

# Outbound Transfer of Intangibles

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# Agenda

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## ■ Part I: Countries Rules and OECD

- United States
- Germany
- Canada
- Chapter IX of OECD guidelines

## ■ Part II: Policy Discussion

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# Overview of US Rules



# U.S. Intangibles Transfer Pricing Rules

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- Transfer pricing for intangibles comes up in at least three contexts under U.S. transfer pricing rules (4 including CFCs) :
  - Pricing for sales and licensing of an intangible. See Treas. Reg. §1.482-4. Developments at OECD.
  - Cost-sharing development of intangibles. Treas. Reg. §1.482-7 finalized in December, 2011.
  - “Outbound” transfers of intangibles—applicable to restructurings. Special rules override corporate non-recognition and deem royalty. Legislative proposal to clarify definition of intangible.
  - CFC rules: active royalties, “look through” treatment and proposed excess income inclusion.

# Current U.S. Issues for Discussion

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- Cost sharing:
  - Cases: Xilinx, Veritas
  - Cost sharing final regulations, challenges
- “Outbound” restructurings, definition of intangible and scope of nonrecognition for intangible transfers and Section 367(d)
- Transfer pricing in context of legislative proposals

Appendix – Overview of US Rules for Intangibles

# U.S. Intangibles Transfer Pricing Rules

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## ■ Cost sharing cases

- *Xilinx* case: Under prior regulations – Ninth Circuit Court of Appeals in reissued opinion holds that stock option compensation costs do not have to be included in cost base for sharing.
- *Veritas* case: Under prior regulations – application of unspecified income method for “buy-in” rejected by Tax Court.

## ■ Cost sharing final regulations: require stock option costs in base and maintains most realistic alternative income method buy-in approach.

# U.S. Intangibles Transfer Pricing Rules

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- “Outbound” transfers of intangible from U.S. to non-U.S. Person in tax-free restructuring triggers deemed royalty for transfer of intangible. Current issues surround scope of definition of intangible (goodwill, etc.) and aggregate or separate transfers.
- Obama Administration budget proposal would extend to goodwill and aggregate transfers – disputed whether this a “clarification.”

# U.S. Intangibles Transfer Pricing Rules

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- Obama Administration CFC proposal to require current inclusion of “excess income” “connected with or benefitting from” intangible transferred from U.S. to CFC if effective foreign tax rate is 10% or less (phased down inclusion as rate increases to 15%).
- Excess income based on mark-up over costs allocable to intangible.
- Back-up to intangible transfer pricing rules.



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# Overview of German Rules



# German Rules 1

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- In general: different rules used for accounting (also for taxation, but not for TP)
- Until 2008: for TP-purposes
  - Tax Regulations in Administrative Rules 1983 (binding only for TA, not for tax payers or Tax Courts)
  - Issues (short):
    - preference for CUP-method
    - nothing about comparability
    - assumption: a reasonable manager would calculate the price according to the earnings and costs expected from the IP [-> if no CUP can be found]
    - nothing about valuation
    - in practice: often Rule of Thumb (Knoppe-Formula)

# German Rules 2

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- After 2008 (Business Tax Reform Act), overview:
  - Regulations in para. 1 sect. 3. Foreign Tax Act (AStG)
    - sentence 5 (not explicit for IP, but implicit!):
      - Usual TP-Methods can be used in principle
      - BUT: often not acceptable lack of comparability
      - Consequence: “Hypothetical ALP” based on profit expectations (two-sided DCF valuation, resulting in a “range of negotiation”)
    - sentence 9, 10
      - In general valuation of the “package” mandatory, but Escape Clauses: Valuation of the **single** parts of the package (**IP!**)
    - sentence 11, 12 (explicit for IP):
      - Adjustment clause by law (refutable assumption)
        - If an IP is concerned (isolated or as part of a Shifting of Function) and the real results differ significantly from the expected results used for valuation (reference to 6.28 ff OECD-GL 2010)
    - sentence 13: legal basis for a (binding) ordinance for ALP

# German Rules 3

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- Technical rules (in the limits of para. 1 AStG) in an **Ordinance** (binding) for cases of "Shifting of Function":
    - For valuation (two sided: different economic facts) taking reference to "German Valuation Standards"
      - IDW S 1, concerning the valuation of enterprises or separate and "independent parts" of an enterprise
      - IDW S 5, concerning the valuation of single IP (!)  
(S 1 or S 5 depending on the kind of Shifting of Function)
    - Consequence: two sided DCF valuation for Shifting of Function
      - for the package (including "Going Concern Value") or
      - for the identified single IP (!)
- because alternatives are redundant (license analogy – CUP) or  
do not give an arm's length outcome (cost based valuation)

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# Overview of Canadian Rules



# Overview of Canadian Rules

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- No specific rules that deal with outbound transfer of intangibles
- Generally, a transfer of intangible assets from a Canadian corporation to a foreign corporation is a taxable event
  - Will often be taxed at rates applicable to capital gains
- Generally, a transfer of intangible assets to a foreign branch would not be a taxable event

# Overview of Canadian Rules

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- Transfer pricing rules would be applicable where intangible assets are transferred from a Canadian corporation to a related foreign corporation
  - Provides the CRA the ability to change the terms and conditions of the transaction so that they reflect those that arm's length persons would have agreed to
  - Additionally, the CRA may re-characterize the transaction if the transaction (1) would not have been entered into between persons dealing at arm's length, and (2) it can reasonably be considered not to have been entered into for purposes other than to obtain a tax benefit

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# OECD Developments





# OECD Intangibles Project

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Started in 2010, first discussion draft for public comment may be as early as this summer

Involvement of:

- 34 member countries and 9 non-OECD economies
- The business community

Goal: reach consensus on uniform application of guidance in line with economic reality, update Chapter VI of TPG

# Intangibles

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## Key considerations

- Definitional
- Ownership
- Identification and characterization
- Valuation
- Examples

# Definitional Aspects

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- Broad or narrow definition (role of legal, accounting and other definitions)
- Characteristics of intangibles (role of protection, transferability, etc...)
- What is an intangible
- What is not an intangible

# Ownership aspects

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- Registrations and contract rights
- Alignment with actual conduct?
- Alignment with entity bearing the costs?
- If not, what factors do you consider?
  - Functions – performance, control, etc.
  - Risks
  - Costs
  - Other?

# Identification and characterization aspects

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- Identification, with specificity, of intangible transfers and uses
- Consequences of transfer pricing rules for other tax determinations
- Aggregation with other intangibles transfers
- Aggregation with sales of goods and services

# Valuation aspects

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- Application of the rules of Ch. I – III
- Comparability issues
- Selecting the most appropriate method
- Use of valuation techniques
- Uncertain values at the time of the transfer

# Valuation aspects

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Internationally, various valuation standards and guidelines for the valuation of intangibles are available

## ■ Examples

- IDW S 5 - Valuation of Intangibles Assets (as of July 2011)
- IVS 210 – Intangible Assets
- ISO 10668 - Brand Valuation - Requirements for Monetary Brand Valuation (as of August 2010)
- DIN 77100 - Patent Valuation - General Principles for Monetary Patent Valuation (as of November 2010)
- IFRS 3 – Purchase Price Allocation at Fair Value

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# Policy Discussion





# Policy Discussion: A U.S. Perspective

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- U.S. sees evidence of substantial income shifting to lower tax countries, including evidence of margin increases correlated inversely with effective tax rates.
- Current transfer pricing likely advantages related over unrelated party transactions. Principle underlying the arm's length standard is neutrality in the decision to engage in a related party versus an unrelated party transaction.
- U.S. developments reflect some frustration with inadequacies in how arm's length standard has been applied.

# Policy Discussion: A U.S. Perspective

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- Responses include increasing preference for holistic approaches that do not limit “arm’s length” economic inquiry when unrelated transactions are not reliable.
  - E.g., increased use of methods that do not rely on artificial “comparables,” cost sharing regulations’ emphasis on most realistic alternative and use of DCF.
  - Another response has been to strengthen outbound transfer rules, but many transfers have already occurred.
- Excess intangible income CFC proposal is in part an ex post facto recovery of prior inadequate transfer pricing. One limitation is that it only is “outbound,” not inbound as well.

# FUTURE – Policy Options

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## THREE Areas of Development :

- Progress of the OECD project on IP
  - Implementation of the OECD results in German Law
- Some of the **main issues** for Germany generally to be addressed:
  - How to find out that IP is part of a transaction if taxpayers do not identify IP by themselves?
    - self developed IP
    - Going Concern Value  
(normally not visible in the business accounts)
  - What is about use of data bases when for pricing a transaction IP must be valued (transfer of IP, independent use of IP)?
  - Is it always necessary to have a two sided (DCF) valuation?
    - Business Restructuring is a two sided transaction
  - What if a “range of negotiation” can not be calculated because it is “negative”?
- Position of BRIC-countries? Conflicts?

# Policy Discussion: A Canadian Perspective

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- Canadian system reflects lacks sufficient common agreement regarding application of transfer pricing rules
- Results in
  - Lack of efficiency in collecting tax for Government (too many resources needed to collect tax); and
  - Lack of certainty for taxpayer that tax return is accurately filed and too many resources used in negotiating matters in dispute with Government
- Useful to explore methods to comply and administer transfer pricing rules to the non-intangible situations so that there is sufficient resources to properly deal with more complicated situations involving intangibles

# Focus on intangibles

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- Economic and commercial reality vs. intellectual property law and contract rights
- Enhanced relationship, transparency and risk assessment
- Distinguishing between services and the use or transfer of an intangibles
- Considering simplification measures for low risk transactions

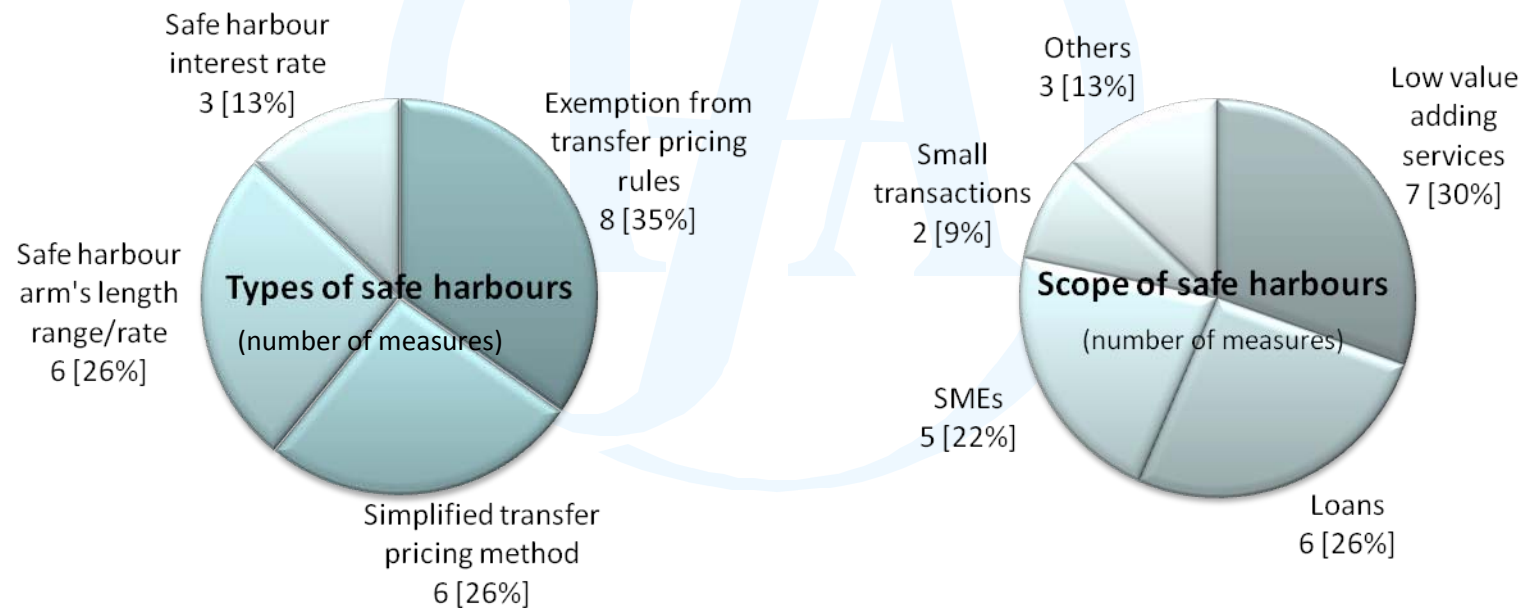
# OECD Project on TP Simplification

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- March 2011, invitation for public comments
- June 2011, first release of the 'Multi-Country Analysis of Existing Transfer Pricing Simplification Measures'

# Statistics from countries surveyed

- Out of 41 countries surveyed, 33 countries (80%) have “simplification measures”
- Out of 69 measures identified, 23 measures (33%) are “safe harbours”
- Details of safe harbours:



# OECD Project on TP Simplification

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## **Revision of the TPG**

- Revisit negative view of transfer pricing safe harbours
- How can they maximize efficiencies

## **Low-Value Added Services**

- Review country experiences
- Consider EU Joint Transfer Pricing Forum guidance

## **Small Taxpayers/ Transactions**

- Bilateral MOU for common types of transactions
- Create flexible instruments, negotiable application

## **Documentation**

- Consider EU documentation approach, best practices
- Relevance and usefulness of information

## **Dispute Resolution**

- Ways to streamline the APA process
- Bilateral MOU for simple cases



# Policy Discussion

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- Substantive issues
  - What has worked?
  - What has not worked?
- issues
  - Issues with taxpayer compliance and ease of verification by tax administration
  - Solutions?

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# Appendix: Overview of US Rules

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# U.S. Intangibles Transfer Pricing Rules: Overview

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- Section 482 (two sentences):

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Transfer pricing for intangibles comes up in at least three contexts:
  - Pricing for sales and licensing of an intangible. Treas. Reg. §1.482-4.
  - Cost-sharing development of intangibles. Treas. Reg. §1.482-7 (finalized in December, 2011).
  - Transfers of intangibles by U.S. person “outbound” to a non-U.S. affiliate under common control intangible –applicable to restructurings.
    - Special rules overriding general corporate nonrecognition rules work in tandem with transfer pricing rules. Section 367(d) regulations.
- Categories distinguish where services are primary and where embedded in goods.

# U.S. Intangibles Transfer Pricing Rules: Overview

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- An "intangible" is defined as an interest that has substantial value independent of the services of any individual, including:
  - (i) patents, inventions, formula, processes, designs, patterns, or know-how;
  - (ii) copyrights and literary, musical, or artistic compositions;
  - (iii) trademarks, trade names, or brand names;
  - (iv) franchises, licenses, or contracts;
  - (v) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
  - (vi) other similar items that derive value from their intellectual content or other intangible properties, not from their physical attributes. Reg. §1.482-4(b).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Four intangible property transfer pricing methods are authorized:
  - comparable uncontrolled transaction method,
  - the comparable profits method (described above under the tangible property rules),
  - the profit split method or
  - an unspecified method. Reg. §1.482-4(a).
- Cost sharing also is permitted for intangibles. Reg. §1.482-7 (finalized in December, 2011).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Comparable uncontrolled transaction method - comparability standards articulated:
  - Be used in connection with similar products or processes within the same general industry or market
  - Have similar profit potential, ideally measured by the net present value of the benefits from the intangible based on prospective profits to be realized or costs to be saved, however, in certain circumstances comparison may be based on other factors. Reg. §1.482-4(c)(2)(iii)(B)(1)(ii).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- All of the factors that could affect prices or profits in arm's length dealings are taken into account when evaluating comparability. Reg. §1.482-1(d)(1).

Factors include:

- Functions performed and resources employed,
- Contractual terms,
- Risks assumed,
- Economic conditions,
- Specific property or services involved.



# U.S. Intangibles Transfer Pricing Rules: Overview

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- Subjective comparability factors may include:
  - the terms of the transfer including the exploitation rights granted, exclusivity, and restrictions in use;
  - the stage of development of the intangible;
  - rights to periodic updates or modifications of the intangible;
  - uniqueness of the property and the period for which it remains unique;
  - duration of license and termination or renegotiation rights;
  - economic and product liability risks assumed;
  - collateral transactions or ongoing business relationships; and
  - functions to be performed by each party. Reg. §1.482-4(c)(2)(iii)(B)(2).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Comparable profits method – uses objective measures of profitability (profit level indicators or PLIs) from uncontrolled taxpayers in similar business activities to compare tested party's profit. Reg. §§1.482-5(b)(1); 1.482-5(a).
- PLIs include: operating profit/operating assets, operating profit/sales, and gross profit/operating expenses (Berry ratio). See Treas. Reg. §1.482-5(b)(4).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Comparable profit-split method – divides operating income of the controlled taxpayers consistent with comparable uncontrolled taxpayers in similar transactions.
- Reliable results depend on similarity of contractual terms; may not be used if the combined operating profit (as a percentage of the combined assets) of uncontrolled comparables varies significantly from that of taxpayers. Reg. §1.482-6(c).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Residual Profit-Split Method : Combined operating profit or loss allocated in a two-step process:
  - First step: allocate arm's-length return to routine contributions (tangible property, services and intangibles that are generally owned by uncontrolled taxpayers engaged in similar activities).
  - Unallocated residual profit divided among the controlled taxpayers based upon the relative value of their contributions of intangible property. Treas. Reg. §1.482-6(c)(2)(i).

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Unspecified methods may be used.
  - Should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.
  - Will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule.

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Cost sharing: Parties share costs of developing intangible(s) in proportion to reasonably anticipated benefits from the intangible(s).
- Buy-in payments required for transfer of any resource or anticipated to contribute to the development of the intangible.
- Cost sharing contribution is based on costs, in contrast to royalty (or sales or services income) for transfer of proven intangible that must be based on market value and include profit mark-up.

# U.S. Intangibles Transfer Pricing Rules: Overview

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- Periodic adjustments may be made under the “commensurate with income” (CWI) standard.
- Consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Treas. Reg. §1.482-4(f)(2)(i).
- However, if the CUT method is not used, no allocation under CWI if
  - Written agreement in effect
  - Consideration was documented to be arm’s length for the first year
  - No substantial changes in functions, and
  - Cumulative arm’s length consideration is not less than 80% or more than 120% of projected amounts under the agreement.