.0	\$205.37	0.5645	\$115.7
2015	\$602.2	\$90.4	\$511.8	\$60.0	\$15.6	\$436.2	\$283.52	0.5132	\$145.5
2016	\$625.0	\$93.8	\$531.2	\$42.7	\$15.6	\$472.9	\$307.41	0.4665	\$143.4
2017	\$613.6	\$92.0	\$521.6	\$30.9	\$ 5.2	\$485.5	\$315.55	0.4241	\$133.8
Total in 2008 dollars:									\$674.5
Total in 2014 dollars:									\$843.1

To identify the CUT using these financial analyses, the Section 482 regulations suggest comparing the profit potentials of the controlled and uncontrolled transactions. In this case, among the potential CUTs in Table 1, the profit potential of the FluGone agreement most closely matches that for Elixir. As discussed above, adjustments for all other comparability factors already are incorporated into the financial analyses through the revenue, costs and discount rate. Therefore, based on the company's experience in the market-

place for similar intangibles, the arm's-length price for the intangible property embodied in Elixir equals 22 percent of the NPV of net income, which is the share for FluGone. Using the financial analysis for Elixir, it is straightforward to calculate the royalty rate that provides this arm's-length result. Tables 3 and 4 show the financial analyses for the licensee and licensor in the controlled transaction, respectively. The royalty rate that results in the arm's-length share of 22 percent to the licensor is 13.2 percent.

Table 3: NPV of Net Income Received by Licensee for Elixir
Share of Income to Licensee Equals 78%

Year	Net Sales (Millions)	COGS (Millions)	Royalties (Millions)	Marketing (Millions)	R&D Expenses (Millions)	Net Income before Taxes (Millions)	Net Income (Millions)	Discount Factor (at 10%)	NPV of Net Income (Millions)
[a]	[b]	[c]	[d] = [b]*13.2%	[e]	[f]	[g]=[b]-[c]-[d]-[e]-[f]	[h] = [g]*0.65	[i]	[j] = [h]*[i]
2008	\$ -	\$ -	\$ -	\$12.0	\$20.8	\$ (32.8)	\$ (21.32)	1	\$(21.3)
2009	\$ -	\$ -	\$ -	\$33.0	\$20.8	\$ (53.8)	\$ (34.97)	0.9091	\$(31.8)
2010	\$ 95.7	\$14.4	\$12.6	\$60.0	\$20.8	\$ (12.1)	\$ (7.84)	0.8264	\$(6.8)
2011	\$171.6	\$25.8	\$22.6	\$63.0	\$20.8	\$ 39.4	\$ 25.62	0.7513	\$19.2
2012	\$265.2	\$39.8	\$34.9	\$63.0	\$15.6	\$111.9	\$ 72.70	0.6830	\$49.7
2013	\$360.9	\$54.2	\$47.5	\$60.0	\$15.6	\$183.6	\$119.33	0.6209	\$74.1
2014	\$460.7	\$69.2	\$60.7	\$60.0	\$15.6	\$255.3	\$165.95	0.5645	\$93.7
2015	\$602.2	\$90.4	\$79.3	\$60.0	\$15.6	\$356.9	\$231.99	0.5132	\$119.0
2016	\$625.0	\$93.8	\$82.3	\$42.7	\$15.6	\$390.6	\$253.92	0.4665	\$118.5
2017	\$613.6	\$92.0	\$80.8	\$30.9	\$ 5.2	\$404.7	\$263.04	0.4241	\$111.6
Total in 2008 dollars:									\$526.1
Total in 2014 dollars:									\$657.7

Table 4: NPV of Net Income Received by Licensor for Elixir
Share of Income to Licensor Equals 22%

Year	Net Sales (Millions)	Royalty Rate (%)	Royalty Income (Millions)	Net Income before Taxes (Millions)	Net Income (Millions)	Discount Factor (at 10%)	NPV of Net Income (Millions)
[a]	[b]	[c]	[d] = [b]*[c]	[e]	[f] = [e]*0.65	[g]	[h] = [f]*[g]
2008	\$ -	13.2%	\$ -	\$ -	\$ -	1	\$ -
2009	\$ -	13.2%	\$ -	\$ -	\$ -	0.9091	\$ -
2010	\$ 95.7	13.2%	\$12.6	\$12.6	\$ 8.19	0.8264	\$6.8
2011	\$171.6	13.2%	\$22.6	\$22.6	\$14.69	0.7513	\$11.0
2012	\$265.2	13.2%	\$34.9	\$34.9	\$22.70	0.6830	\$15.5
2013	\$360.9	13.2%	\$47.5	\$47.5	\$30.88	0.6209	\$19.2
2014	\$460.7	13.2%	\$60.7	\$60.7	\$39.43	0.5645	\$22.3

Year	Net Sales (Millions)	Royalty Rate (%)	Royalty Income (Millions)	Net Income before Taxes (Millions)	Net Income (Millions)	Discount Factor (at 10%)	NPV of Net Income (Millions)
[a]	[b]	[c]	[d] = [b]*[c]	[e]	[f] = [e]*0.65	[g]	[h] = [f]*[g]
2015	\$602.2	13.2%	\$79.3	\$79.3	\$51.53	0.5132	\$26.4
2016	\$625.0	13.2%	\$82.3	\$82.3	\$53.49	0.4665	\$25.0
2017	\$613.6	13.2%	\$80.8	\$80.8	\$52.51	0.4241	\$22.3
Total in 2008 dollars:							\$148.4
Total in 2014 dollars:							\$185.5

Extending the approach to exceptional intangibles

In some cases, the intangibles transferred in the controlled transaction may have profit potential that far exceeds those in the set of potential CUTs. While there may not be a CUT, this does not mean that the useful data and information from the taxpayer's agreements with third parties should be discarded. In such cases, the set of potential CUTs likely provides the best available information to model the taxpayer's own behavior when entering into a license agreement. Therefore, it is possible to use *all* of the potential CUTs to apply the comparable profit split method. Specifically, the range of shares to the licensor and licensee and the median value of that range provide useful information for applying the comparable profit split.

Consider the example above for the product Elixir. If the profit potential for Elixir were, for example, \$1.5 billion, there would be no clear comparable uncontrolled transaction.¹⁷ However, the shares to the licensor in the set of potential CUTs range from 18 percent to 33 per-

¹⁷ Note that if the product with the highest profit potential were chosen, it would result in a share to the licensor of 22 percent, which does not correspond to the highest licensor's share for the set of potential comparable uncontrolled transactions. In the author's experience, profit potential and the share of profits to the licensor do not move in lock step. As a result, the uncontrolled transaction with the highest profit potential may not be an appropriate CUT.

cent, with a median of 23.75 percent.¹⁸ Applying the financial analysis for Elixir and the 23.75 percent share to the licensor, it is straightforward to calculate the resulting royalty rate using the approach illustrated in Tables 3 and 4.

Conclusions

Companies that are active in the marketplace for intangible property should consider examining their license agreements with third parties as potential comparables for controlled transfers of intangible property. The rich set of information typically available in these circumstances often allows for reliable adjustments. The result is a defensible transfer price based on the application of the CUP or CUT method, the preferred methods when sufficient, reliable data exist. Even in situations where the controlled transaction involves an exceptional intangible, the same data and information can be used to apply the comparable profit split method.

These approaches also may reduce the risk of tax controversies, adjustments and penalties as they do not require the selection of comparable license agreements or companies based on a more limited set of information available in public databases. Instead, these approaches rely on the taxpayer's own experience in the marketplace for intangible property and its own method for evaluating arm's-length license agreements with third parties.

¹⁸ In this case the median is equal to the midpoint of the interquartile range.