Transfer pricing and intangible planning

Bob Ackerman
Americas Director of Transfer Pricing Services
Ernst & Young LLP
Washington, DC
USA

Taxation Conference Mumbai 2008

Ernst & Young
Quality In Everything We Do

Disclaimer

The views reflected in this presentation and paper are the views of the presenter/author and do not necessarily reflect the views of other members of the global Ernst & Young organization.

Any information contained herein was not intended or written to be used, and cannot be used (and should not be relied upon) for the purpose of tax advice or accounting advice.

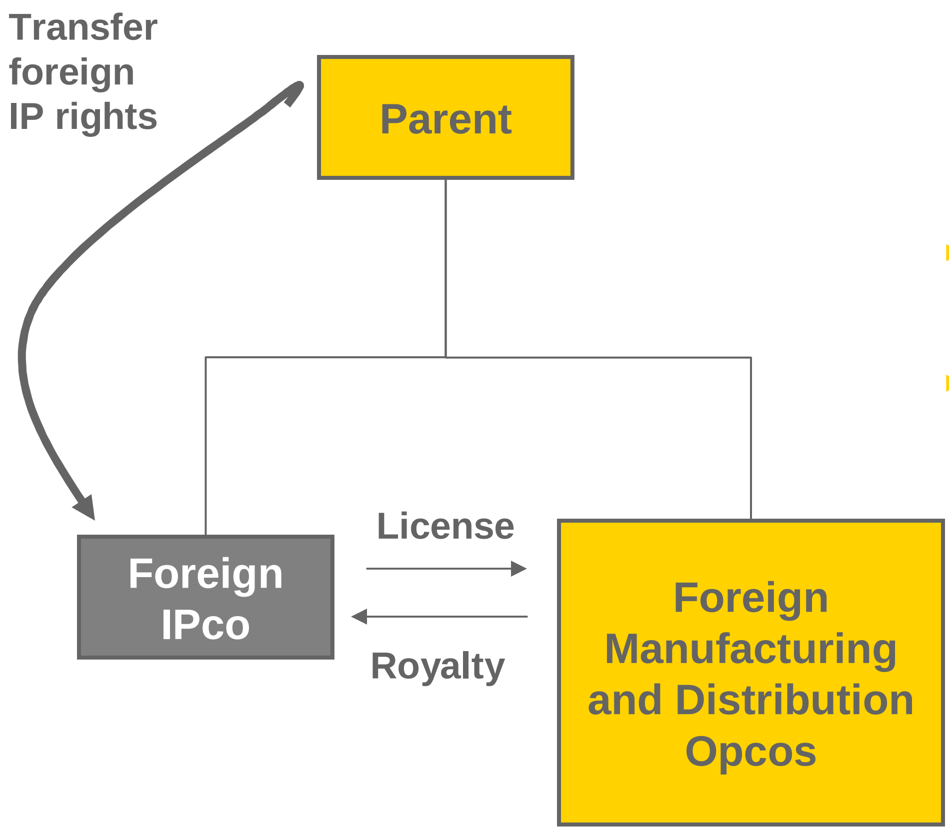
Agenda

- Intangible Property (IP) planning
- Identifying IP
- Transfer pricing and IP planning
- Transfer pricing and OECD guidelines
- Transfer pricing and valuation approaches
- Leading practices

What is Intangible Property (IP) planning?

- The transfer of intangibles to an affiliate that uses the intangibles, directly or indirectly to manufacture, market, and sell products outside the country where the intangibles were originally owned.

What is Intangible Property (IP) planning?



- Idea
  - Transfer of the IP to the Foreign principal / IPco
  - Parent is compensated for the transfer, e.g., royalty, sale
  - Foreign principal / IPco becomes responsible for its share of future IP development and improvements, e.g., Cost Contribution Arrangement or service fee
- Benefits
  - Profits on foreign exploitation of IP taxed at a lower ETR than Parent
- Issues
  - Need to ensure proper characterization of the transfer, e.g., license or sale?
  - Impact of transfer payments to Parent, e.g., sourcing, indirect taxes, anti-deferral treatment of IPco results
  - Legal issues, Business Operations, Compliance issues, etc
  - Cost benefit analysis required to compare benefits under different characterization / treatment options

ERNST & YOUNG
Quality In Everything We Do

What is Intangible Property (IP) planning?

- IP planning involves the following support:
  1. The tax treatment of a transaction determined by the commercial purpose of the transaction, even if the transaction has tax benefits
  2. Place foreign market risks attributable to IP development and ownership offshore (income follows risks)
  3. Management of functions, risks and ownership of IP changes and any operational changes (income follows key people activities)
  4. Identify the income to be migrated by functional & economic analyses (Use rights, Make/Sell rights)
  5. Implement various tax planning techniques, e.g., structuring, financing and TP planning to benefit from lower ETR

Defining intangible property

- The definitions of intangible assets is subject to a particular purpose. There are numerous legal, accounting and taxation-related definitions.

- Generic IP attributes
  - Non-physical in nature
  - Separately identifiable from other assets of the business, e.g., goodwill, going concern
  - Transferable
  - Legally protected or capable of protection through a de facto right
  - Able to produce on-going benefits for the business
- IAS
  - An intangible asset is an identifiable non-monetary asset without physical substance
  - IT assets shall be recognized as an asset separate from goodwill if it is separable, i.e., capable of being separated from the entity and sold, transferred, licensed, or exchanged
  - The asset has to be used in production, supply of goods, rental to others, or for administrative purposes

Defining intangible property

- OECD definition
  - Commercial intangibles
    - Patents, know-how, designs and models used in production of goods or provision of services, and computer software.
  - Trade intangibles
    - Research and development activities.
  - Marketing intangibles
    - Trademarks and tradenames
    - Customer lists, distribution channels, unique names, symbols, or pictures with important promotional value.
  - “Know-how”
    - All the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions
    - Secret processes or formulas not covered by a patent.

Transfer pricing and IP planning

Usually implemented through a three-step process:

1. **An offshore affiliate in a low-tax country with an extensive tax treaty network acquires the rights to key manufacturing and/or marketing intangibles. Must have Commercial Substance (e.g., ability to manage IP value – key people activities.)**

2. **The offshore affiliate, as tax legal owner of rights to use the intangibles, either manufactures, markets, and sells products on its own account or enters into contract manufacturing with either related or unrelated manufacturers.**
   - **Need for Structuring & Financing planning**
   - **Avoid PE risk**
   - **Avoid anti-deferral treatment**
   - **VAT & Customs issues**

3. **The offshore affiliate, as tax legal owner of the manufactured inventory, sells the inventory directly to third parties or enters into contract distribution arrangements with either related or unrelated resellers.**
   - **Need for Structuring & Financing planning**
   - **Avoid PE risk**
   - **Avoid anti-deferral treatment**
   - **VAT & Customs issues**

Transfer pricing and IP planning

- Issues
  - Business purpose
    - Business purpose
    - Economic substance
    - Commercial realities
  - Supply chain or operational changes
    - Functions
    - Risks
    - Assets
  - IP Remaining Useful Life (RUL)
    - General
    - Qualitative
    - Quantitative
    - Specific issues
    - Factors for documenting

Transfer pricing and OECD guidelines

- Assess where functions, risks and IP ownership occurs
- Strategies
  - Buy-ins and cost sharing
  - Licensing
  - Sale
  - "Inbound" vs. "outbound" R&D structures / services
- Identify IP value influencing factors
  - Geographic range of rights to use
  - Exclusivity
  - Required investments of licensee
  - Start-up and market penetration cost of licensee
  - Extent of rights granted (e.g., sub-licensing rights)
  - Distribution network of licensee
  - Right to use future developments by licensor
  - Type of license
  - Extent and duration of patent protection from an economic and legal perspective
  - Substitutes
  - Increases of products` value resulting from IP
  - Risk (e.g., Product liability, environmental risk)

Transfer pricing and valuation approaches

Consistent process to derive value:
Step approach

Identification of IP

↓

Data collection and analysis

↓

Traditional approaches to valuation

↓

Value conclusion

Transfer pricing and valuation approaches

Transfer/sale	License
Sale or contribution	• Subject of license • Type of license: - Quota license (produced/sold units) - Sales license - Profit license • Scaling: fix, degressive, progressive, etc.
Transfer of ownership (legal and/or economic)	No ownership transfer

→ **Consider different implications for valuation purposes.**

Transfer pricing and valuation approaches

- OECD guidelines prefer transaction versus profit-based methods
  - The Comparable Uncontrolled Price (CUP)
    - Used in cases where comparable data (comparable intangible, comparable circumstances) is available.
  - The Transaction Net Margin Method (TNMM)
    - Used to test less complex entity. For example, for determination of a royalty rate by applying routine return to the licensee (one party owns IP).
  - The Profit Split method
    - Used in cases where both parties own non-routine intangibles.
  - Other method: Anticipated Benefits approach
    - Used when valuation is highly uncertain at the time of the transaction
    - Income Method (Note: See recent issuances e.g., by the German and USA tax authorities)

Transfer pricing and valuation approaches

- Comparable Uncontrolled Prices
  - If a transaction involves the transfer of a comparable intangible under comparable circumstances as the controlled transaction, the results derived will generally be the most direct and reliable measure of the arm's length price of the controlled transfer of an intangible.
  - Analysis:
    - Is the uncontrolled transaction a transfer of intangible property that is used in conjunction with similar products or processes within the same general industry or market?
    - Does the intangible property transferred in the uncontrolled transaction have a similar profit potential? In this regard, the profit potential should be evaluated with due regard to the unreliability of projections that extend beyond the foreseeable future.
    - A CUP for intangibles in a single product area (of representative profitability) that has consideration payable in the form of running royalties may be useful in determining a royalty rate for all products covered.
    - A lump-sum consideration for a CUP in a representative product area may be converted into a equivalent running royalty that could be applied to all products.

Transfer pricing and valuation approaches

- **Profit Split Method**
  - **The PSM relies primarily on (a) a determination of <u>residual</u> <u>profit</u>, (b) the <u>useful life</u> of the transferred intangibles, and (c) the <u>ramp-down rate</u> (i.e., the changing division over time between non-routine profits attributable to pre-existing and cost shared intangibles).**
  - **Analysis:**
    - **Can the profit from routine functions be reliably determined?**
    - **What is the evidence for the useful life of the buy-in intangibles?**
      - **Evidence of when the market ceases to place a premium on the features and functionally provided by the buy-in intangibles?**
      - **Evidence of when the buy-in intangibles are "commoditized" (meaning that there are low-cost alternatives)?**
      - **Examine evidence from the scale of re-engineering of the major products (*e.g., frequency* of major revisions or re-design efforts), or of the speed at which new market entrants have been able to develop a comparable product.**
    - **Is there evidence to suggest that the capitalized cost approach is reliable for determining a ramp-down? If so, does a weighing factor improve the analysis? In cases where the transaction is integrated with use rights and make/sell rights in existing products, the ramp-down should commence after a lag.**

Transfer pricing and valuation approaches

- **Income Method**
  - The income method relies primarily on (a) a determination of the expected term of the arrangement; (b) projections of annual profits of the payer over the expected term (c) projections of annual expenses of the payor for functions outside the IP development area over the expected term; (d) a determination of the return on functions of the payor outside the IP development area over the expected term; and (e) projections of annual spend for the IP development area.
  - In many cases, the reliability of the data and assumptions will depend on the period over which projections are made. Long term projections will usually be less reliable than short term projections.
  - Analysis:
    - Can the term of the arrangement be reliably determined?
    - Can the hurdle rate of intangible development expenses over term be reliably determined?
    - Are there reliable projections consistent with the assumptions of the method, e.g., rational economic projections (of the sort given to shareholders) or “aspirational” projections (of the sort used for motivational purposes)?
    - Where projections have been extrapolated, is the extrapolation based on company specific or industry specific evidence?
  - CAUTION: Tax authorities suggests a terminal value should be applied to the resulting residual profit to account for the long term foregone profit of the seller. This view suggests the transferred IP has an infinite life and that the buyer’s intangible development expenses adds no additional value above costs. A realistic view suggests the IP has a finite life (in the absence of ongoing IP development investments)

Leading practices

- Step approach: Support and documentation
  - Identification of IP tax issues
    - Risk Management: IP planning is a facts / circumstances analysis and the tax law of the paticipation related parties must be appropriately analyzed and applied.
  - Data collection and analysis
    - Clear and comprehensive description of all relevant rights to be transferred (don't just transfer "all IP rights")
    - Exact scope of transaction, e.g., license: time, territory, content
    - Be precise with data collection
  - Traditional approaches to valuation
    - A tranactional approach is preferred, if supporable
    - Reliance on profit based methods should protect against TP penalties
    - Anticipated Benefits approach should be attempted and, as appropriate, reasonably applied as a confirming approach
      - Alternatives to traditional technology life ramp-down buy-ins should be considered.
        - Draft arrangements as yearly renewable and yearly adjustable agreements based on facts and circumstances at the end of each year.
        - Consider adding a "no loss" clauses for IPco at initial stage.
        - Consider contingent payments or royalties

Conclusions

- Intangible tax planning is more important than ever with increasing focus on intangible management, financial and tax reporting, controversy avoidance/minimization.
- Underlying premises of intangible migration
  - IP planning involves discrete issues
  - Risks and uncertainties can be managed with thoughtful tax and economic analysis