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Comment on Revised Discussion Draft on the Transfer Pricing Aspects of Intangibles

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INTRODUCTION

This document provides comments and suggested edits to the revised discussion draft; specifically related to the use of market evidence (commonly known as “comparables” to transfer pricing practitioners).

Market evidence can and should be used 1) to determine the behaviors, specifically the deal structure including functions performed, risks assumed, and assets utilized, of independent parties to transactions involving intangibles, and 2) to determine the arm’s length pricing in such transactions. By failing to examine the behaviors of the market, tax payers and practitioners are not exercising proper due diligence to complete a prudent arm’s length analysis.

The revised discussion draft spends significant time asking “how would independent parties act given the tested transactions’ facts and circumstances”, yet lacks guidance on what market evidence exists to determine an answer. It is my hope this document begins the discussion on this matter.

In its capacity as an intellectual property business intelligence company, and as a small business with significant interests in transfer pricing matters, ktMINE humbly submits the following comments related to the revised discussion draft. Any questions or comments should be forward to David R. Jarczyk - President & CEO of ktMINE – at david.jarczyk@ktMINE.com or (773) 401-8962.

SUGGESTED EDITS TO REVISED DISCUSSION DRAFT

The suggested edits are highlighted in yellow within the listed paragraphs.

Paragraph 80:

An entity claiming the right ultimately to retain all or material parts of the return attributable to a given intangible on the basis of legal ownership will generally perform, through its own employees, the more important functions related to the development, enhancement, maintenance and protection of that intangible that are described in paragraph [79]. Those important functions usually make a significant contribution to intangible value and, if those important functions are outsourced in transactions between associated enterprises, they should be compensated accordingly. *Proper due diligence should be performed to identify market evidence on the structure of such outsourced functions as well as compensation structure agreed to by independent parties under similar facts and circumstances. If it becomes* difficult to find comparable transactions involving the outsourcing of such important functions, it may be necessary to utilise transfer pricing methods not directly based on comparables, including profit split methods and valuation techniques, to appropriately reward the performance of those important functions...

Paragraph 126:

However, the principles of Chapters I through III can sometimes be difficult to apply to controlled transactions involving intangibles. Intangibles may have special characteristics that complicate the search for comparables, and in some cases make pricing difficult to determine at the time of the transaction. *Proper due diligence should be performed to identify market evidence*

on the deal structure and pricing structure agreed to by independent parties under similar facts and circumstances. Further, for wholly legitimate business reasons, due to the relationship between them, associated enterprises might sometimes structure a transaction involving intangibles in a manner that independent enterprises would not contemplate. See paragraph 1.11. *In these instances, the functional and/or industry analysis should identify the reasons the controlled transactions differ from market behavior, and consequently how these differences impact pricing.* The use or transfer of intangibles may raise challenging issues regarding comparability, selection of transfer pricing methods, and determination of arm's length conditions for transactions. This section D. provides supplemental guidance for use in applying the principles of Chapters I through III to determine arm's length conditions for controlled transactions involving intangibles.

Paragraph 132:

It will often be the case that a price for a transaction involving intangibles can be identified that is consistent with the realistically available options of each of the parties. The existence of such prices is consistent with the assumption that MNE groups seek to optimise resource allocations. If situations arise in which the minimum price acceptable to the transferor, based on its realistically available options, exceeds the maximum price acceptable to the transferee, based on its realistically available options, it may be necessary to consider whether the actual transaction should be disregarded under the second circumstance of paragraph 1.65, whether the principles of paragraphs 9.34 – 9.38 or 9.122 should be applied, or whether the conditions of the transaction should otherwise be adjusted. Similarly, if situations arise in which there are assertions that either the current use of an intangible, or a proposed realistically available option (i.e. an alternative use of the intangible), does not optimise resource allocations, it may be necessary to consider whether such assertions are consistent with the true facts and circumstances of the case. This discussion highlights the importance of taking all relevant facts and circumstances into account in a comparability analysis involving intangibles. *Where appropriate, an analysis of market behavior for similar transactions should be performed to determine the key factors that drive deal structure - including functions performed, risks assumed, and assets utilized or contributed – as these facts and circumstances will necessarily point to the comparability factors that drive arm's length pricing. Market behavior can be determined through an in-depth industry analysis as well as through review of comparables, both internal and external.*

Paragraph 148:

Comparability, and the possibility of making comparability adjustments, is especially important in considering potentially comparable intangibles, *deal structures*, and related royalty rates drawn from commercial data bases or proprietary compilations of publicly available licence or similar agreements. *In general, market evidence exists in the form of over 100,000 license agreements that can be used to determine typical deal structures among independent parties. Market evidence also exists in the form of c which can be used to determine arm's length pricing for transactions involving intangibles.* The principles of paragraphs 3.30 through 3.34 apply fully in assessing the *usefulness application* of transactions drawn from such sources. In particular, it is important to assess whether publicly available data drawn from commercial data bases and proprietary compilations is sufficiently detailed to permit an evaluation of the specific

features of intangibles that may be important in conducting a comparability analysis. *At a minimum, copies of executed license agreements between independent parties should be reviewed to determine comparability of market evidence.* The provisions of paragraph 3.38 should be considered in evaluating comparable licence arrangements identified from data bases.

Paragraph 149:

The principles of these Guidelines related to the selection of the most appropriate transfer pricing method to the circumstances of the case are described in paragraphs 2.1 through 2.11. Those principles apply fully to cases involving the transfer of intangibles or rights in intangibles. In selecting the most appropriate transfer pricing method in a case involving a transfer of intangibles or rights in intangibles, attention should be given to (i) the nature of the relevant intangibles, ~~(ii) the difficulty of identifying comparable uncontrolled transactions and intangibles in many, if not most, cases,~~ *proper due diligence to identify market evidence regarding independent deal structure, pricing structure, and pricing* and (iii) the difficulty of applying certain of the transfer pricing methods described in Chapter II in cases involving the transfer of intangibles. The issues discussed below are particularly important in the selection of transfer pricing methods under the Guidelines.

Paragraph 156:

Proper review of market evidence should be performed in order to determine typical structures and pricing between independent parties. However, it ~~will often~~ *may* be the case in matters involving transfers of intangibles or rights in intangibles that the comparability analysis (including the functional analysis) reveals that there are no reliable comparable uncontrolled transactions that can be used to determine the arm's length price and other conditions. This can occur if the intangibles in question have unique characteristics, or if they are of such critical importance that such intangibles are transferred only among associated enterprises. It may also result from a lack of available data regarding potentially comparable transactions or from other causes. Notwithstanding the lack of reliable comparables, it is usually possible to determine the arm's length price and other conditions for the controlled transaction, except in circumstances where paragraph 1.65 applies.

Paragraph 163:

The transfer pricing methods most likely to prove useful in matters involving transfers of one or more intangibles are the CUP method and the transactional profit split method. Valuation techniques can be useful tools. Supplemental guidance on the transfer pricing methods most likely to be useful in connection with transfers of intangibles is provided below. *Whether classifying the CUP method or the transactional profit split method as a primary method, corroborative method, or rejected method, proper due diligence dictates determining the answer to the question: how would independent parties behave given the tested transactions' facts and circumstances? An analysis should be performed to identify market evidence on the structure of such transactions as well as compensation agreed to by independent parties under similar facts and circumstances.*

Paragraph 164:

Where reliable comparable uncontrolled transactions can be identified, the CUP method can be applied to determine the arm's length conditions for a transfer of intangibles or rights in intangibles. The general principles contained in paragraphs 2.13 through 2.20 apply when the CUP method is used in connection with transactions involving the transfer of intangibles. Where the CUP method is utilised in connection with the transfer 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. The comparability factors described in paragraphs 1.38 through 1.63 should be considered. The matters described in section D.2.(i) – (iv) of this Chapter are of particular importance in evaluating the comparability of specific transferred intangibles and in making comparability adjustments, where possible. It should be recognised that *the identification of reliable comparables in many cases involving intangibles may be difficult or impossible market evidence on independent deal structures and payments structures exist in many cases involving intangibles; however, a proper evaluation of comparability factors and market behavior should take place to ensure consistency with the tested transactions' facts and circumstances.*

Paragraph 166:

In some circumstances, a transactional profit split method can be utilised to determine the arm's length conditions for a transfer of intangibles or rights to intangibles where it is not possible to identify reliable comparable uncontrolled transactions. Paragraphs 2.108 through 2.145 contain guidance to be considered in applying transactional profit split methods. That guidance is fully applicable to matters involving the transfer of intangibles or rights in intangibles. In evaluating the reliability of profit split methods, however, the availability of reliable and adequate data regarding combined profits, appropriately allocable expenses, and the reliability of factors used to divide combined income should be fully considered. See paragraph 2.114. *In the event perfect comparables do not exist, proper due diligence should be performed to determine how the market structures and prices similar transactions. An analysis of market behaviors may be used to corroborate the results under the profit split method.*

Addition of Annex Discussing Use of Market Evidence:

In my work with actual negotiators of independent license agreements, I have concluded that market behavior and deal structure directly impact pricing decisions. Therefore, pricing decisions cannot be determined without first understanding the market behavior for independent transactions with similar facts and circumstances as the tested transactions.

I recommend adding the following points to the revised discussion draft.

MYTH: *The CUP Method Cannot Be Applied Because Perfect Comparables Do Not Exist*

FACT: The OECD Guidelines' state a preference for comparable uncontrolled transactions; specifically, the CUP Method is preferable over other methods. Of course, in practice, it becomes extremely difficult if not impossible to identify perfect comparables, especially when searching for comparable license agreements. This does not mean, however, that the CUP Method should be rejected. The OECD Guidelines state in Chapter II that "where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those

transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method.” Furthermore, the OECD Guidelines state that “practical considerations dictate a more flexible approach to enable the CUP method to be used...”

A practical application of the CUP Method – one which utilized market evidence as a benchmark of how independent parties typically structure and price transactions involving intangibles - generally provides more-than-sufficient benchmarks to act as one part of a prudent transfer pricing analysis involving intangibles. While these benchmarks may not be perfectly comparable, they do offer guidance with respect to the tested intangibles transactions and provide professionals real-life negotiated data points for consideration.

MYTH: Global Market Information is Not Available

FACT: There is a common misconception that global license agreements - which may be used as comparable, uncontrolled transactions – are not available. Based on ktMINE’s research, over 60% of publicly available license agreements include territories for regions outside the United States. Indeed, the public domain contains uncontrolled license agreements for most regions and many countries.

MYTH: Redacted License Agreements Have No Value

FACT: There is a common misconception that only unredacted license agreements provide value to transfer pricing analyses involving intangibles. To transfer pricing professionals, the definition of “unredacted” generally means that royalty rate information is published within the license agreement. Based on ktMINE’s research, to date there are around 15,000 unredacted license agreements available in the public domain.

Unfortunately, a transfer pricing practitioner who bases an analysis exclusively on 15,000 data points is likely missing the big picture. Based on ktMINE’s research, to date there are over 100,000 license agreements available in the public domain. Contained within these license agreements are various terms, deal structures, and divisions of functions and risks that can aid in the analysis of the arm’s length nature of tested transactions.

In fact, basing a transfer pricing analysis on a subset of available data (i.e., only those license agreements with unredacted royalty terms) would be a disservice to clients and shareholders, effectively turning a blind eye to the majority of available market information. Through my involvement with APA submissions, litigation situations, and third party license negotiations, I have first-hand experience working with experts who rely on agreements with unredacted terms, only to miss several key factors of comparability; factors that would have been evident by reviewing all comparable, publicly-available agreements. As with any scientific approach, it is prudent for professionals to review all information available to them in order to provide a sound analysis.

RATIONALE BEHIND SUGGESTED EDITS – A PRACTICAL APPROACH TO STRUCTURING & PRICING TRANSACTIONS INVOLVING INTANGIBLES

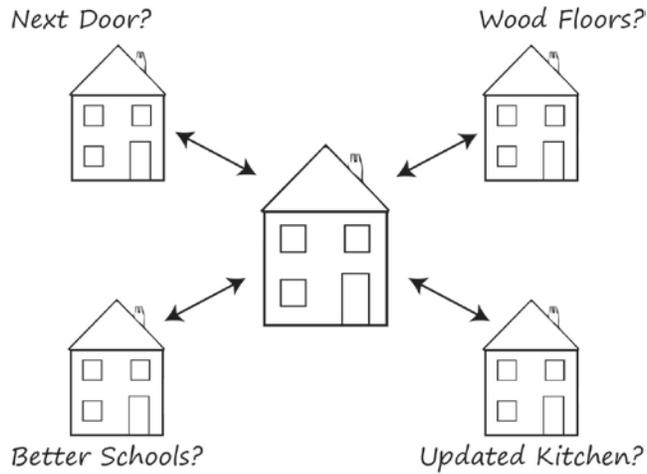
I sincerely applaud the quality and content of the revised discussion draft. Specifically, I agree that transfer pricing analyses of intangibles transactions should be “the determination of the conditions that would be agreed upon between independent parties...” as well as dependent on “evidence”. The revised discussion draft does an excellent job referring to the OECD Guidelines’ preference for comparable uncontrolled transactions; specifically, the fact that the CUP Method is preferable over other methods. Of course, in practice, it becomes extremely difficult if not impossible to identify perfect comparables. This does not mean, however, that the CUP Method should be rejected.

The revised discussion draft has a recurring theme, best communicated in paragraph 40, “rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction”. This theme is repeated in various paragraphs, including paragraph 66 (discussion of “arm’s length conditions”), paragraph 74 (discussion that “require that all members of the group receive appropriate compensation for any functions they perform, assets they use and risks they assume in connection with the development, enhancement, maintenance, and protection of intangibles”), and the introduction to the revised discussion draft (discussion of the “re-characterization of transactions that might not occur between unrelated parties”, which is listed as one of BEPS actions in that Action Plan). In fact, the real theme of the revised discussion draft can be summarized by one question: how would independent parties behave given the tested transactions’ facts and circumstances?

Recall, the OECD Guidelines state in Chapter II that: “where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions...[these differences] or the difficulties that arise in attempting to make adjustments should not routinely preclude the possible application of the CUP method.” Furthermore, the Guidelines state that “practical considerations dictate a more flexible approach to enable the CUP method to be used...”

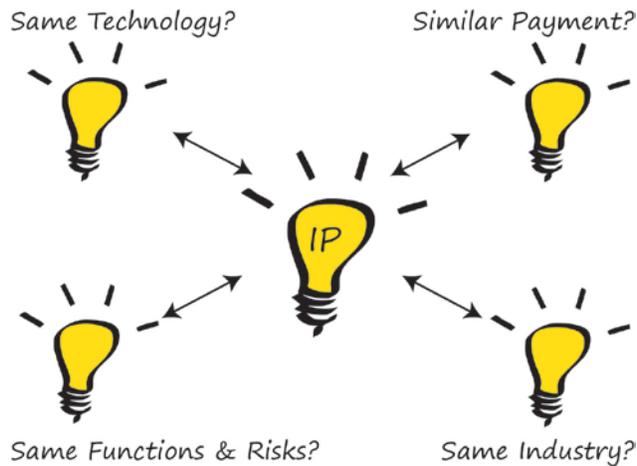
This concept is not unlike using comparables when purchasing a house (see Exhibit 1). The house next door is similar, but it has a better kitchen. The house down the block is also similar, but it has updated floors. The house in the next neighborhood is spot on, but it is in the wrong neighborhood. While not perfect comparables, all of these serve as benchmarks for the price of the house.

Exhibit 1: The CUP Method...In a Practical Way



Similar to this analogy, the use of comparables for IP analyses provides much needed transparency regarding independent-party deal structures, the functions performed, the risks assumed, and the payments made (see Exhibit 2). In fact, based on my experience, the practical application of the CUP Method generally provides more-than-sufficient benchmarks to act as one part of a prudent transfer pricing analysis involving intangibles. While these benchmarks may not be perfectly comparable, they do offer guidance and provide experts with real-life negotiated data points for consideration.

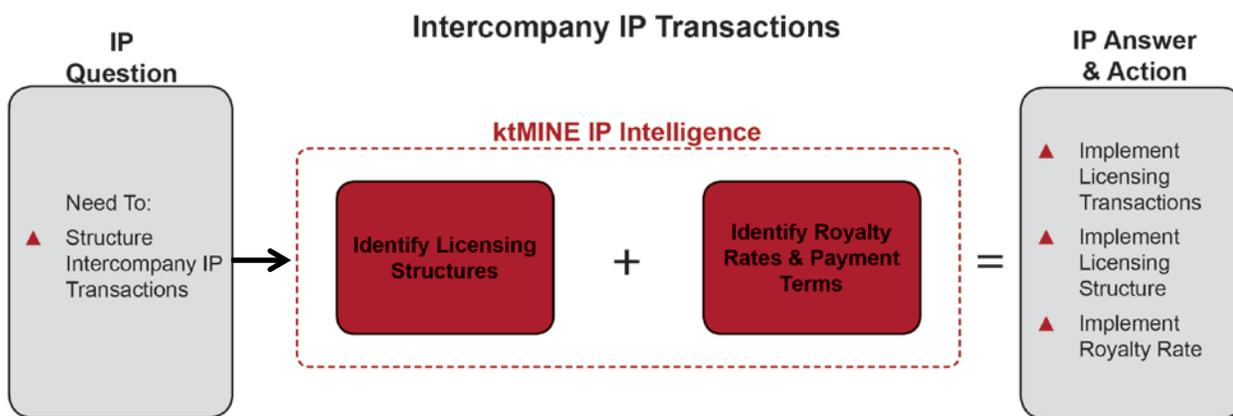
Exhibit 2: The CUP Method...In a Practical Way



As transfer pricing practitioners, having access to ALL possible information is critical for our intangibles analyses. It should be noted that there are really two questions posed by the revised discussion draft: 1) how would independent parties structure an IP transaction given the tested transactions' facts and circumstances? and 2) what price would be agreed upon given this structure?

Determining the deal structure of intangibles transaction is separate and distinct from the process for determining the price for use or transfer of the intangible (see Exhibit 3). We are fortunate to have two categories of useful data to answer these important questions.

Exhibit 3: Two Step Process For Determining Independent Deal Structures & Arm’s Length Pricing



Step 1: Determine Independent Deal Structures (or “How Does the Market Structure Intangibles Transactions?”)

License agreement intelligence products can be used to identify market evidence of deal structures typical among independent parties. ktMINE maintains a license agreement intelligence product called License Agreement Analyzer. This tool provides access to over 100,000 license agreements available in the public domain, encompassing ALL license agreement data points that should be used as market evidence. Historically, these license agreements were wrongfully ignored because most practitioners did not know they exist. We strive to change this through education.

License Agreement Analyzer is a very powerful tool, providing transparency to independent-party deal structures; specifically the functions performed, the risks assumed, and payment terms by independent parties. This set of license agreements can be used as benchmarks to structure related-party transactions involving intangibles. With this market evidence, experts can better answer any structural questions including those listed below. This information can also be used to identify market behaviors for the examples in the revised discussion draft.

- Do third parties share significant fluctuation in the foreign exchange rates?
- Would a licensee ever pay to register the licensor's trademark in the licensed territory?
- How do third parties share rebates?
- Would a licensee bear warranty risk and product liability risk for its territory?
- Would third parties set a royalty rate to increase as the sales of the licensee increase?

Step 2: Determine Independent Pricing Structures (or “How Does the Market Price Intangibles Transactions?”)

Royalty rate intelligence products can be used to identify market evidence of prices typical among independent parties. ktMINE maintains a royalty rate intelligence product called Royalty Rate Finder, which provides access to license agreements with published royalty rates ,sometimes referred to as “unredacted agreements”. This tool is meant to assist in the determination of comparable royalty rates for intercompany transactions involving intangibles. Royalty Rate Finder contain over 60,000 royalty rate structures, with various royalty payment structures such as Gross Sales, Net Sales, Gross Profits, Operating Profits, Cost Plus, as well as commission payments, sublicense payments, and various other payment structures. It is searchable by various factors of comparability, including type of IP, industry, and exclusivity. Used in conjunction with a prudent analysis that considers factors of comparability, these data points can provide excellent market evidence of intangible value.

CONCLUSION

Whether classifying the CUP method as a primary method, corroborative method, or rejected method, proper due diligence dictates determining the answer to the question: how would independent parties behave given the tested transactions’ facts and circumstances? By failing to examine the behaviors of the market, tax payers and practitioners are not exercising proper due diligence to complete a prudent arm’s length analysis.