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Transfer Pricing Aspects of Intangibles

Dear Mr. Owens,

We appreciate the opportunity to provide our input which is supplementing the PwC comments from Sept. 2, 2010 from a valuation and economics point of view. We would welcome considerations by the OECD WP 6 on the Transfer Pricing Aspects of Intangibles. The past two transfer pricing projects, confirmed that transfer pricing issues pertaining to intangibles are key area of concern to governments and taxpayers, due to insufficient international guidance in particular on the definition, identification and valuation of intangibles for transfer pricing purposes.

Most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles

The most significant issues encountered in practice in relation to the transfer pricing aspects of intangibles are the **identification** and **valuation** of intangibles. The identification and valuation of intangibles are of course not just a hot topic for transfer pricing, but also for management information, strategic planning, value reporting, financial accounting, tax and non-tax dispute resolution and loan or equity financing, to name just a few valuation purposes. That is why some five years ago several standardization committees set out to work on valuation standards for brands, patents and intangibles assets in general to standardize and document what is already best practise of valuation practitioners. As the interpretation of the arm's length standard should reflect normal behaviour between unrelated parties it seems to be worthwhile to pay attention to the standards developed by non-tax organizations.

Identification and Valuation of Intangibles:

a) German Institute of Public Auditors: IDW Standard: Valuation of Intangible Assets (IDW S 5)

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The Institut der Wirtschaftsprüfer in Deutschland e.V. (the Institute of Public Auditors in Germany, Incorporated Association – IDW) is a privately run organisation established to serve the interests of its members who comprise both individual Wirtschaftsprüfer (German Public Auditors) and Wirtschaftsprüfungsgesellschaften (German Public Audit firms). The IDW was established on a voluntary basis rather than having been established under German law. In accordance with its Articles of Incorporation, the IDW does not operate as a commercial business and is a not-for-profit organisation.

The IDW S 5 (standard on the valuation of intangible assets) is an open standard, which was first published in 2007 giving guidance on the general framework as well as on the valuation of brands. It was supplemented by the special principles for the valuation of customer-related intangible assets in 2009 and will be more or less accomplished this year by the valuation principles for technology-based intangibles. So far the IDW S 5 is well received not just by German companies with a national and international focus but also by companies with headquarters outside Germany, as it was the first monetary valuation standard to be published on the framework of intangibles and brands.

The IDW standard sets forth the principles according to which auditors value intangibles. These principles are primarily based on general business valuation procedures and not for the question of whether intangible assets can be accounted for and how they are valued for measurement purposes. The standard starts with the general principles for valuing intangibles before focussing on the special considerations relating to the brands, customer-related intangibles and technology-related intangibles.

b) International Organization for Standardization: ISO Standard 10668: Brand valuation – Requirements for monetary brand valuation

The ISO (International Organization for Standardization) is a worldwide federation of national standards bodies. The ISO's work programme ranges from standards for traditional activities, to standards for good management practice and for services (such as the ISO 10668). ISO standards are voluntary. As a non-governmental organization, ISO has no legal authority to enforce the implementation of its standards.

ISO standards are developed by technical committees comprising experts from the industrial, technical and business sectors which have asked for the standards, and which subsequently put them to use. These experts may be joined by representatives of government agencies, testing laboratories, consumer associations, non-governmental organizations and academic circles. The experts participate as national delegations, chosen by the ISO national member institute for the country concerned. These delegations are required to represent not just the views of the organizations in which their participating experts work, but of other stakeholders too. According to ISO rules, the member institute is expected to take account of the views of the range of parties interested in the standard under development. This enables them to present a consolidated, national consensus position to the technical committee. All international standards are reviewed at the least three years after publication and every five years after the first review by all the ISO member bodies. A majority of the members decides whether an international standard should be confirmed, revised or withdrawn.

According to the introduction of the ISO 10668 the international standard provides a consistent, reliable approach to brand valuation, including financial, behavioural and legal aspects. The ISO 10668 was approved end of July this year and will soon be published.

c) German Institute for Standardization: Draft of the DIN Norm 77100: Patent valuation – General principles for monetary patent valuation

The Deutsches Institut für Normung e.V. (the German Institute for Standardization – DIN) develops norms and standards as a service to industry, state and society as a whole. By agreement with the German Federal Government, DIN is the acknowledged national standards body that represents German interests in European and international standards organizations. Ninety percent of the standards work now carried out by DIN are international in nature. DIN's primary task is to work closely with its stakeholders to develop consensus-based standards that meet the market requirements. DIN is a registered non-profit association.

The draft of the DIN Norm 77100 on the valuation of patents was published in June this year and is open to comments until 7th of October 2010. The expectation is that it will be approved and published this year. According to the scope of the norm it specifies requirements for procedures and methods of monetary patent value measurement as well as their interdependent value drivers. Depending on the availability and the quality of the data for such a valuation the different valuation approaches are prioritized. The norm specifies a framework for patent valuation, including objectives, bases of valuation, approaches to valuation, methods of valuation, sourcing of quality data and assumptions including the reporting of results of such a valuation.

Although it is too soon to judge the acceptance of the DIN as well as the ISO valuation standards on patents and brands it should be stressed that according to the general rule of the standardization bodies both technical committees took account of the views of the range of parties interested in the standard under development, which led to a consolidated, interdisciplinary view on the value drivers of the brands and patents and their effect on a monetary valuation of these intangibles. That is why it is expected that the standards will be well received by multinational companies in giving guidance on how to interdisciplinary acknowledge the business effects of the most important intangibles.

Definition of Intangibles

In contrast to the importance of the identification and the valuation of intangibles the abstract definition of the intangibles is from a pure practical point of view highly controversial. We therefore would like to suggest, not to start with defining the intangibles as our experience from other technical committees is, that this is a rather lengthy process with no sufficient benefit. Instead we believe it worthwhile to focus on the business effects of the intangibles. These business effects must be acknowledged as part of the identification and valuation of the intangibles. If the OECD would like to give some guidance on the technical terms and definitions for the two most important intangibles assets, brands and patents, it might like to consider using the terms and definitions of the ISO standard on brand valuation and the DIN standard on patent valuation.

Some of the comments in the past projects suggested that compensation should be provided only where legally protected property interests, including interests in legally protected intangible property, are transferred. We do not support this view, as it is too narrow. In practice the question whether an intangible is legally protected depends on the one hand on the legal strategy of the company and on the other hand on the question whether and how it is legally protectable. Instead the business impact of a legal protection as well as the quality of its protection should be taken care of in determining the risks associated with the intangible. This is by the way one of the fundamental requirements of all the above mentioned valuation standards.

The existing OECD guidance and focus of further work of the OECD

OECD guidance on the transfer pricing aspects of intangibles is currently found in the TPG, especially in Chapters VI and VIII. A general update of the TPG is available in the revised Chapters I-III and in the new chapter IX: Report on the Transfer Pricing Aspects of Business Restructuring. Intangibles are also addressed in the July 2008 Report on the Attribution of Profits to Permanent Establishments and in the Commentary on Article 12 of the Model Tax Convention.

In Chapter VI of the existing TPG on the special considerations for intangible property the focus is already accurately on the most important value drivers of intangible property i.e. patents and trademarks or as defined a bit more broadly on the trade intangibles and the marketing intangibles. Regarding "trade" intangibles we would like to suggest rephrasing the term into technology-based intangible to be in line with the above mentioned standards.

The general description of the marketing and the trade intangibles covers quite diligently the value drivers and the business effects of these intangibles. What is currently missing is guidance on how the information gathered should be used i.e. how these factors are interlinked, what effect they have on the value of the intangibles and how to avoid double counting of risks and returns. The identification of patents and trademarks is quite helpful, although we would like to recommend to not so much focus on comparing these two different categories of intangibles, but rather use both as an anchor to qualify the business effects of other intangibles in the group they are belonging to, which is for trademarks the family of marketing intangibles and for patents the trade intangibles. In addition we think that in the TPG there should be included some comments on the sometimes called "soft intangibles" like workforce in place, business synergies, goodwill and going concern value. We would like to call these intangibles derivate intangibles, because they only will be effective through the use of other intangibles or tangibles. That is why we believe their nature should be reflected in the analysis of the value drivers of their base intangible or tangible.

As already stated in the TPG the arm's length pricing for intangible property must take into account for the purpose of comparability the perspective of both the transferor of the property and the transferee. As this means having regard to other options realistically available there should be some guidance on how to apply this assumption regarding the valuation of intangibles. In the case, where intangible property will be bundled in a package by contract it would be helpful to reflect on how a package valuation should look like in such cases.

Regarding the calculation of arm's length prices it is accurately stressed in the TPG that the expected benefits from the intangible property (determined through a net present value calculation) should be considered. The other factors mentioned are helpful although not exhaustive and it should be expressed that these factors are included in the net present value calculation. An additional hint would also be helpful, that based on the net present value calculation the implicit licence rate can be derived and be used as a basis for licence agreements under arm's length considerations. We highly appreciate that the current TPG already favour the price premium approach for a brand valuation, as this is the preferred method for the valuation of intangibles of the above mentioned valuation standards. We would just like to recommend choosing this approach also for the trade intangibles, as the rationale behind is exactly the same, i.e. what price or volume premium can be achieved in the market by providing the technology.

Regarding the arm's length pricing when valuation is highly uncertain at the time of the transaction we would like to include some remarks on the nature of intangibles such as brands. As intangibles are in contrast to tangibles ubiquitous and as they are highly sensitive they can have a high volatility. It is like the saying: You build up a good reputation in 20 years and can destroy it in 20 seconds. On the other hand a brand can lend additional stability to the company in cases where a negative incident is overcompensated by a smart communication and response. As this is inherent to intangibles, an independent enterprise being familiar with the type of intangible would know this and would judge very carefully the valuation rather by the rationale of the economic assumptions at the time of the valuation than by reserving the right to make future adjustments. If such a careful valuation has not been performed (contrary to the behaviour of real third parties) tax administration might argue that third parties – without such very careful valuation – would have agreed on a price adjustment clause. But the OECD guidelines should avoid the impression that for intangibles a price adjustment clause is more or less in any case mandatory.

As the new chapter IX of the TPG: Report on the Transfer Pricing Aspects of Business Restructurings does not provide additional insights regarding the intangible assets as well as regarding intangibles transferred at a point in time when it does not have an established value we would suggest to just taking reference to chapter VI and VIII of the TPG. As stated in this chapter business restructurings sometimes involve the transfer of an ongoing concern, i.e. a functioning, economically integrated business unit. As the transfer on an ongoing concern comprises multiple contemporaneous transfers of interrelated assets, risks, or functions a valuation on an aggregate basis may be necessary. According to the TPG valuation methods that are used, in acquisition deals, between independent parties may prove useful for this purpose. Both hints: The aggregate valuations as well as the valuation methods in acquisition deals require some additional guidance as it is not clear, what exactly is meant by this reference.

The business restructuring discussions regarding compensation for restructurings also raised issues of the meaning of ownership of intangible property under the guidelines. In particular, distinctions between legal ownership of property and beneficial or economic ownership created when one member of a multinational group funds and/or manages development activities have been seen to affect consideration of whether compensation should be provided in the context of a business restructuring. The existing guidelines do not elaborate on the notion of economic ownership of intangible property and its relevance to transfer pricing analyses.

Final output of the OECD work

As the final output of the OECD work we envision either an amendment of Chapter VI and IX, or an additional chapter where the above mentioned valuation standards are interpreted for transfer pricing purposes to give guidance on how to actually apply the available valuation standards on intangibles in this context.

If we can be of any further assistance, please feel free to contact us.

Yours very truly,

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