

Comment on the scoping of a future project on the Transfer Pricing Aspects of Intangibles

Special considerations for intangible property according to the current OECD Transfer Pricing Guidelines

A Current topics

The Transfer Pricing Guidelines for intangible property as set out in the most recent OECD update begin by describing the objectives of the chapter dedicated to this topic (chapter VI) and defining the term “intangible property” for these purposes (section A). In a further section (section B) a discussion on “commercial intangibles” is presented dealing especially with the differentiation between “trade” and “marketing intangibles”. A third section (section C) looks at the application of the arm’s length principle. In this context the question is raised as to how the general principles, as set out in chapters I to III, are to be applied to intangible assets. The required comparability analysis, as well as the question of identifying arrangements made for the transfer of intangible property, plays a major role here (subsections 1 and 2). A further subsection (subsection 3) deals with the calculation of the arm’s length consideration. More specific discussion of arm’s length pricing when valuation is highly uncertain at the time of the transaction follows (subsection 4). The special considerations for intangible property conclude by looking at marketing activities by enterprises not owning trademarks or trade names (section D).

In the course of discussing the arm’s length consideration, the Guidelines mention the application of the comparable uncontrolled price method, the resale price method and, in cases involving highly valuable intangible property where it may be difficult to find comparable uncontrolled transactions, the use of transactional profit methods. However, the Guidelines reject the application of the cost plus method with respect to intangible property on the grounds that there is not necessarily a link between costs and value.

B Methodological issues

1 Taking account of the transferee’s willingness to pay

As far as the comparability analysis is concerned, the Guidelines require that arm’s length pricing for intangible property must take into account the perspective of both the transferor of the property and the transferee. Moreover they state that the arm’s length principle has always to take into account *at what pricing the transferor and the transferee of the property are willing to enter into a transaction*, thus looking for scope for agreement (par. 6.14). In this context it is not evident as to how this basis for action on

the part of the contracting parties fits in with the application of the transfer pricing methods as described in the relevant chapter (chapter II). According to these general guidelines, the arm's length principle focuses in particular on the functions, assets and risks of all the parties to the transaction, *but not on the question of whether or not a party to the transaction would be willing to pay a certain price*. On this note, the Guidelines make clear that one-sided methods (e.g. the resale minus method or the transactional profit method, both of which are applicable in the context of intangible property) “only require examining a financial indicator or profit level indicator for one of the parties” (par. 3.20), although it must be said that some information is also required on “the functional analysis of the non-tested party to the transaction” to appropriately characterize the controlled transaction. Moreover, “once a one-sided method has been chosen, there is no need to take account of financial data of the other party” (par. 3.22). Therefore, the question arises whether *looking at the willingness of the transferee* (in more general terms, the acquiring party) to pay a certain price could be seen as a *kind of plausibility check* or is a *necessary part of the transfer pricing mechanism*.

2 Determining arm's length prices based on anticipated benefits

Furthermore, the OECD Guidelines also remain somewhat vague when it comes to dealing with situations where valuation is highly uncertain at the time of the transaction. The Guidelines indicate that one possibility is to use anticipated benefits as a means for establishing the pricing at the outset of the transaction, taking into account subsequent developments to the extent to which they are foreseeable. Moreover it is said that independent enterprises might adopt shorter-term agreements or include price adjustment clauses in the terms of the agreement (par. 6.30). This latter provision suggests that the OECD Guidelines associates price adjustment clauses with license agreements. The Guidelines leaves it open, whether, and if so how, to adjust prices in the case of an outright sale of an intangible property. The same holds true for the possible alternative that the contracting parties agree on renegotiating the pricing arrangement, as soon as unforeseen developments change the fundamental assumptions upon which the pricing was determined (par. 6.31). Irrespective of this it becomes evident that the guideline allowing tax authorities to consider a price adjustment or modification if “independent enterprises would have insisted on a price adjustment clause or would have considered unforeseeable subsequent developments so fundamental that their occurrence would have led to a prospective renegotiation of the pricing of the transaction” (par. 6.34), is of little avail. This holds even more so as it has to be taken into account that integration is driven to a large extent by integration. A strong degree of uncertainty leads to high transaction costs especially in the area of technology having the effect that market transactions become inefficient (Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting*, New York 1985), so that true comparables are missing and tax

authorities are forced to develop their own view regarding the scope of uncertainty at the time when the transaction was carried out. Instead, it would be helpful if the OECD Guidelines could provide guidance on how to deal with uncertainty as well as related documentation at the point in time when the transaction is carried out. Moreover it would be helpful if the Guidelines discussed the methods according to which anticipated benefits should be determined and capitalized, and how to determine the required rate of return or the useful lives of the different intangibles. Finally, guidance would be desirable on how to take account of the fact that anticipated benefits are taxable and whether the taxation of capital gains and taxes on a possible adjustment as well as tax amortization benefits have to be considered when determining the minimum or maximum prices that independent enterprises would offer or ask for.

C The German approach to meeting the arm's length principle in transactions involving intangible assets

1 Notional conditions that would have been agreed, had the parties transacted with each other at arm's length, as the method of last resort

The significance of these issues emerges in view of the new German transfer pricing rules introducing a "hypothetical arm's length method" as will be elaborated in the following. In 2007 Germany amended its provisions on the arm's length principle regarding in particular transactions where no arm's length values can be found (including business restructurings). In view of the fact that the issue of highly valuable intangible assets as well as business restructuring is highly important for the tax revenue potential of Germany, it comes as no surprise that Germany chose not to wait until the OECD Working Group had presented its findings. The new German provisions, however, result in international double taxation where the transferor and the transferee are required to apply different methods and the compensation resulting from the two approaches varies.

The focus of the changes to the arm's length principle in German tax law (§ 1 Foreign Tax Act) is on the determination of a hierarchy and the terms of application for individual transfer pricing methods. Consequently, for intra-group cross-border business transactions the German Foreign Tax Act requires the transfer price to be determined primarily according to the comparable uncontrolled price method, the resale price method, or the cost plus method. The condition for this is that arm's length values can be found that, after adjustment as appropriate in view of the functions performed, the assets employed and the opportunities and risks assumed, are comparable without limitation to those methods; several such values form a range. If no such arm's length values

can be found, the application of a suitable transfer pricing method is to be based on values of limited comparability as appropriately adjusted.

If no third party values of at least limited comparability can be found, the taxpayer is to base his income determination on a hypothetical third-party comparison. For this he or she is to estimate the lowest price for the seller and the highest price for the buyer on the basis of a functional analysis and internal planning calculations. This scope for agreement is to follow from the profit expectations (profit potential) of each party. The price to be taken is that most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is to be taken.

2 Evaluation of (intangible) assets and other advantages as a whole (“transfer package”) in the case of a transfer of functions

Where a function including the related opportunities and risks is transferred accompanied by assets and other advantages transferred or lent, for which no arm's length value of even limited comparability can be found, the taxpayer shall determine the scope for agreement on the basis of the transfer of the function as a whole (transfer package). This has to be done on the basis of capitalization at adequate interest rates. The piecemeal determination of the transfer prices for all assets and services transferred, as appropriately adjusted, is to be accepted if the taxpayer can show convincingly, either that no important intangibles or advantages, or the use thereof, were transferred with the function, or that the sum of the piece-meal prices is equivalent to the arm's length price for the transfer package as a whole. The same holds true regarding all elements of a transfer package if a taxpayer makes it plausible that the transfer of an activity is associated with at least one intangible asset being clearly identified.

3 Introduction of the “commensurate with income” approach to intangibles

Where significant intangibles and advantages derive from a business connection and the future profitability varies significantly from the assumption on which the transfer price was based, there is to be a rebuttable presumption that, at the time of the contract, there was uncertainty as to future profits, and independent third parties would have agreed on a suitable price adjustment provision. If no such provision was agreed and there is a significant variance during the first ten years from the date of the contract, the adjustment is to be made in an appropriate lump sum amount as a correction to the original transfer price with tax effect for the business year following that in which the variance occurred.

D German approach to the methodological issues addressed above

1 Taking account of the transferee's willingness to pay

The hypothetical arm's length test is aimed at determining prices independent enterprises would have agreed on under circumstances similar or comparable to the conditions governing the controlled transaction under review. Corresponding negotiations would take as a starting point the price that the transferor or transferee would at least require or be prepared to pay at most. These minimum or maximum prices constitute the expected scope for agreement. German tax law requires that these minimum or maximum prices are to be determined on the basis of a functional analysis and internal financial planning taking the expected future profits (profit potential) into account (Sec 1 par. 3 s. 6 FTA). Where the assets form part of a transfer of an activity the minimum prices and maximum prices as well as the resulting scope for agreement are to be determined on the basis of a transfer package (Sec 1 par. 3 s. 9 FTA). In principle, the relevant transfer price is again given by that value within the scope for agreement that is most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is to be taken (Sec 1 par. 3 s 7 FTA).

2 Determining arm's length prices based on anticipated benefits

a Outline

In order to determine the values of the relevant profit potentials it is necessary to

- identify the surpluses associated with the transferred asset or transfer package,
- determine the useful lives of the corresponding assets, and
- establish the required rate of return for purposes of calculating the net present value of the profit potential associated with the assets or transfer packages transferred.

The minimum and maximum prices are further determined by action alternatives as well as the transaction costs including, but not limited to, taxes on capital gains arising in the course of the transfer or sale of assets or other benefits (e.g. goodwill).

b Determination of anticipated future benefits

According to the guidelines provided by the German tax authorities the relevant income for determining the net present value of anticipated future benefits refers to the financial surpluses net of expenses, interest on debt capital, and taxes flowing to the enterprise over the useful life of the asset or transfer package transferred. Typically, these cash-flows are derived from planned results.

From a business management perspective, the value of an asset results from the anticipated future benefit which may be derived from using the corresponding asset. In order to value an asset, a key starting point therefore is to identify the specific revenues and expenses associated with using this asset. In theory, both a direct method and an indirect method are possible for purposes of determining the corresponding financial surpluses. Where individual assets are subject to valuation, the indirect method, however, will have to be ruled out. This method serves primarily as a practical alternative for determining the value of transfer packages (e.g. where activities are subject to business reorganization). In evaluating individual assets according to the direct method the value of an asset is calculated as the net present value of the expected future cash flows at the point in time when the valuation is carried out (referring to e.g. the date of a possible transaction). To this end, the relevant cash flows are to be discounted by the cost of capital relating to the specific asset under review.

As far as the determination of the relevant cash flows is concerned, four different methods may essentially be distinguished. According to the “direct cash flow forecast-method” it is the goal to identify the cash flows that may directly be allotted to the asset under consideration. Where use is made of the “license fee analogy method“, the value of an asset is derived from comparable license fee payments saved through acquisition of the asset. The “residual value method” acknowledges that attributing cash flows is in many cases difficult since corresponding cash flows are typically generated in combination with using other tangible and intangible assets. Therefore, the residual value method requires identification of the cash flows relating to the relevant “cash flow generating unit” as a whole and subtraction from these cash flows of all expenses that are deemed to accrue in relation to the “supporting assets”. Finally, the “additional surplus method” looks at the cash flows that may be anticipated if the enterprise abstained from using the asset to be valued. Any difference is then deemed to flow to the asset under consideration.

Where in the case of a transfer of activities it is necessary to determine the value of a transfer package, making use of the indirect method is an alternative. According to this indirect method the value of a transfer package results from the difference between the enterprise value before and after the activity has been transferred. In this context, the enterprise values may be determined as capitalized earnings value according to both the gross rental method and a discounted cash flow-method.

As taxes on income typically reduce to varying extent the cash flows attributable to the asset or transfer package and the cash flows of an investment alternative (represented by the cost of capital), corporate taxes have to be taken into account as expenses on the level of the corporate entity. Relevant amounts are those taxes which will presumably be

assessed or have actually been assessed, paid and, as the case may be, already reduced by a given tax relief. Different views exist on whether or not to take personal taxes on corporate dividends into account.

From the perspective of the acquiring enterprise it is to be noted that the acquisition of a (bundle of) assets is associated with tax amortization benefits. The need to take this benefit on board results from the fact that the corporate tax to be paid is calculated on the basis of cash flows (whereas the tax base is corporate income). If looking at (parts of) an enterprise as a whole, it is not uncommon to factor in the corresponding tax benefits on a global basis. This global procedure, however, is not without difficulties as it does not allow for an appropriate allocation of the purchase price to the individual assets transferred. Instead, it would be more consistent to differentiate between the assets involved in the transfer when adding the tax amortization benefit to the net present value of the anticipated cash flows.

c Determination of the discount period / useful lives

Regarding transfer of activities, the German administrative guidelines require us to act on the assumption that the useful lives of the assets involved are not limited (i.e. to calculate the net present value based on an infinite capitalization period) when determining the profit potential of an enterprise as a whole. This does not hold if reasons speaking in favor of a shorter capitalization period exist or can be shown credibly.

In contrast to the valuation of enterprises as a whole, the Principles of the Institute of German Chartered Accountants regarding the valuation of intangible assets provide for referring to the useful life in economic terms or the remaining useful life of the asset to be valued. As, in principle, the use of an intangible asset is of temporary nature, calculating the net present value based on perpetuity is not an option. An exception may exist where the useful life of the asset covers such a long time period that basing the calculation on a limited or unlimited capitalization period is insignificant in terms of the net present value. As in the context of business reorganizations (i.e. transfer of activities) assets or other advantages are subject to valuation, there is much to commend the view that in principle this valuation should also be based on the limited useful lives of the assets and other advantages involved, whereas reference to an infinite capitalization period may be acceptable in exceptional cases only.

d Determination of the required rate of return

In order to determine the required rate of return, the customary interest rate regarding a quasi riskless investment serves as a point of departure. More precisely, the calcula-

tion is to be based on riskless investments, the duration of which is equivalent to the expected term of the activity or the useful lives of significant intangible assets. Where capitalization is to be based on an unlimited period of time, the rate of return regarding a comparable investment of a term as long as possible should be decisive.

The basic interest rate is to be increased by a premium reflecting the risk of the underlying investment. Where the subjects of valuation are activities, such premiums shall be determined by looking at the customary market return which may be earned when carrying out comparable activities. Where capital market data does not exist with respect to the company concerned, the risk premium may in principle be derived on the basis of an individual comparable enterprise (“pure play”) or a corresponding peer group. In order to determine the pure play or peer group companies care should be taken that the operative business and the size of these companies correspond as far as possible, whereas financing differences (in particular the debt-equity-ratio) may be corrected. Where it is not possible to determine sufficiently comparable market rates of return, the risk premium is to be derived from the anticipated returns of the company itself. Since comparability may be limited, this reference to the company itself has the effect that the determination of the required rate of return is often to be based on competent assessments. As an example, evaluators in practice sometimes try to derive rough estimates for asset specific rates of return by way of *wacc* (weighted average cost of return) reconciliation.

Where the profits of a corporation are reduced by shareholder taxes, the required rate of return is also to be reduced by corresponding taxes. If consideration of taxes is limited to corporate taxation, there is no need to explicitly take taxes into account when determining the relevant rate of return as corporate taxes are already factored into the share prices, serving as a basis for determining the market rate of return. Comparatively low wage costs, investment incentives, or tax benefits are reflected in the cost of capital only insofar, however, as the companies forming the peer group correspond to the acquiring company also in these respects (i.e. benefit from low wage costs, investment and/or tax incentives). Where companies forming part of the peer group are in the position to benefit from similar cost advantages or are subject to a similar tax burden, important drivers determining the net present value of anticipated benefits from the perspective of acquiring companies are “automatically” factored into the required rate of return. In the case that companies forming part of the peer group did not benefit from comparable wage cost advantages, investment or tax incentives, there is the need for a corresponding adjustment.

e Determination of the arm's length price

The scope for agreement is determined by minimum and maximum prices that seller and acquirer wish to achieve / are prepared to pay. Such a scope for agreement results if the minimum price of the seller falls below the maximum price of the acquirer. In determining the minimum price, the seller looks at the profit potential associated with the asset(s) and other benefits transferred. Moreover, the expected costs arising as a consequence of the transfer (e.g. costs associated with closing down an enterprise or terminating an activity, but also possible taxes on capital gains relating to the asset transfer) factor into this calculation. In this context, options realistically available to the seller (e.g. outsourcing a production activity by way of contract manufacturing) are to be taken into account. When determining the maximum price, the acquiring company looks at the profit potential which it expects to realize through making use of the asset to be transferred or the activity to be carried out. In this context, options realistically available to the acquiring company are to be taken into account, assuming that the acquiring company is independent from the seller and is able to make use of complete information.

Regarding the scope for agreement, the price to be taken is that most likely to accord with the arm's length principle. If no other value is plausibly put forward, the mean of the scope for agreement is to be taken. This "mean solution" is based on the assumption that (1) the benefit accruing to the contracting parties corresponds to the difference between the mean value and their minimum or maximum price and (2) the allocation of related benefits for the parties is fair if these benefits are of equal weight. Among third parties, moreover bargaining skills, bargaining power, haste and other impacting factors may play a role.

Typically, the transfer of an asset or the transfer of an activity are associated with additional costs at the level of the transferor. An orderly and prudent business manager would be indifferent in opting for either making use of the assets (or carrying out the activities) to be transferred, or selling the assets, only if the net realizable value less all costs associated with selling the asset or transferring the activity corresponds to the net present value of the anticipated future benefits which he expects to realize in the case of continued use. These "selling costs" cover, for example, the costs of a possible shut down of a plant. In the case of an asset deal, however, they also include tax on the possible capital gains associated with the asset transfer. If possible taxes on capital gains realized through the transfer of an asset or activity were ignored, the transferring company would find itself in a adverse position compared to the situation pre-sale or pre-reorganization. As a consequence, an orderly and prudent business manager would take

these taxes into account and increase his minimum price by taxes on capital gains arising in the context of the transfer. Moreover, he would also consider the additional taxes resulting from a potential price adjustment to be carried out in order to commensurate the transfer price with income from the asset or activity. These additional taxes may already be determined at the time of the transaction using probability calculations and option pricing, therefore forming part of the transaction costs associated with the transfer of the asset or activity.

According to the German administrative principles, a „significant determination“ justifying a later price adjustment is given if a retrospective calculation based on the actual development of profits shows that the true transfer price is outside the original scope for agreement. In re-considering this true transfer price, however, it is only correct to take those developments into account for which uncertainty existed at the time of the transfer, thus leading to some flawed assessment regarding later developments. On the other hand, those changes in future developments resulting from post-transaction activities (later investments or reorganization measures) should not to be taken into account when retrospectively calculating the “true” transfer price.

Price adjustment clauses do include price tags that have to be taken into account when determining the minimum price of the transferor and, as a consequence, the resulting transfer price for an asset or a transfer package. Therefore, the transferor will take on board the probability according to which a later price adjustment will take place (and will consider related additional tax costs) due to a later development of profits deviating from the future anticipated profits at the time of the transfer. Where this risk of a possible later price adjustment is factored into the minimum price, the result is that the minimum price is to be increased by a corresponding amount. The relevant markup depends on the probability according to which the pre-requisites of such a price adjustment will occur.

E Implications for a future OECD project on the Transfer Pricing Aspects of Intangibles

A future project on the transfer pricing aspect of intangibles should cover the question as to whether, in the context of intangibles (or a bundle of intangible assets in particular transferred in the course of a business reorganization) for which a market price does not exist, the OECD supports the determination of transfer prices using the “hypothetical arm’s length test”. Under the latter method the transfer price is determined by reconstructing the pricing process in the market. This process demands consideration not only of the value of an (intangible) asset for the transferor (derived from the future anticipated benefits resulting from the use of these assets), but also taking into account (1) the minimum and maximum price a transferor and transferee would require or be pre-

pared to pay, and (2) the transfer price on which both parties would agree in this context. When determining these minimum or maximum prices it would have to be borne in mind that a transferor would take account of the taxes payable on any related capital gain: the transferee would take on board the tax amortization benefits associated with the assets acquired.

It would also be desirable for the OECD to indicate how, in detail, the value of an asset is to be determined based on anticipated benefits. These indications would necessitate a concretization by the OECD of how the profit potential (i.e. relevant cash flows), the useful lives, and the required rates of return are to be determined.

Finally, it would be helpful if the OECD clarified the issue of whether or not price effects neither present nor expected at the time when the transaction was carried out may be taken into account when retrospectively adjusting transfer prices commensurate with income. Moreover, it should also be made clear in what way the likelihood of transfer prices later having to be adjusted as a result of new developments should play a part in the calculation of the transfer price at the time when the transaction is carried out.