

TRANSFER PRICING

Intangible Property,
Tangible Profits
2015



Edgeworth
Economics

PREFACE

Transfer Pricing: Intangible Property, Tangible Profits 2015 is a white paper published by Edgeworth Economics. Edgeworth created and fielded two surveys—one was sent to attorneys at law firms, and the other to transfer pricing professionals at companies. Edgeworth administered the online survey, and collected and analyzed the data. Please note that the survey results are based on a small sample of transfer pricing professionals who responded to our survey, and the results may not be indicative of the larger group of transfer pricing practitioners. Judgments based on small samples should be made with caution.

We would like to thank the survey respondents; those who provided input into the questions; and, especially, Sam Maruca and Clark Armitage for their insights.

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Following the success of the Edgeworth Economics/ALM Legal Intelligence survey release in 2014, *Transfer Pricing: Intangible Property, Tangible Profits (2014 Transfer Pricing Survey)*, Edgeworth once again surveyed leading transfer pricing professionals to provide an update on best practices in transfer pricing for intangibles. A lot has happened in the last year, and we have worked to capture practitioners' responses to critical developments in our survey questions. This survey will inform practitioners about the key issues facing transfer pricing professionals and guide their decision-making process on how best to address them.

In particular, Edgeworth's 2015 Transfer Pricing Survey was fielded after several relevant issuances by the Organisation for Economic Co-operation and Development (OECD) including the *Guidance on Transfer Pricing Aspects of Intangibles*, the *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*, the *Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains*, the *Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)* [hereafter referred to as the *Risk and Recharacterisation Draft*], and the *Discussion Draft on Hard-to-Value Intangibles*. Subsequently, on October 5, 2015, the OECD released its final Base Erosion and Profit Shifting (BEPS) package, which included over 1,000 pages of text that set the stage as we move forward.

With this survey, we sought to gauge the state of practitioners' current transfer pricing practices for intangibles and their practical responses to regulatory developments. In particular, what intangibles are important to companies and how are they identified? What are current tax planning practices, and what are the drivers of the chosen transactional structures? What transfer pricing methods are used, and how aggressive are the tax positions taken? And, finally, how have recent regulatory developments affected planning and execution of transfer pricing for intangibles? Given the prominence of the issue, we also polled practitioners on their practical experience with how independent parties behave in transactions involving intangibles.

In addition, there were several other notable developments related to intangibles that occurred in the latter part of 2015. The United States Tax Court decided, in *Altera Corporation and Subsidiaries v. Commissioner of Internal Revenue*, that a 2003 amendment (Treas. Reg. §1.482-7(d)(2)) requiring stock-based compensation to be included in cost-sharing arrangements was arbitrary and capricious. There were numerous Congressional proposals for changes to the tax code, including modifications for repatriation of profits and a potential "patent box." Finally, the European Commission (EC) began taking a close look at certain Advance Pricing Arrangements in terms of whether they constituted violations of rules on state aid. There will be much to discuss in 2016.

When the OECD issued its final BEPS package, it was noted that it was time to move beyond guidance and to begin implementation and monitoring. Significant uncertainty remains about what implementation will bring as a practical matter, and monitoring may lead to further changes in guidance. The results of this survey illuminate fundamental issues in transfer pricing for intangibles while also providing practical guidance on how peers are executing their transfer pricing strategies and responding to uncertainty.

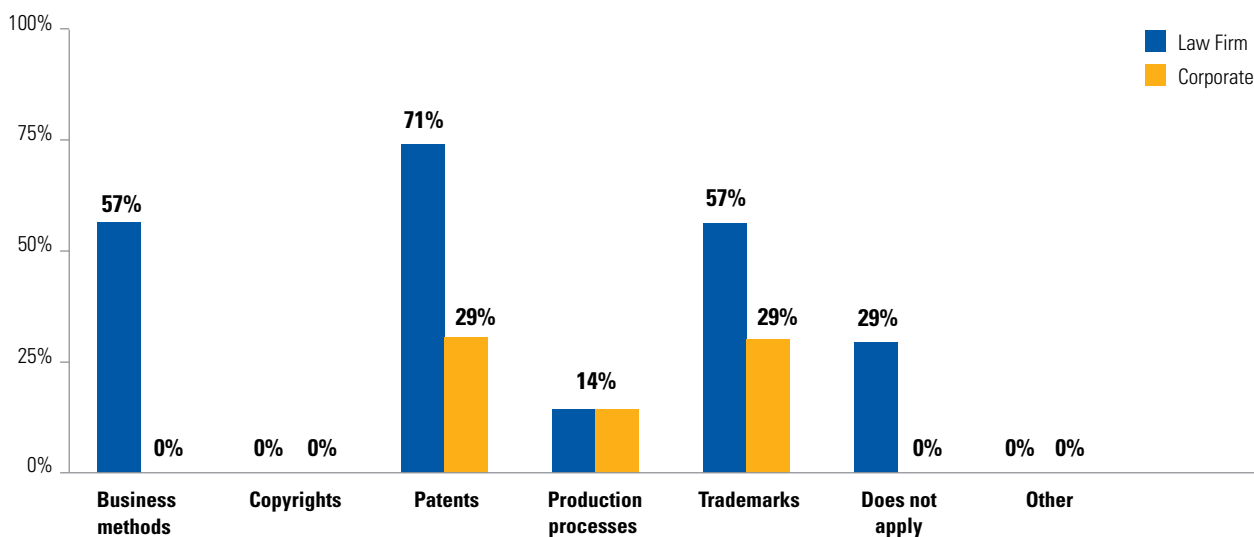
Setting the Stage

Intangible assets are a vital driver of value for many firms, especially in industries such as pharmaceuticals, media, and electronics, to name a few. Moreover, the regulatory landscape is more dynamic than ever with numerous proposed (and some actual) changes spurred by the work of the OECD, the US Treasury and Internal Revenue Service, the EC, and governments and tax authorities around the world. In particular, the final BEPS package issued on October 5, 2015 could have significant implications for companies' transfer pricing arrangements.

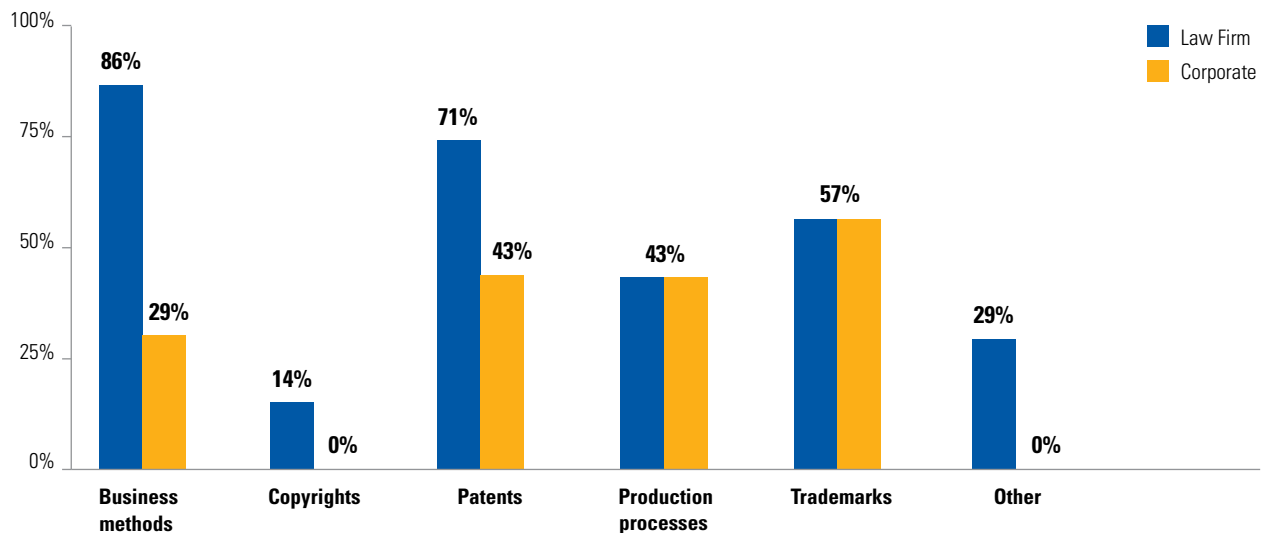
Companies employ many different types of intangibles, and these intangibles add value in a variety of ways. For example, patents provide exclusive rights to the use of a specific technology, but the value of a patent will depend on, among other things, whether it provides broad exclusivity or merely exclusive rights to a niche product in a crowded marketplace.

Similarly, a trademark may have more value when the mark is widely known and perceived as representing qualities that are important to consumers. As with our 2014 *Transfer Pricing Survey*, respondents utilize and address transfer pricing issues on many different types of intangible property.

What types of intangible assets are at issue in most of your transfer pricing work on intangibles? Please select all that apply.



What types of intangible assets does your company or do your clients most frequently own and use? Please select all that apply.



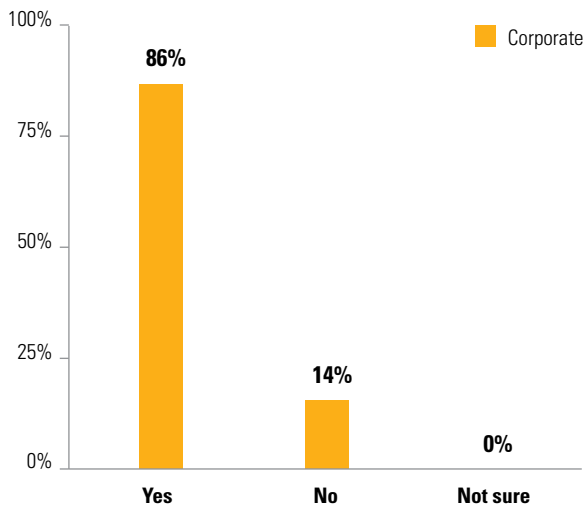
The “other” category in this case included assets such as goodwill and 936(h)(3)(B) property. Notably, the referenced section of 936 provides a definition of intangibles, including “any similar item, which has substantial value independent of the services of any individual.” Clearly, transfer pricing professionals deal with a wide array of intangibles, making the changing environment even more complicated.

Companies that own and use intangible assets are also frequently actively engaged in licensing them. Our survey respondents are no exception, with 86 percent of companies and 71 percent of law firms reporting that they or their clients are engaged with third parties in the marketplace for intangibles.

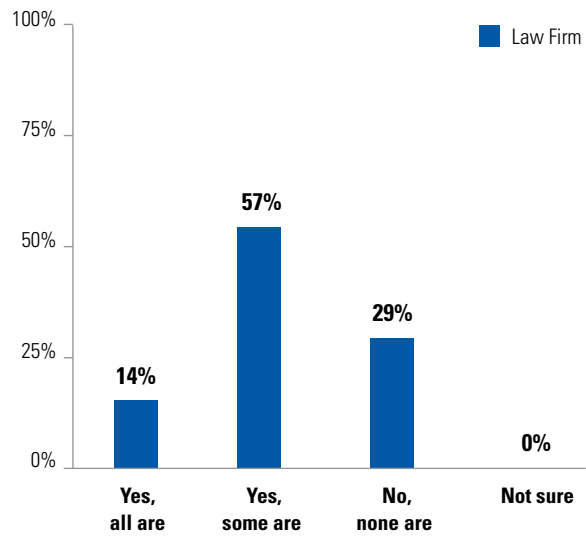
“The final revisions to Chapters 1 and 6 of the TPG have been issued from the OECD. Thankfully, they retreat from many of the more novel and ill-defined concepts floated in earlier drafts, and represent a re-affirmation of traditional analysis under the arm’s length principal, such as separate-entity accounting, the importance of contracts, recharacterization only in unusual circumstances, and reliance on benchmarking. The real question is, what impact will the revised guidance have on the ground, particularly in emerging economies? I suspect that in the absence of greater discipline, and ground-up reform, in some jurisdictions, MNEs should expect a long and difficult slog, exacerbated by CbC reporting and, potentially, wide-spread use of profit splits.”

Sam Maruca, Partner, Covington & Burling

Is your company active in licensing in or licensing out intangible assets?



Are your clients with intangible assets active in licensing in or licensing out technologies?



This is a critical question because firms that are active participants in the marketplace for intangible assets may well have agreements with third parties that could be viewed as potential comparables for intercompany transactions.

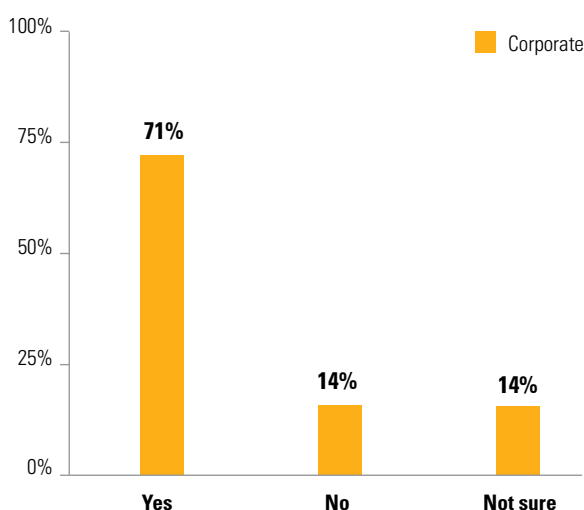
Internal Agreements as Potential Comparables

“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 his or her own method for evaluating arm’s length license agreements with third parties.”

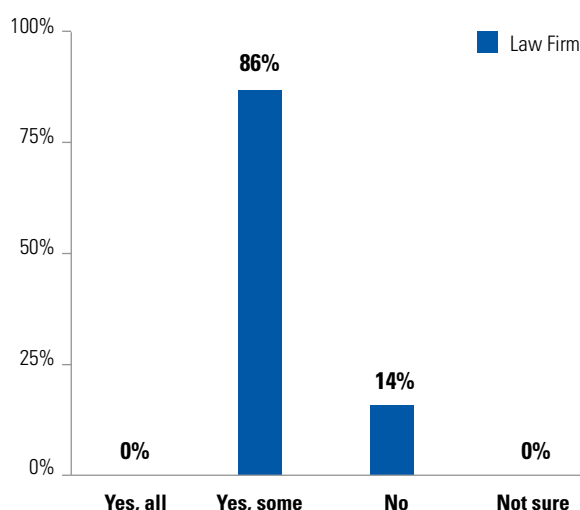
For additional discussion and examples, see G. Korenko, “Using Internal Agreements to Price Intangibles Transfers,” *Tax Management Transfer Pricing Report*, Vol. 23 No. 6, 7/10/2014. Available at www.edgewortheconomics.com.

One important development since our last survey was fielded is with respect to the reporting of intangibles. Specifically, the OECD's *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* requires companies to, among other things, provide a "list of intangibles or groups of intangibles of the MNE group that are important for transfer pricing purposes and which entities legally own them" in their Master File. Our survey indicates that most transfer pricing attorney and company respondents actively work to identify and document all relevant intangible assets. The requirements of country-by-country reporting are extensive, but those that already have processes in place for identifying and documenting intangibles will be well served for meeting this aspect of their reporting obligations.

Does your company identify and document all relevant intangible assets for transfer pricing?



Does your law firm or company work with clients to identify and document all relevant intangible assets for transfer pricing?

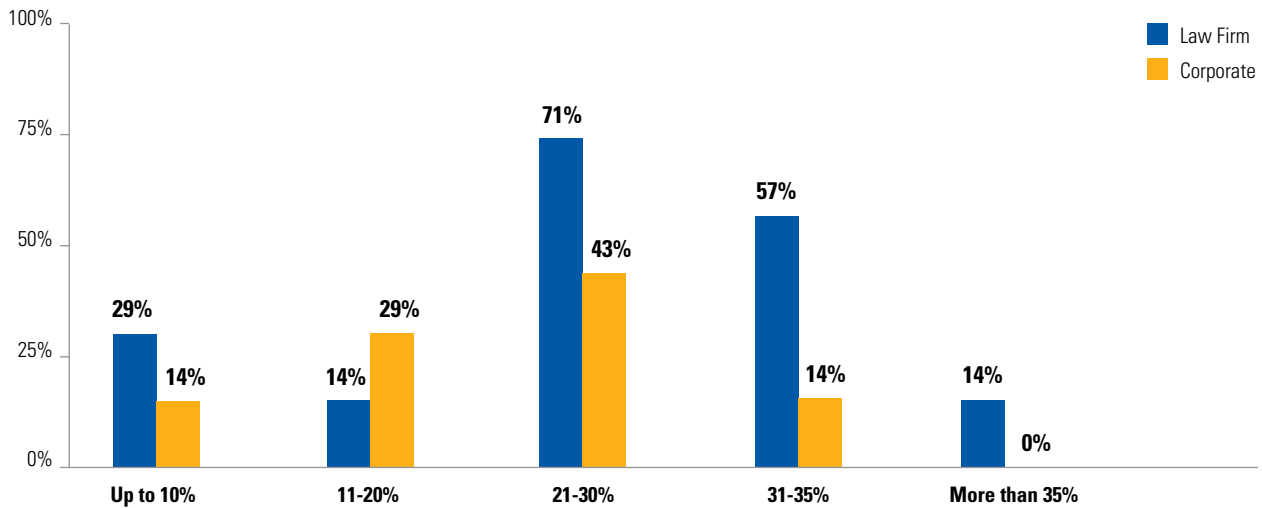


Tax Planning for Success

Intangible assets are often mobile and can be shifted from one jurisdiction to another, thus providing a key motivation for the BEPS project. Indeed, certain BEPS initiatives, US Congressional proposals, and EC actions have been aimed at practices that are perceived to be taking "unfair" advantage of tax planning opportunities in low-tax jurisdictions.

The ability to shift intangible assets for tax benefits and the interest in doing so may vary from company to company. As a result, we observe a myriad of effective tax rates for respondents.

In what range does your company or do your clients' overall effective tax rates tend to fall? Please select all that apply.



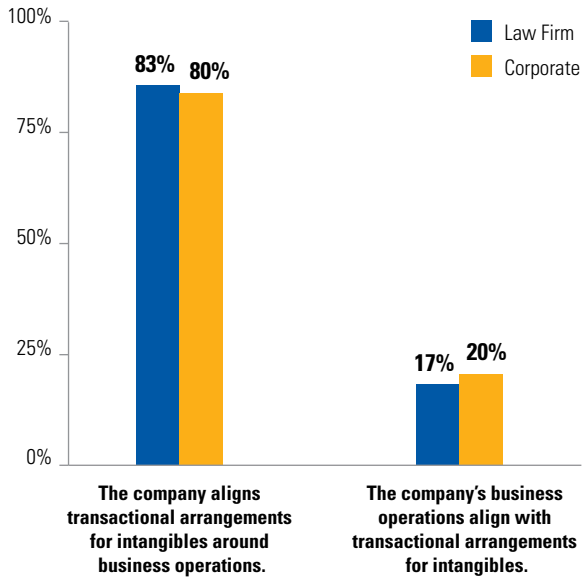
However, practical business realities may prevent companies from shifting intangible assets to low-tax jurisdictions. For example, the vast majority of corporations and law firms prefer a company to align its transactional arrangements around business operations rather than to restructure a business operation just to take advantage of potential tax savings. Often for companies, efficiency of operations outweighs potential tax savings. Moreover, with increased scrutiny of intangible asset transfers has come an increased burden of demonstrating that the transactions have “substance”.

EC Focuses on Possible Illegal State Aid to Amazon

The EC has been reviewing transfer pricing arrangements in Luxembourg to determine whether there have been violations of the EC’s rules on state aid. For example, in January the EC released a 23-page letter describing its concerns that Luxembourg’s 2003 transfer pricing arrangement with Amazon was in violation of rules on state aid. Amazon is one of many global corporations with its European headquarters in Luxembourg, largely due to the country’s favorable tax environment. The letter states that in the EC’s view, the Luxembourg tax authorities approved an advance pricing arrangement or “APA” that allowed Amazon’s European entity to lower the company’s overall tax burden in a way that was inconsistent with the arm’s length standard. Specifically, the EC charged that this tax arrangement allowed Amazon to structure its transactions so that substantial profits flowed to an untaxed entity in Luxembourg. Amazon is not alone—other companies whose arrangements are being scrutinized by the EC include Google and Apple.

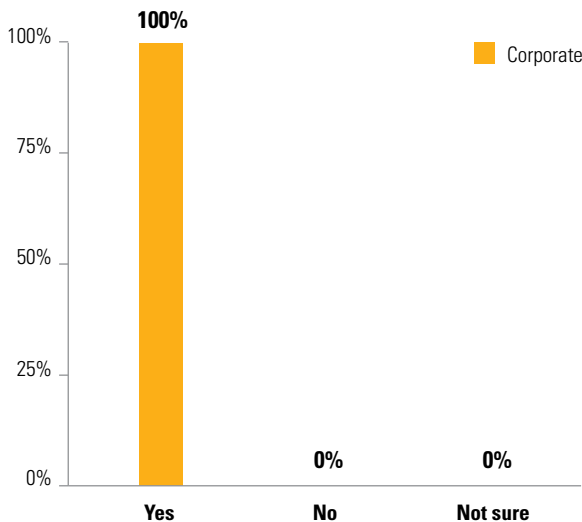
Read the complete article at www.edgewortheconomics.com.

Which of the following statements best characterizes your preferred approach to transfer pricing for intangible assets?

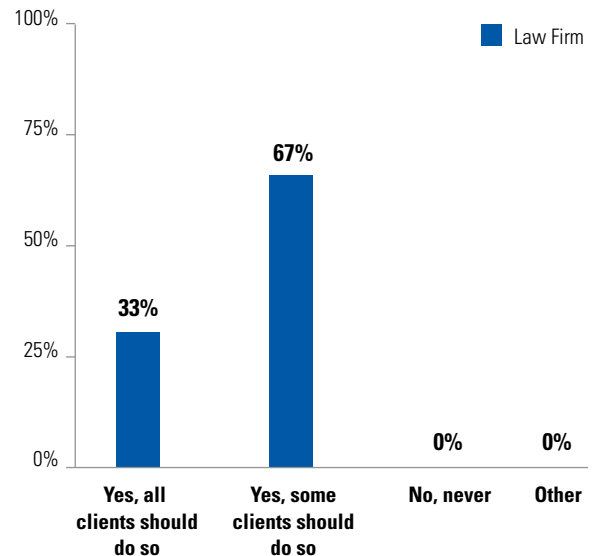


One of the more controversial positions taken by the OECD during the BEPS work is that an entity that only owns an intangible and funds its development may only be entitled to an arm's length return for funding. To obtain additional returns—especially residual returns—from the use of the intangible, an entity also has to exercise managerial control over the development, use, and protection of the intangible. The 2014 *Transfer Pricing Survey* found that 76 percent of companies already located such managerial functions with the entity that owned and funded the intangible. The results from this year's survey confirm that companies and tax advisors already prefer to provide more "substance" to such arrangements.

Do you currently locate functions associated with managerial control of the development/use/protection of intangibles with the entity that legally owns and funds the development/use/protection?

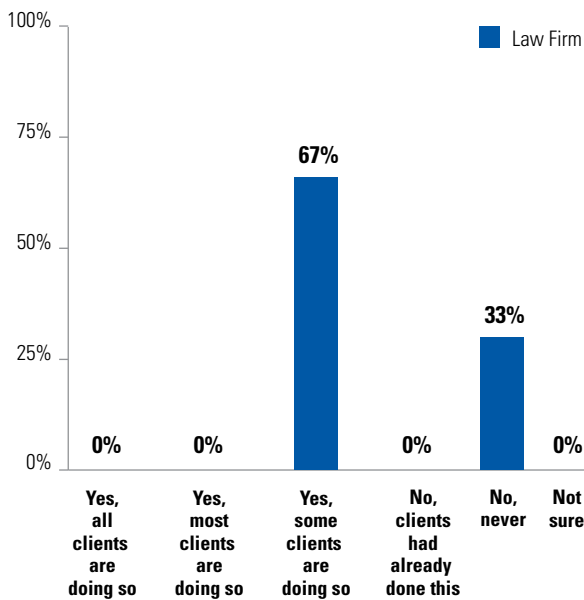


Do you currently recommend that your clients locate functions associated with managerial control of the development/use/protection of intangibles with the entity that legally owns and funds the development/use/protection?

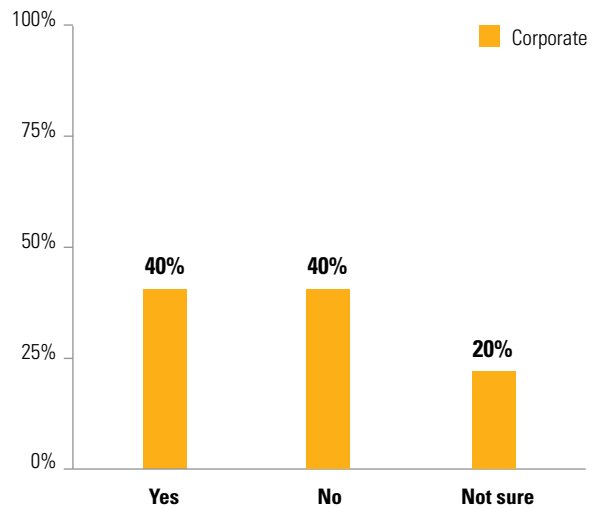


Interestingly, this does not necessarily mean that existing staff is being relocated to conform to the OECD’s recommendations. Companies and law firms both appear to either be reticent to make such changes or consider such changes to be unnecessary, perhaps because they believe there is already sufficient substance in the entity that owns and funds the intangible.

Are your clients staffing or relocating managerial personnel to the locations where functions associated with legal ownership and funding of the development/use/protection of intangibles are performed?

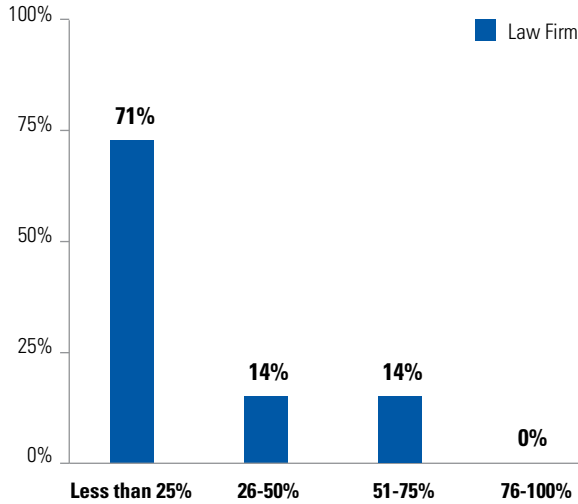


Are you staffing or relocating managerial personnel to the locations where functions associated with legal ownership and funding of the development/use/protection of intangibles are performed?

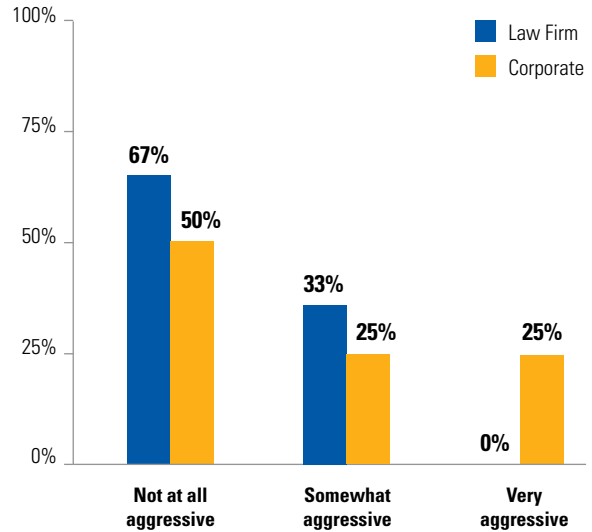


Taxpayers’ concern over substance is not new, as the US Section 482 regulations already require transactions to meet certain requirements, such as ensuring that the parties can realistically perform the functions required and bear the risks anticipated. However, the concern is heightened in the current environment as the OECD has proposed that tax authorities could recharacterize a transaction if they consider it to be problematic in certain respects. Importantly, tax structures that lack “substance” could be subject to substantial adjustments. Given that many companies and law firms have already considered issues related to substance, it may not be surprising that most attorneys expect fewer than 25 percent of their clients to realize a significant tax adjustment on their transfer pricing for intangibles in the next 3-5 years.

What percentage of your clients do you expect to realize a significant tax adjustment on transfer pricing for intangible assets over the next 3–5 years?



How aggressive do you typically consider your tax positions or recommendations regarding tax positions for intangibles?

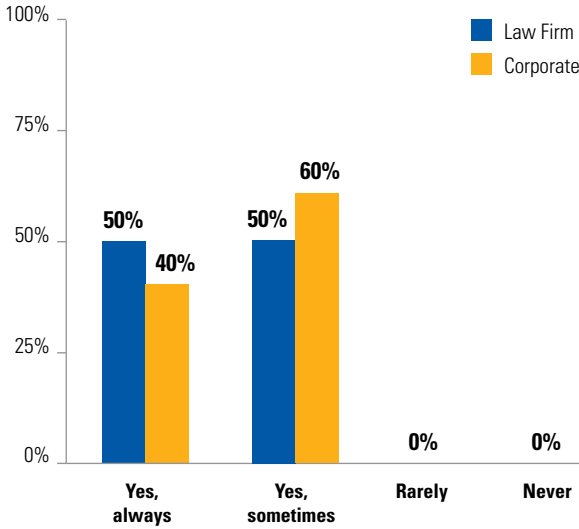


Muted concern over tax adjustments may also be reflected in the perceptions of corporations and law firms about the aggressiveness of their tax positions. Most consider their positions, or that of their clients, not to be at all aggressive.

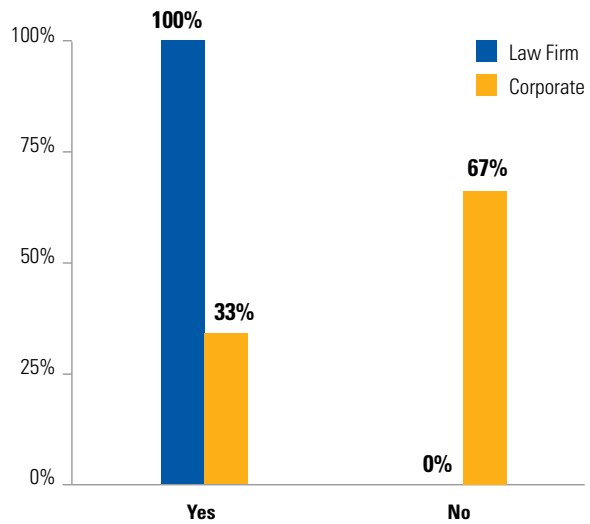
Transfer Pricing at Work

Because the effects of taxes and tax planning stretch across geographic boundaries and operational functions, such planning is often conducted with involvement across multiple departments. All respondents said that they work with other departments at least some of the time when formulating arrangements or developing documentation.

Do you or do you suggest that your clients engage with other departments when formulating transfer pricing arrangements or documentation?



Do you or do you recommend your clients' tax department coordinate with other departments when determining appropriate data and valuation methodologies to use in transfer pricing for intangibles?



Indeed, cooperation with other departments is critical, as the value of intangibles is the subject of scrutiny in multiple forums. For example, it may be important for tax departments to work with other corporate departments to identify appropriate forecasts, assumptions, and valuation methods used in other forums. Such coordination can ensure that information used in transfer pricing documentation does not conflict with information on the same intangible that is used for financial reporting, litigation, or other relevant purposes. While all law firm respondents suggested coordinating across departments, significantly fewer companies reported actually doing so.

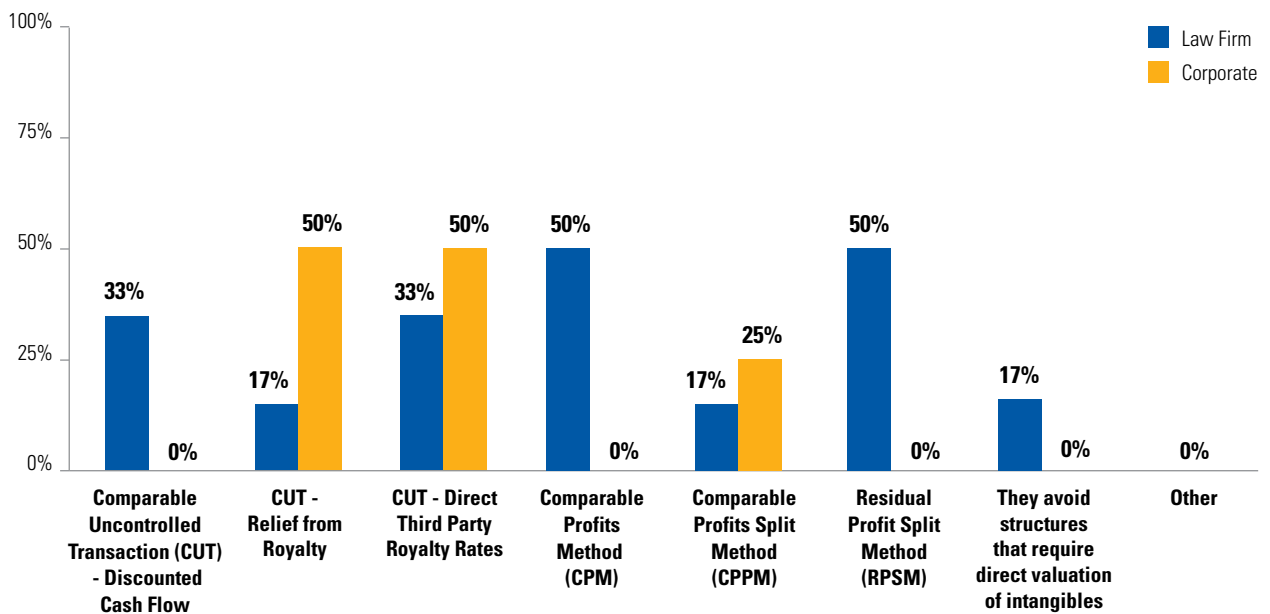
Internally Consistent Valuation Across Forums

One way to avoid transfer pricing valuations that conflict with valuations utilized for alternate purposes is to coordinate with other departments in the company. R&D personnel, financial analysts, sales personnel, and other similar departments may have relevant information contained in internal company documents prepared in the ordinary course of business. If a financial analysis prepared for financial statements is inconsistent with a transfer pricing analysis, either in terms of sales or cost projections or assumptions, the company should have an explanation at the ready. For example, the best source of financial projections for valuing intangibles are often internal company documents prepared during the ordinary course of business for management to review when making decisions. This is the same type of document one might consider using for patent litigation, as it may enhance the credibility of the analysis.

Read the detailed analysis of this topic at www.edgewortheconomics.com.

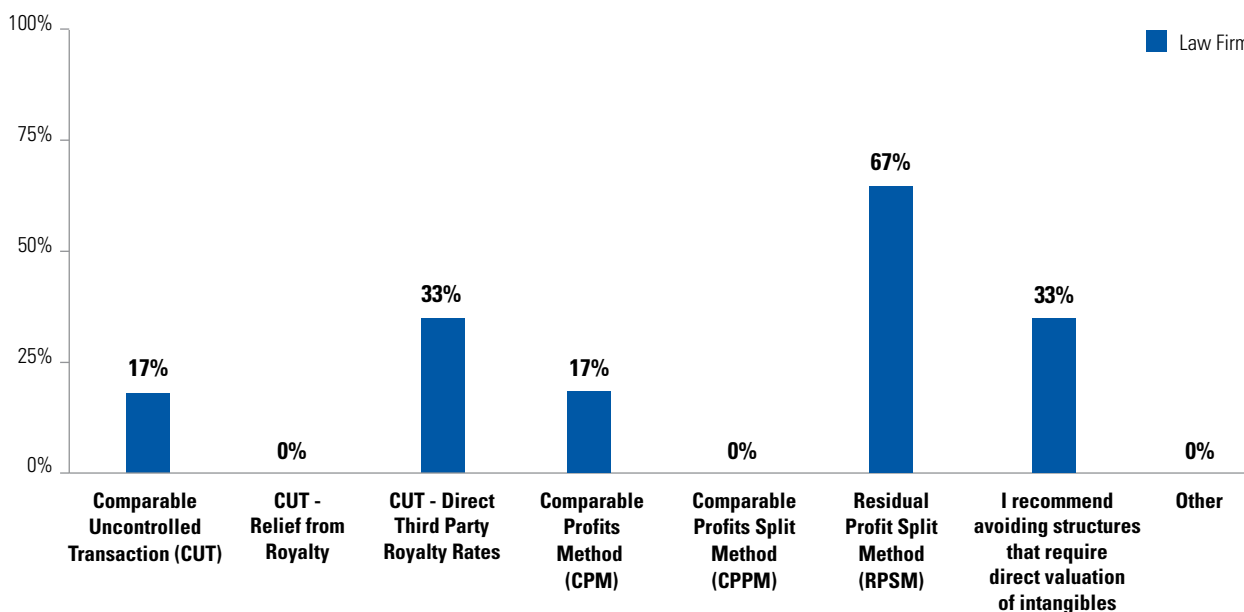
Applying appropriate economic principles and fully explaining a company's data and pricing methodology can provide defensible application of the arm's length standard and help alleviate future controversies. For example, the choice of methods to use in valuing intangible assets depends on an assessment of the type, amount, and quality of the data available. Survey respondents report using a variety of methods to value transfers of intangibles.

What techniques do you or do your clients most often use to value intangible assets for tax purposes?



Variations of the comparable uncontrolled transaction (CUT) method are often applied by both law firms and companies. In our 2014 Transfer Pricing Survey, the CUT method was identified as a preferred method. However, this year we further distinguished the possible CUT methodologies to include discounted cash flow (either straight discounted cash flow or relief from royalty discounted cash flow) or third-party royalties. It appears that respondents employ all three types of CUT analyses to value intangibles for transfer pricing, though more frequently refer to third-party royalty rates. And, while law firm respondents recommend a variety of methods to apply when valuing intangibles, surprisingly, the preferred method among law firm respondents is the residual profit split method, which ranked next to last in 2014.

What techniques do you most often recommend to value intangible assets for tax purposes?



Navigating Regulatory Developments

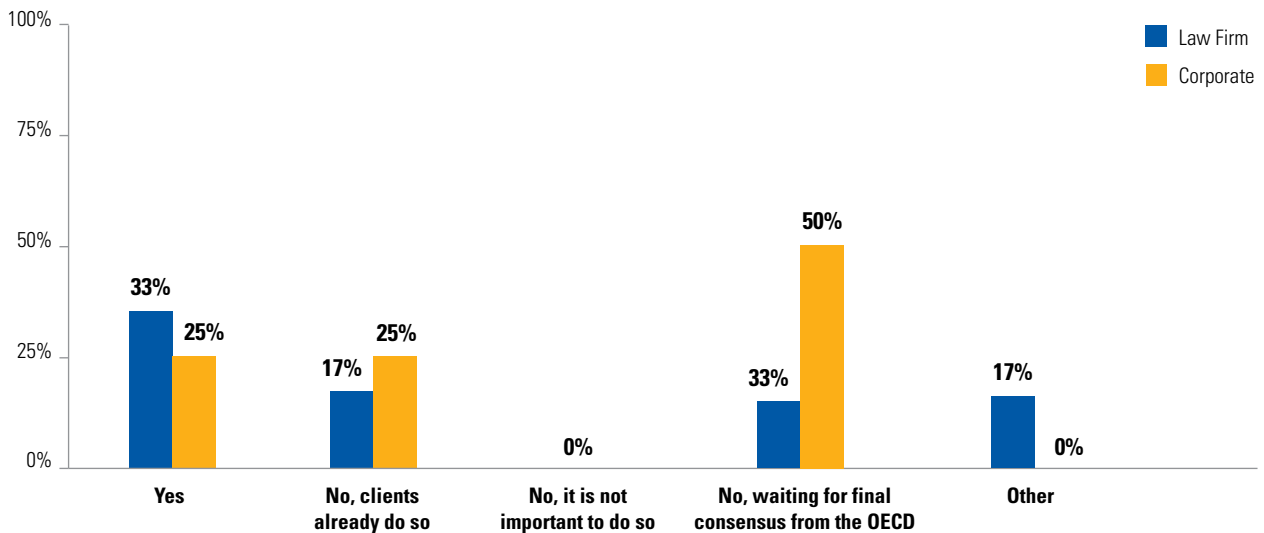
While most respondents report waiting for a final rule from the OECD with regard to BEPS, a handful report already having shifted the “substance” of key intangibles in response to the OECD’s recent *Guidance on Transfer Pricing Aspects of Intangibles and Risk and Recharacterisation Draft*. These documents provided more information on where the OECD is heading and, importantly, some countries may seek to apply the principles from them on a unilateral basis.

“The risk of BEPS, especially unilateral BEPS, is that some intangible income will be taxed in multiple places at a net rate in excess of 100%. Yes, business decisions shouldn’t be driven by tax considerations. But that changes where the tax environment ensures a negative business outcome.”

J. Clark Armitage, Member, Caplin & Drysdale

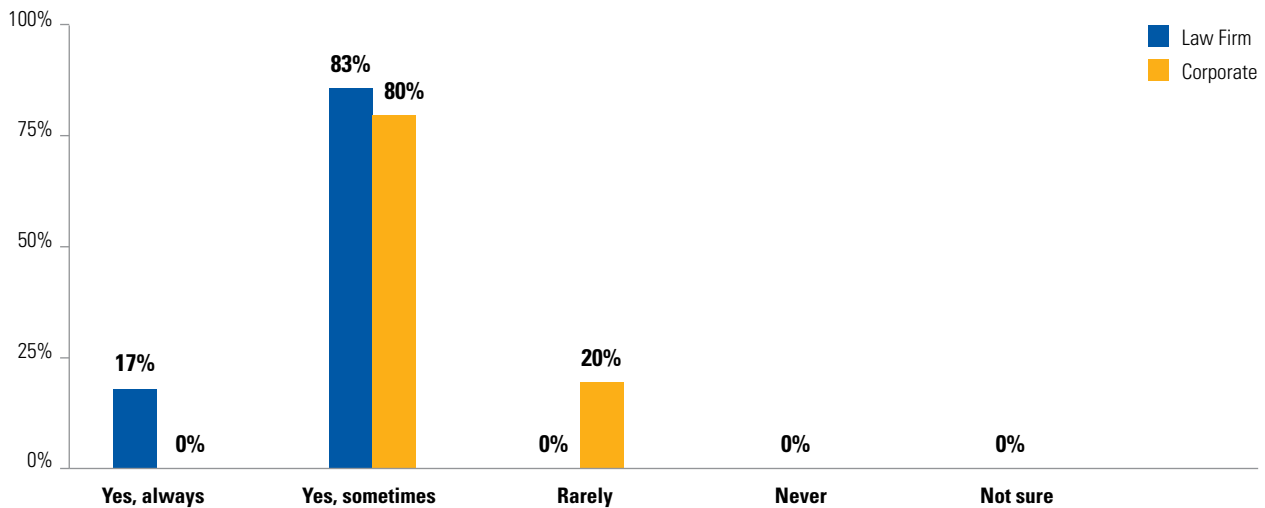
In this context, the results from our survey are not surprising. Similar to last year’s survey results, respondents report a variety of reactions, from a continued approach of waiting for further developments, to active recommendations or intentions to make changes to current arrangements. Notably, 17 percent of law firm respondents and 25 percent of corporate respondents state that clients are already compliant with the recommendations in the *Guidance on Transfer Pricing Aspects of Intangibles*.

Do you or do you recommend your clients review or plan to review existing tax arrangements to shift “substance” (e.g., control of development, maintenance, and protection of the IP) in response to the OECD’s *Guidance on Transfer Pricing Aspects of Intangibles*?



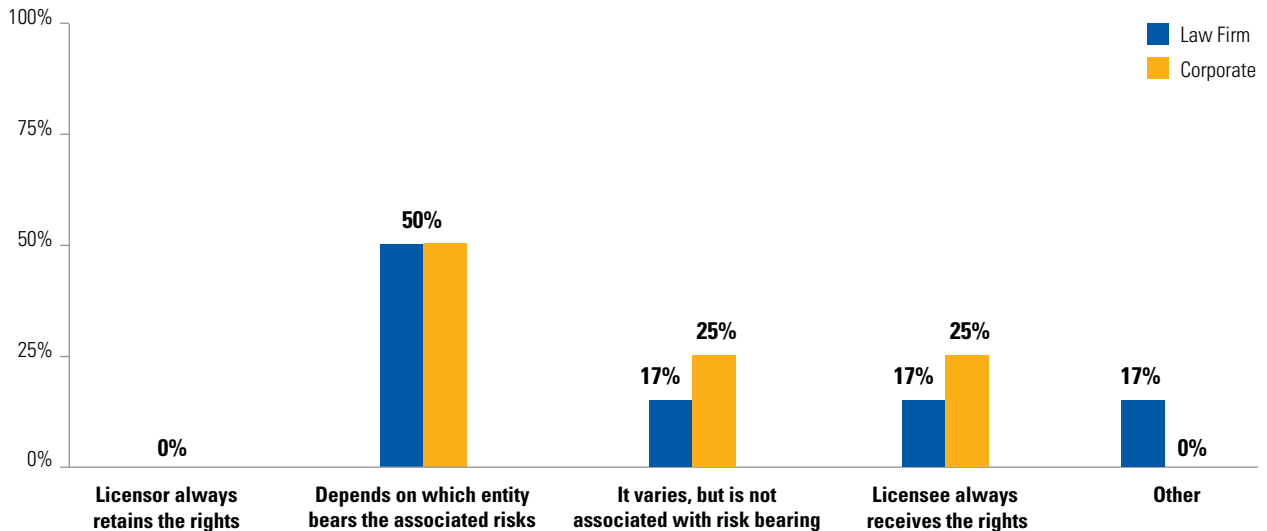
Also of interest is that the respondents of the 2015 survey report that third-party licenses tend to situate managerial oversight and control of the intangible with the entity that is the legal owner and funds the development.

In your experience in negotiating or reviewing licensing transactions between third parties, does the same entity that has legal ownership and/or provides funding also provide managerial oversight and control?



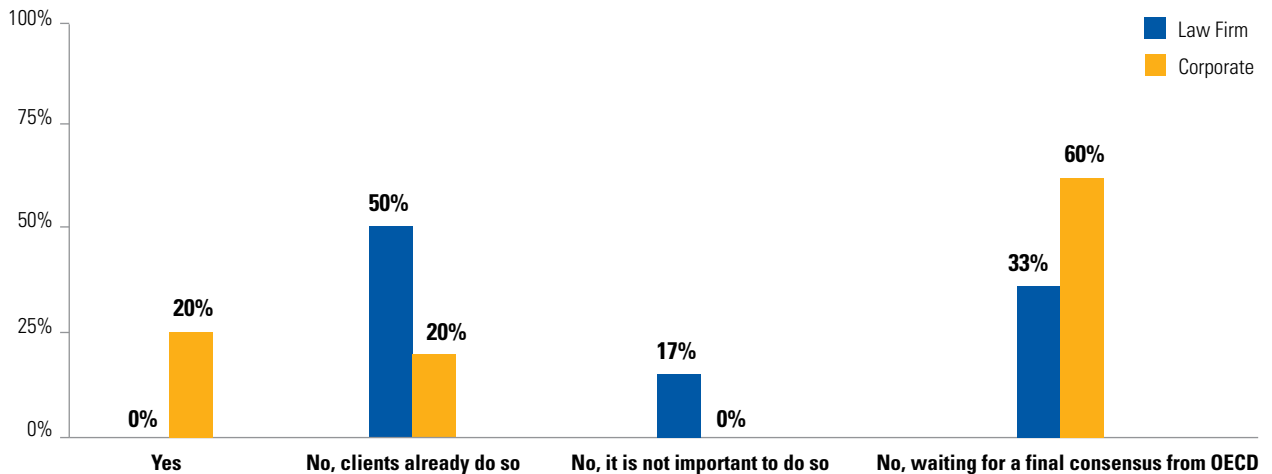
The OECD *Risk and Recharacterisation Draft* discussed the allocation of unanticipated returns (and losses) to entities based on risk. To better understand what practitioners observe at arm’s length, we asked how they observe risks allocated in license agreements between third parties. The majority of respondents said that in third-party licenses, which entity receives the right to unanticipated returns depends on which entity bears the associated risks. This allocation of risk and return is consistent with economic principles—in general, parties that agree to bear risk require higher potential returns to do so.

In your experience, if a party licenses a commercial asset to another entity that manages the exploitation of the asset, does the licensor retain the right to earn unanticipated returns or is that right transferred to the licensee?



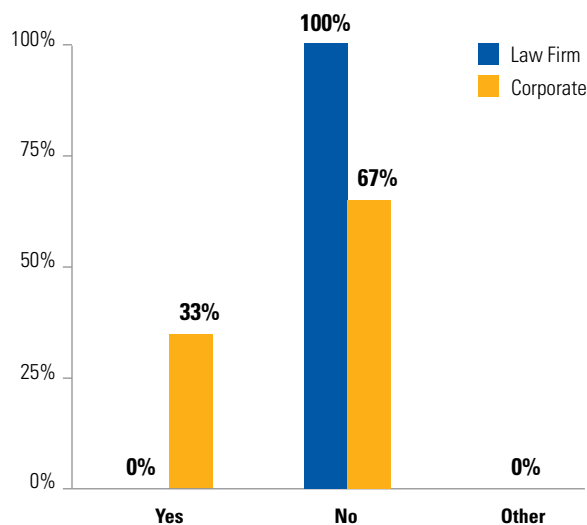
One area of interest in the *Risk and Recharacterisation Draft* is the allocation of returns to risk management functions rather than risk bearing functions. Based on the numerous comments the OECD received, practitioners may have anticipated substantive changes coming. Many respondents reported waiting for a final consensus from the OECD before making changes to tax arrangements. Interestingly, many respondents noted that these practices are already followed.

Have you or your recommended clients reconsidered tax arrangements to allocate returns to risk management functions rather than risk bearing functions given the OECD's *Discussion Draft on Risk and Recharacterisation*?



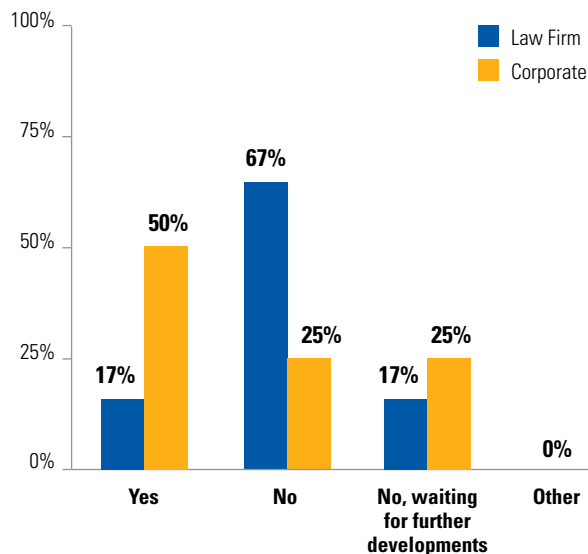
The OECD's issuance of the *Guidance on Transfer Pricing Aspects of Intangibles and its Risk and Recharacterisation Draft* has had no effect on law firms' recommendations for valuation methods and limited effect on companies' use of particular valuation methods.

Have you changed or recommended clients change valuation methods in response to the OECD's recent *Guidance on Transfer Pricing Aspects of Intangibles* or its *Discussion Draft on Risk and Recharacterisation*?



The OECD's *Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* can also affect company tax arrangements, as tax authorities will receive more information than ever before on a taxpayer's value chain, including royalty payments. Given that some countries have already stated that they will move forward under this guidance, it is not surprising that corporate respondents are taking the lead in making changes to their tax planning strategies. In contrast, law firms appear to be somewhat more reticent to do so.

Has the OECD's Country-by-Country reporting guidance caused you or caused you to recommend clients to make changes to tax planning strategies?



Conclusion

The dynamic landscape of transfer pricing for intangibles continues to evolve. Disputes about the appropriate arm's length consideration for the transfer of an intangible asset have become increasingly common. Regulatory bodies are proposing and implementing new rules, some of which will have substantial effects on tax planning and could lead to double taxation of returns from intangibles. In such an environment, transfer pricing practitioners must navigate murky regulatory waters while rationalizing tax effects with business operations to successfully plan and execute tax strategies around transfers of intangibles.

About Edgeworth

Edgeworth Economics provides quantitative and economic consulting in the course of litigation and business to its clients, which include world-class law firms, Fortune 500 companies, and government agencies. Edgeworth experts apply their knowledge and experience, along with state-of-the-art computing infrastructure, to help clients efficiently manage complex issues including antitrust litigation, privacy & data security, transfer pricing, intellectual property, mergers and acquisitions, class actions, labor, and data & HR analytics. As a rapidly growing firm with a fresh approach, Edgeworth attracts leaders and teachers from across the industry including PhD economists, MBAs, statisticians, and programmers. Edgeworth has offices in Washington, DC, Pasadena, San Francisco, and Toronto.

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