Organization for Economic Co-operation and Development (OECD)

Revised Discussion Draft

Transfer Pricing Aspects of Intangibles

Response of the
Royal Institution of Chartered Surveyors (RICS)

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Introduction

RICS welcomes the opportunity to provide our comments to the OECD on the revised discussion document on the transfer pricing aspects of intangibles ("the Revised Discussion Draft"). This letter and the comments contained herein represent the collective view of RICS on the Revised Discussion Draft and we agree to our comments being made available via the OECD website.

About RICS

RICS is the global leading organisation for professionals in real estate, land, construction and related environmental issues as well as working in the personal property and business assets sectors.

Over 120,000 RICS members, who are Chartered Surveyors, exist globally and operate out of 146 countries, supported by an extensive network of regional offices (detailed on our website) located in every continent. RICS Headquarters is based in London and our international work is supported by a network of regional offices and national associations.

RICS members play a vital role throughout the entire asset life cycle – from initial inspection and measurement, development through to investment in, and the use of physical structures and other assets, as well as financial and business interests. In the valuation field our members' expertise covers a very wide range of disciplines, including business valuation. We also provide impartial advice to governments, policymakers and non-Government organisations.

RICS is an independent professional body, which was established in 1868 and has a UK Royal Charter. It is committed to setting and upholding the highest standards of excellence and integrity, providing impartial and authoritative advice on key land and asset issues affecting businesses and society.

RICS is a regulator of both its individual members and firms enabling it to maintain the highest standards and providing the basis for unparalleled client confidence in the sector. This regulation includes a specific focus on valuation via Valuer Registration.

As well as technical standards there are also rules of conduct for members and rules for the conduct of business for firms. These rules are coupled with ethical standards for all members.

RICS and Valuation Standards

A significant proportion of our members are involved in valuation practice on all manner of assets. The first RICS Valuation Standards publication was produced in 1976 and the current standards are the “RICS Valuation – Professional Standards” effective from 30th March 2012. The standards are commonly known as “the Red Book” and contain mandatory rules and best practice guidance for valuations of real estate and other assets.

RICS adopts the International Valuation Standards (IVS) 2011. The adoption of IVS in the Red book provides an implementation and practice framework for the application of IVS globally, ensuring that RICS members follow consistent methodologies throughout the world.

The Red Book is mandatory for all RICS members and regulated firms worldwide when carrying out Red Book specific valuations. It is also widely referred to by non-RICS valuers.

The global section of the Red Book comprises a broad ethical framework which can be applied to valuations of any asset type in any jurisdiction, in harmony with national legislation. They comprise a framework for the following:

- Compliance, competence, independence and ethical requirements;
- Terms of engagement;
- Valuation bases (global);
- Valuation applications;
- Investigations, inspections and verification of information; and
- Valuation reports.

More specifically the standards relating to application, competence, independence and objectivity are set out in Valuation Standards VS1.2-1.9.

The global standards are accompanied by detailed national standards.

For more information please visit http://www.ricsvaluation.org/

We support the OECD's proposition that valuation methods when properly applied by qualified practitioners can and should play an important role in establishing the arm's length price for the transfer of intangible assets.

The two main points we would make on the Revised Discussion Draft are as follows:

- Key to any valuation is the "basis of valuation" that provides the valuer with guidance as to how to approach the valuation. This typically sets out the applicable information standards i.e. what data and information can be relied upon in the circumstances, as well as what factors should and should not be taken into consideration when assessing value. This framework provides a guide to the valuer when selecting which valuation techniques and methodologies are to be applied in the circumstances. In our view, the Revised Discussion Draft does not provide sufficient guidance on the framework or parameters that the valuer should work within. Whilst reference is made throughout the Revised Discussion Draft to the principles of Chapters I - III of OECD's transfer pricing documentation, it is still unclear as to how the arm's length principle informs these choices from the perspective of a valuation. We believe that further guidance in this regard would help resolve current ambiguity and drive greater consistency in valuations performed for transfer pricing purposes. We expand on this below.

- The Revised Discussion Draft makes statements about the limitations of valuations for financial reporting purposes, but does not go on to investigate or discuss how a valuation performed under the arm's length principle can be reconciled to market value or other tax bases of valuation, or which aspects of market value are irrelevant. By implication, this could infer the OECD do not expect alignment with valuations for financial reporting purposes and would also not expect valuations under the arm's length principle to reconcile with valuations of the same asset for other tax purposes in the same jurisdiction.

We note that the OECD's approach to the application of the arm's-length principle in establishing the transfer price of intangible assets requires the consideration of a number of factors that go beyond an assessment of the economic value of the asset itself and appears to bring a wider concept of "compensation" into play. For example, the OECD's suggestion that the exit taxes borne by a vendor should be taken into consideration in forming a view on the value of an asset contrasts with the determination of the exchange value of an asset in the open market where it is excluded. The pricing of an asset in the market is commonly based on the economic benefit (i.e. cash flows) generated by the asset. As an example, the market value of a rental property can be established by references to the rental cash flows available from the property and an investors required post-tax rate of return. However, the value of the property does not consider the specific tax circumstances of any particular investor, as this is entirely separate to the value of the asset itself. The value of the property in the open market should remain the same irrespective of the vendor's tax position.

Including exit taxes as a component of the consideration paid to effect a transaction can be seen as a “compensation” payment to the vendor to encourage them to enter into a transaction or structure that may be sub-optimal from their position. The challenge is, therefore, how to reconcile the desire to “make whole” the transferor of an intangible asset to cover their exposure to taxes arising from the transaction. In addition, the OECD raises other factors such as the potential sharing of tax related benefits arising from the transaction e.g. lower foreign tax rate and tax amortisation benefits which do not necessarily align with the concept of market value, which itself represents an arm’s length standard of value.

Clearly, any compensation in respect of a transferor’s exposure to transaction taxes that may be paid as part of the overall consideration paid in connection with the transfer of an intangible asset is separate from the value of the asset itself. We can envisage issues arising where the tax administration in the territory of the acquiring entity does not allow the whole amount paid to effect the transfer of the intangible asset to qualify for certain tax reliefs e.g. patent box, as they may contest that the consideration paid is in excess of the value of the discrete intangible asset and includes a component of goodwill.

In addition, there is a dichotomy between the market value based determination of value that might apply to an equity valuation of an entity owning a particular intangible asset and the valuation of the underlying intangible assets themselves.

As an example, where a business generates income from licensing a portfolio of intangible assets (e.g. music rights) there may be little or no difference between the cash flows that would underpin a valuation of the business as a whole and the cash flows that would underpin the valuation of the discrete intangible assets. In such circumstances, it is feasible to arrive at a market value of say, 100 for the equity of business, but the factors put forward by the OECD in the Revised Discussion Draft could result in a “value” for the intangible assets of say, 150. Logically, an independent enterprise would not consider the intangible assets to have a value of 150 if they could acquire the full economic benefit of the cash flows generated by the assets for 100 through the acquisition of the equity of the business.

The use of valuation techniques remains equally relevant in such circumstances, however, care should be taken not to confuse the value of the intangible asset itself, and the overall compensation to be paid.

In commercial transactions, the price paid to acquire an asset or business must implicitly be sufficient to cover the seller’s exposure to exit taxes. Such considerations are often not explicitly considered in the pricing analyses used to establish the deal price, but rather are bound up within valuation metrics used to drive the valuation, for example in the discount rate or in the multiple of earnings. As such, there is some risk of a double count if direct adjustments are made in the valuation of an intangible to reflect the above but these factors have already been considered by implication in the discount rate or multiple adopted in either income or market based approaches.

If we consider the actual identify of the buyer and seller and their specific circumstances we begin to move away from establishing the price at which a discrete asset would trade in an open market based on the underlying economics of the asset itself. For example, if the taxation adjustment applied to the asset's cash flows to arrive at post-tax cash flows needs to reflect the taxes the asset will be subject to on a post-transaction basis then different "values" for the same asset will be arrived at depending on the actual structure of the proposed transaction and the tax rates applicable in the territory to which the asset is to be transferred.

Whilst this may be the OECD's view, guidance around how to address the overpayment in "market value" terms for an asset by the transferee would be welcomed. One possibility would be to have a rebuttable presumption that market value represents an arm's length price if such value falls between the respective gain or loss in value between the transferor and the transferee.

More detailed comments on the Revised Discussion Draft including the examples provided by the OECD are presented at Appendix A.

Yours faithfully

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Appendix A

Transactions involving transfer of intangibles or rights in intangibles

Transfers of combinations of intangibles

- Paragraph 112 of the Revised Discussion Draft states the importance of understanding which parties performed the functions, bore the risks and incurred the costs associated with securing the intangibles in performing a transfer pricing analysis with regard to a transfer of intangibles. It is also important to consider the relative contribution to value creation where different associated enterprises hold rights in the intangibles used. We agree with this view and would suggest a sensible starting point should be a robust commercial assessment of the value contribution of the intangible asset or combination of assets to the financial performance of the wider business before attempting to allocate that value amongst the respective parties based on their relative contributions.

Supplemental guidance on transfer pricing methods in matters involving the transfer of intangibles or rights in intangibles

- Paragraph 161 implies that a cost approach is not a form of valuation. Cost based approaches are a sub-set of valuation techniques in their own right and can be appropriate to apply where assets are at a very early stage of development and therefore income based approaches would need to rely on highly speculative projections and hence yield highly uncertain valuations. There is market evidence of independent enterprises transacting based on invested costs, or on a hybrid income and cost approach that look to the opportunity cost of capital over the period of investment to develop the subject intangible. Such hybrid approaches seek to remunerate developers based on their costs invested plus an appropriate return (perhaps a venture capital type return) on their invested capital.

- Further to the comments in paragraph 164,where a price is established based on any form of net present value technique involving the discounting of future income or cash flows, value judgements are inherently being made and so this type of analysis falls within the domain of valuation techniques - even if the income flows being discounted are ultimately driven by assumptions or variables derived from the CUP method. The CUP method defines one fundamental parameter necessary to determine the income attributable to the subject intangible, however, other important parameters would also need to be considered within the context of a valuation.

- The capitalisation of profits is clearly a valuation technique and in employing this technique a number of factors need to be considered, such as the investment horizon period (matching risk with the duration of investor returns) and assumptions around the useful economic life of the asset e.g. the shape of revenue/profit curve, short vs. long-tail revenues, patent cliff etc. All of these factors inform the choice of discount rate, which has material bearing on valuation.

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- We concur that a proportion of the goodwill, as defined in the financial reporting allocation, will form part of the overall bundle of intangible value for which the transferor is to be compensated for under OECD's framework. However, this should not imply that the valuation of intangibles performed for financial reporting purposes is necessarily any less robust or overly conservative, but rather that the form of the transaction involves more than just the transfer of what would be regarded as separately recognisable intangible assets for accounting purposes.

- In general, we agree with the statement that value should not be destroyed from a business reorganisation. However, we should also recognise that there may be instances of strategic reorganisations that are driven by an enterprises need to mitigate the negative impact of adverse competition or regulatory change that at a micro level may appear to be value destructive, but at a macro or enterprise level the transaction preserves significantly more group value.

Use of valuation techniques

- Paragraph 173 reiterates the point that valuations performed for financial reporting purposes need to be treated with caution when used in a transfer pricing context. However, this may be because the structure of the transaction and assets involved extend beyond the separately recognisable intangibles and whilst the transaction may headline the transfer of only specific IP assets (e.g. software copyrights) the wider reorganisation may result in the migration (intended or otherwise) of goodwill value from one entity to another, as the previous IP holder's right to continue to innovate or explore new market opportunities that may provide higher returns is either diminished or extinguished. It follows that the potential reduction in the risk profile of the business should also be reflected.

- Specific reference is made in the Revised Discussion Draft to valuations for financial reporting purposes, but little mention is made of valuations for other purposes e.g. commercial valuations to support a transaction or investment or valuations performed for regulatory or other fiscal purposes. In each case, the valuation for any one particular purpose will take into consideration facts and circumstances specific to that purpose that may not necessarily translate to any other purpose. As the valuation community would well recognise, caution should always be exercised in using a valuation for anything other than its originally intended purpose. We disagree with the notion that accounting valuations for fair value purposes contain inherent conservatism and observe that many financial reporting valuations imply substantially higher values for intangibles than the in situ transfer pricing would imply.

- We strongly agree with the statement in paragraph 175 that discounted cash flow techniques can be particularly useful when properly applied. The challenge is to ensure that those performing such valuations have sufficient experience and are well versed in generally accepted valuation principles and practices. Where such techniques lack credibility is in their misapplication by those without the experience or ability to properly apply such valuation techniques.

- We disagree with footnote (4) that income projections and not cash flow projections may yield a more reliable result in a transfer pricing context. In particular, substantial capital expenditure in early-stage projects or changes in working capital can have a significant impact on cash flows and could result in substantially different values when performed on an income rather than cash flow basis. The ease of use or of income to avoid the complexities of constructing cash flows should not be a reason to rely on the discounting of income. Importantly, this can significantly skew the value split between an entity funding the investment activity and the entity that may undertake the development work on its behalf.

- We agree with the notion in paragraph 178 that the valuation analyses performed, key assumptions adopted and applicable sensitivity analyses should be fully documented – ideally in a valuation report.

- We would question the suggestion in paragraph 179 that valuations performed to support operational business decisions may be more reliable than those prepared exclusively for the purpose of a transfer pricing analysis. The reliability of a valuation will depend largely on the rigour with which the underlying financial projections have been prepared. However, we agree with the view in paragraph 180 that in many cases, valuation techniques may provide a more reliable indication of transfer price for complex intangibles than any other transfer pricing method.

Accuracy of financial projections

- In contrast to the view set out in paragraph 182, providing the projections represent management's best estimate of the likely future financial performance of the business or asset subject to valuation for tax or transfer pricing purposes this projection may not be any less robust or reliable than projections prepared for any other purpose. In many cases, forecasts that are contemporaneous with the date of the transfer pricing analysis may not exist. In such circumstances, forecasts will need to be prepared (which may or may not be based on a prior financial projection) to address factors such as changes in the probability of technical or commercial success of a product or changes in the competitive landscape for example. In such circumstances, a revised projection is likely to provide a far more reliable view on the outlook for the subject asset than reliance on an outdated projection produced historically for business planning purposes.

- Looking at paragraph 185, we need to separate issues around the credibility of forecasts given their basis of preparation and the risks associated with delivery of such projections. Paragraph 185 creates ambiguity about whether an income based approach is appropriate by suggesting that projections for intangibles with no track record are inherently "less reliable". However, this does not mean they wouldn't still provide a sound basis for valuation providing appropriate adjustments to reflect the inherent uncertainties in the projections are made. Businesses and assets frequently transact in the market place at values based on uncertain or speculative forecasts and many companies will rely on such forecasts as the basis for making the commercial decision whether or not to fund a particular R&D programme.

Useful life of intangibles and terminal values

- Further to the comment in paragraph 194, where "off-patent" technologies are incorporated into future products consideration should be given to the ease with which the technology could be reverse engineered and the cost of doing so. Where a particular patent is relatively easy to copy there may be limited value in the previously patented technology beyond its period of legal protection despite its continuing use in future generations of products. However, other intangibles that co-exist with the patent and are also fundamental to the creation of a marketable product derived from the patented technology, such as technical drawings, log books, manuals, specification sheets etc. may be harder to recreate, as unlike the patent they are not in the public domain. This also leads to the question of whether the transaction relates just to the patent rights or all the ancillary intangibles that relate to the patent also.

Assumptions regarding taxes

- We concur with the notion in paragraph 196 that after tax cash flows should be applied in the valuation of the subject intangibles. However, we question whether the taxes projected to be imposed on future cash flows should reflect the current tax position (i.e. the status quo) or the specific tax attributes of the proposed transaction. If we are bringing into consideration the specific tax attributes of the transaction we are clearly moving away from the value of the asset itself and potentially determining a "compensation" payment. All the points raised by the OECD as to how to approach the valuation intangible assets are salient and remain valid, however, once the specific attributes of the buyer and seller (including their tax positions) are taken into account the valuation moves beyond a discrete valuation of a patent and begins to incorporate elements of goodwill. The valuation itself is a business opportunity valuation. It is this point that we believe has caused most confusion and angst between valuation practitioners, transfer pricing specialists and tax authorities.

- Moreover, if the taxes to be imposed on the transferor as a result of the transfer are to be taken into consideration then these taxes (e.g. exit taxes) should be considered under all approaches i.e. income, market and cost-based approaches.

- As an example, if we had a hypothetical intangible asset A that traded in the market at a value of 100 then we would assign a value of 100 to the asset. However, if the transferor has no tax basis in the asset and is therefore exposed to a taxable gains charge of, say 50%, then their net proceeds from the transaction will be 50. In order for the transferor to be made whole based on OECD's guidance they will need to receive payment of 200 (100 grossed-up for the tax) for undertaking the transaction such that their net receipt after tax is 100.

- In this example, the value of the intangible asset A is clearly not 200, but rather the 100. Looking at it another way, if the same example above applied, but this time the transferor had a base cost of 100 in the asset, then a payment of only 100 would be required to make them whole. Care should be taken not to confuse the value of the intangible asset itself with the specific attributes of the transaction that may also need to be taken into consideration for transfer pricing purposes.

- Looking at the issue of tax amortisation benefit, it is unclear whether this should be based on the tax legislation in which the asset currently resides, or reflect the benefit that may be available to the purchaser in their particular jurisdiction. Is it the OECDS's position that the value arising from a transaction needs to take into consideration all relevant tax legislation in the territory of the transferee? This approach appears to be moving toward a sharing of potential tax benefits arising from the proposed transaction and again away from the valuation of discrete intangible assets. There is a question here about the risk/uncertainty associated with some of the projected tax benefits coming to fruition and so how this aspect should factored into the analysis. Again, this would surely be a comparability issue when looking at other TP methods that would require consideration.

Form of payment

- We agree with the comments in paragraph 198 that there should be some "read across" between the quantification of risk in the valuation analysis and the implied risk in the structuring of payments where such payments are deferred and contingent. Care should be taken to correctly address only the risk that the transferor remains exposed to, for example, they may be exposed to sales volatility but this may be substantially lower than the earnings (profit) volatility that the transferee is now exposed to.

Arm's length pricing when valuation is highly uncertain at the time of transaction

- Further to the statements in paragraph 204, it should be recognised that the transaction of an uncertain assets results in the transfer of risk from the transferor to the transferee. As such, the outperformance of the asset against expectations is an up-side risk that the transferee is exposed to in the same way that they are exposed to the downside-risk of asset underperformance. Deviation of actual financial performance from plan numbers should not therefore automatically be seen as a reason to revisit the consideration paid. These are risks that independent enterprises expose themselves to regularly in transactions.

- In addition, there are further challenges as to how any reassessment of the consideration at a future point in time should be undertaken and caution should be exercised to avoid a situation where the transferor gets to participate in the up-side, whilst not being exposed to any down-side risk. If as a result of unforeseen adverse competitive action the prospects for a transferred pharmaceutical asset are significantly diminished it is unlikely that the transferee will be able to recover a proportion of their development costs invested in the asset post transfer from the transferor. Indeed, even re-setting the consideration paid for the asset to nil could still leave the transferee with a significantly greater value loss from an overall project NPV perspective.

- It does not seem reasonable that the transferor can remain insulated from many of the risks borne by the transferee, whilst at the same time be allowed to participate in unforeseeable future upside. This asymmetry does not appear equitable and would arguably not form the basis of a commercial arrangement between independent enterprises. As such, careful consideration should be given to the risks borne by the transferee and transferor post-transaction when determining the extent to which (if any) the transferor should participate in unforeseen future upside.

Examples to illustrate the guidance on special considerations for intangibles

- Example 18 can be broken down in to a number of components. Firstly, Company T is transferring its formalised intellectual property assets to Company S, secondly Company T is giving up its right to continue to act as an innovator, despite having done all the difficult work to bring together all the assets necessary to accomplish this (e.g. highly skilled R&D workforce). A significant proportion of company value will typically reside in its goodwill, representing *inter alia* an entity's ability to perpetuate itself far beyond the life of its existing asset portfolio by developing new and as yet untried and untested technologies. To this extent, some guidance on the OECD's views whether value generated from unproven or unknown opportunities should be reflected in compensation would be welcome. Generally, this would be excluded in market value as too remote. This example provided is an extreme one, as there are many cases of financial reporting valuations – particularly for early-stage innovative companies – where the majority of the purchase price is allocated to acquired "platform" technology assets. However, we should recognise that in valuing the intangibles in this example the suggestion is that the arm's length principle seeks to measure the aggregate "value shift", which will be a combination of a transfer of intangible rights plus a transfer of goodwill. In such transactions, there is effectively a "migration" of goodwill value associated with a loss of future business opportunity. As noted above, at what point does future value become too remote for compensation?

- Example 21 suggests that synergies should be incorporated into the value of the intangible, if geographically relevant, whether or not these are unique to the buyer (i.e. whether they are buyer specific or market participant). Again, the example reorganisation is resulting in the transfer of what may have been recorded as goodwill for accounting purposes, as well as the discrete intellectual property rights.

- Example 22 highlights the limitations of applying a single valuation technique in isolation. Wherever possible, valuation professionals should attempt to corroborate their valuation analyses by employing a number of valuation methodologies from value which to triangulate value. In this example, an excess earnings approach having regard to the specific returns attributable to Company B for its ongoing contribution to group profits from its functions and retained IP in the transaction should help resolve this issue. However, this example also serves to illustrate the importance of performing a business valuation of Company B in order to provide context to the valuation of the intangible assets subject to transfer. The performance of a business valuation on a status-quo basis would help to define the upper and lower bounds of value for the intangibles subject to transfer and provide a useful frame of reference for the valuer in their assessment of the value of the intangible assets themselves.