Transfer Pricing and Intangible Assets

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Arguably one of the most complex areas of transfer pricing, a topic in evolution and an area of controversy

One of most important commercial developments in recent decades has been growth in significance to enterprises & MNE groups of intangible property: less reliance on physical capital.
Emerging markets attaching importance to local “specificities” and growth potential.
Conflicting views?
Chapter VI (intangibles) and VIII (CCAs) of the OECD TP Guidelines (1995 – 2006)

Chapter IX of the OECD TP Guidelines (2010)

BEPS (2013 – 2015…):

- Actions 8, 9 and 10
  - September 2014, December 2014, June 2015
    - Revised Chapter I and Chapter VI and VIII of the OECD Guidelines
    - Revised Chapter IX(?)
- Action 4 (on capital)
- Action 13 (on disclosure)

UN Manual on Transfer Pricing (2013)

Relevant international case law
A definitional issue?
Well or poorly defined IP?

- Copyrights
- Patents
- Trademarks
- Contracts
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- Patents
- Trademarks
- Contracts
- Know-how
- Trade secrets
- First mover advantages
- Network effects
- Human capital
- Non-contractual relationships
- Barriers to entry
- Business Opportunity
- Goodwill
- Market power
- Well defined and understood, generally accepted analytical framework for valuation
- Poorly defined and understood, little agreement on valuation approach

Well defined and understood, generally accepted analytical framework for valuation

Poorly defined and understood, little agreement on valuation approach
Separate intangible assets?

Network effects

Non-contractual relationships

First mover advantages

Market power

Human capital

Barriers to entry

Goodwill

Business opportunity

Financial / tangible assets

Trade secrets

Know-how

Contracts

Trademarks

Copyrights

Patents

Market power

Human capital

Barriers to entry

Goodwill

Business opportunity

Financial / tangible assets

Trade secrets

Know-how

Contracts

Trademarks

Copyrights

Patents
Or value enhancers?

M
A
R
K
E
C
A
P

Financial / tangible assets

Network effects
copyrights
know-how
First mover advantages

Human capital
trademarks
Barriers to entry
contracts

Market power

Non-contractual relationships

Business opportunity

Goodwill

Trade secrets
Chapter I of OECD TP Guidelines
- intangibles vs comparability factors
  - location savings and other local market features
  - assembled workforce
  - group synergies

New Chapter VI
- Identifying intangibles and on determining arm's length conditions
- Comparability in intangibles transactions
- Transfer pricing methods and use of valuation techniques for intangibles transactions
- 33 examples
What is an intangible?

…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 [...] between independent parties in comparable circumstances.

not an accounting definition, not a legal definition, not an economic-only definition…
Ownership: Who Owns the Key Intangibles?

- If intangibles are centrally (i) developed, (ii) managed, (iii) funded and (iv) maintained → ownership is clear
- If one or more of the elements is performed by different group companies → ownership is unclear
Which parties are entitled to intangibles return?

- Interim guidance on ownership
- 6 steps analysis
- Legal ownership as starting point only
- DEMPE functions
  - Development
  - Enhancement
  - Maintenance
  - Protection
  - Exploitation
- Allocation of returns should be in line with value creation

Identifying and characterizing transactions involving intangibles

- Outright sale
- Licensing
- Intangibles used in the manufacture of goods or provision of services

Arm's Length Conditions?

- Use of valuation techniques
- Arm's length principle
- Consider two-sided perspective / options realistically available
- Value of intangibles can be highly volatile
Valuing vs pricing: comparability analysis

Industry and functional analysis

- Identify industry root causes of profitability
- Identify what competitors or investors would be willing to pay for
- Consider quality and availability of competitor pricing information within industry
- Identify group specific root causes of profitability
- Understand processes around root causes of profitability
- Understand strategic and tactical functions within processes
- Map and align key players performing significant economic functions

This is a key factor especially for African countries, where the availability of large data set on local comparables may be limited; more reliance on economic theory and empirical studies?
Comparability analysis (cont’d)

- Comparability and method selection
  - The rules of Chapters I-III Realistic alternatives for each of the parties need to be considered in transactions involving both transfer and use of intangibles
  - Two sided analysis - the perspective of both parties to the transaction need to be taken into account
  - Any of the OECD approved methods can be used in appropriate circumstances
    - Valuation techniques are useful tools
    - Cautions regarding the use of some methods:
      - Cost based methods discouraged
      - One sided methods (TNMM, CP, RPM) not typical useful to directly value intangibles, but may be used in some residual valuation approaches
  - Price does not necessarily equal value:
    - Why do price and value deviate?
    - What does that mean for pricing?
Valuation and TP for intangibles

Best practices today are centered around the following approaches:

- Transfer pricing methods
  - CUP / CUT
  - RPM
  - TNMM / RPM
- Traditional valuation methods
  - Cost Approach
  - Market Approach (including Multiples, Acquisition Price Method / Market Cap)
  - Income Approach (cash flow / income-based), e.g.:
    - Multi Period Excess Earnings (MEEM)
    - Relief from Royalty
    - Incremental cash flow

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Consider whether the party to which risk is allocated can actually control/manage the risk at issue AND consider whether the transaction possesses the fundamental economic attributes of arrangements between unrelated parties, otherwise recharacterization may occur.

Special Measures include:

- Contingent payment terms for certain transfers of hard to value intangibles (lack of reliable comparables, “speculative” assumptions, “acute” “information asymmetries”): see DD June 2015

- Reallocate returns from an entity that is capital-rich, asset-owning company or has minimal functions, to the entity that actually performs the activities makes possible a return from the asset.
An ever evolving area of TP!

▶ Quoting Mr B. Gates:

(TP guidance for)

IP has the shelf life of a banana!
Some relevant cases

- Maruti Suzuki v. ACIT India (2013)
- Cadbury Ltd. v. ITAT Mumbai
- Veritas (2009)
- Cytec (2008), Norway
Thank you!