

Thought Leadership

Overcoming Obstacles in the Intellectual Property Transfer Price Analysis

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When a multinational corporation develops and owns intellectual property that is used by its controlled foreign subsidiaries, a reasonable intercompany transfer price should be established as a charge for the use of the intellectual property. The purpose of such an intercompany transfer price is to ensure that the appropriate amount of taxable income is recognized—and the appropriate amount of income tax is paid—in each national taxing jurisdiction. The intercompany transfer price should reflect an arm’s-length price (ALP) that unrelated parties would agree to for the use of similar intellectual property. The Internal Revenue Service provides guidance on the procedures to estimate the intellectual property intercompany transfer price in such a situation. However, the analyst is likely to encounter unique circumstances in each individual case. This discussion addresses issues that the analyst may encounter when applying the procedural guidance provided by Internal Revenue Code Section 482 (and the corresponding Regulations) with regard to the calculation of a fair, arm’s-length royalty rate for the intercompany transfer of intellectual property.

INTRODUCTION

This discussion addresses issues that the analyst may encounter when complying with Internal Revenue Code Section 482 (“Section 482”) and the related Treasury Regulations regarding multinational corporation intercompany transfer pricing.

The purpose of Section 482 is to ensure that a taxpayer (particularly a multinational taxpayer) clearly reflects the income attributable to controlled party transactions. The standard to be applied in every case is that of a third-party taxpayer dealing at arm’s length with an uncontrolled (and unrelated) taxpayer.

A controlled transaction meets the arm’s-length standard if the results of the controlled transaction are consistent with the results that would have been realized if two uncontrolled (i.e., unrelated and independent) taxpayers had engaged in the same transaction under the same circumstances.

An intercompany transfer price is the price that one entity charges a related party for the use of:

1. tangible property,
2. intangible property, or
3. services.

The intellectual property transfer can be between a parent corporation and a subsidiary, or the transfer can be between two affiliated (brother/sister) corporations. Likewise, the U.S. domestic company could own the intellectual property and the foreign company use the intellectual property (i.e., a hypothetical outbound license). Or, the foreign company could own the intellectual property and the domestic company could use it (i.e., a hypothetical inbound license).

The scope of this discussion is limited to the fair, arm’s-length royalty rate (i.e., transfer price

in terms of a percent of operator revenue) that one unrelated party intangible property (IP) owner would charge an unrelated party IP operator for the use of the subject IP.

THE ARM'S-LENGTH PRICE STANDARD

In this discussion, the IP owner is the hypothetical licensor in the arm's-length license transaction. And, the IP operator is the hypothetical licensee in the arm's-length license transaction.

The estimation of a fair, arm's-length transfer price is particularly important when two or more national taxing jurisdictions are involved—that is, when the intangible property owner/operator conducts operations in two or more different countries.

Corporate strategic management decisions will almost certainly encompass income tax implications when a multinational corporation (with subsidiaries in multiple taxing jurisdictions) is involved.

When the intangible property transfer involves a highly profitable corporation, potential earnings manipulation issues related to transfer prices are of great interest to both domestic and foreign taxing authorities.

Congress promulgated Section 482 to address the concern that a domestic taxpayer could shelter income (and avoid income taxes) by transferring assets (tangible or intangible) to a foreign affiliate.

Likewise, the Internal Revenue Service (the "Service") is concerned that a foreign taxpayer could avoid domestic income tax by not allocating sufficient income to the U.S. taxpayer for the use of the tangible or intangible assets.

Section 482 addresses these concerns by laying out general rules for the transfer prices charged in multinational transfers of property and services.

The goal of the Section 482 regulations is to determine an arm's-length transfer price that two unrelated parties would have negotiated for the exchange of the subject property or services. This transfer price is then applied to the subject inter-company transaction.

According to the Section 482 regulations:

A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. . . .¹

THE SECTION 482 INTANGIBLE PROPERTY TRANSFER PRICE METHODS

To determine the arm's-length transfer price related to the subject intangible property, Section 482 lists three specified methods and one unspecified method.

The specified methods are:

1. the comparable uncontrolled transaction (CUT) method,
2. the comparable profit margin (CPM) method, and
3. the profit split method.

The unspecified method is any method not specified in Section 482. The unspecified method "should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives



to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it.”²

THE BEST METHOD RULE

All of the intercompany transfer price methods listed in Section 482 should be considered by the analyst in the estimation of the ALP.

However, Section 482 requires that the “best method” be used to determine the arm’s-length price for each asset (or service) included in an intercompany transaction.

To determine the best method, the analyst should consider the following factors:

1. The degree of comparability between the subject controlled transaction and any selected uncontrolled transactions
2. The quality of the data and the assumptions used in the transfer price analysis.

This discussion addresses the issues that may arise, and the potential solutions to those issues, when the analyst performs a Section 482 transfer price analysis.

To address these issues, first the discussion presents guidance from Section 482.

Next, the discussion presents a case study example that is based on an actual intercompany transfer price analysis engagement.

The general transfer price issues are from an actual intercompany transfer price analysis engagement. However, the specific information concerning the case study presented in this discussion has been altered for both presentation and client confidentiality purposes.

THE CUT METHOD AND THE CPM METHOD

This discussion focuses on the CUT method and the CPM method. This discussion addresses issues that are often encountered in the application of the CUT method, including (1) the comparability of CUTs and (2) considerations when applying the same CUTs to multiple regions

This discussion also addresses issues that are often encountered in the application of the CPM method, including the following:

1. Selecting the appropriate tested parties
2. Adjusting the tested parties to more accurately represent the impact of the subject IP

3. Selecting appropriate uncontrolled comparable companies
4. Selecting an appropriate profit level indicator
5. Adjustments made to calculate an IP intercompany transfer royalty rate

ISSUE NUMBER 1—COMPARABILITY OF CUTS

According to the Section 482 regulations, “The comparable uncontrolled transaction method evaluates whether the amount charged for a controlled transfer of intangible property was arm’s-length by reference to the amount charged in a comparable uncontrolled transaction.”³

The CUT method is a widely used transfer price estimation method for Section 482 engagements. This is because the CUT method (1) is specifically listed in Section 482 and (2) is based on actual sale or license transactions involving comparable intangible property.

The primary procedures the analyst should use in applying the CUT method are summarized as follows:

1. Search for and select arm’s-length unrelated party sales or licenses of comparable intangible property
2. Verify that the comparable intangible property transactions were conducted under comparable circumstances
3. Analyze the CUT data and select a subject intangible property-specific royalty rate from the empirical pricing data indicated by the uncontrolled intangible property transfer transactions

The following discussion presents (1) Section 482 guidance relating to the selection of CUTs and (2) practical advice for the valuation analyst related to the CUT selection.

This practical advice will help the valuation analyst to determine (1) which CUTs are comparable and should be included in the CUT method and (2) if the CUT method is the best method to use in a particular Section 482 transfer price analysis.

Section 482 Guidance

Selecting CUTs is a challenging but important procedure in the CUT method. This CUT selection procedure will accomplish the following:

1. Help determine if the CUT method is the best method in the subject Section 482 analysis
2. Affect the subject IP-specific royalty rate concluded from this method

The Section 482 regulations list factors that may be considered when selecting CUTs. According to the Section 482 regulations, “Such factors include the following—(i) Functions; (ii) Contractual terms; (iii) Risks; (iv) Economic conditions; and (v) Property or services.”⁴

Within factor (i), the functional analysis, the regulations instruct the valuation analyst to consider:

(A) Research and development; (B) Product design and engineering; (C) Manufacturing, production and process engineering; (D) Product fabrication, extraction, and assembly; (E) Purchasing and materials management; (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities; (G) Transportation and warehousing; and (H) Managerial, legal, accounting and finance, credit and collection, training and personnel management services.⁵

Within factor (ii), contractual terms, the regulations instruct the valuation analyst to consider:

(1) The form of consideration charged or paid; (2) Sales or purchase volume; (3) The scope and terms of warranties provided; (4) Rights to updates, revisions or modifications; (5) The duration of relevant license, contract or other agreements, and termination or renegotiation rights; (6) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and (7) Extensions of credit and payment terms.⁶

And, finally, according to the regulations:

In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm’s length result.⁷

Practical Advice—An Illustrative Example

Each of the factors listed in the prior section provides useful guidance regarding the selection of CUTs in the CUT method. The factors presented are both well-reasoned and thorough.

However, there are at least three issues that the valuation analyst sometimes faces when selecting CUTs as part of the CUT method.

These three issues are summarized as follows:

1. How does the valuation analyst prioritize the many factors listed in the prior section (i.e., is the product design and engineering within the functional analysis more important than the rights to updates, revisions, or modifications in the analysis of contractual terms)?
2. What does the valuation analyst do when information regarding many of the factors listed in the prior section is not available for the CUTs?
3. How comparable do the CUTs and the subject IP have to be in order for the CUT method to produce a meaningful transfer price conclusion?

The following discussion presents an illustrative example to address these three issues. Although the names and data from the actual transfer price engagement have been altered, this example is based on a recent actual engagement.

In this illustrative example, the subject multinational corporation (“MNC”) is a U.S.-based company that manufactures widgets that are used in the manufacture and remodeling of both residential and commercial buildings.

The Wonderful Widget Trademark

The subject intangible property is the “Wonderful Widget” trademark.

The subject transaction is a license agreement between MNC and certain foreign subsidiaries. The license agreement grants the foreign subsidiaries the right to use the Wonderful Widget trademark in an exclusive territory.

The royalty rate paid by each foreign subsidiary to the U.S. parent corporation is calculated based on a percent of the Wonderful Widget product sales in each specified foreign territory.

In order to select CUTs for the CUT method, the analyst searched the following databases:

1. RoyaltySource Royalty Rate database⁸
2. ktMINE Royalty Rates and Records database⁹

The analyst searched each source, by keyword and by industry classification.

In total, these searches yielded over 100 potential CUTs. To further refine the sample of selected license agreements/transactions, the analyst focused on two basic comparability factors:

1. The product
2. The comparable license contract terms

According to Robert Reilly:

The general standards of comparability govern the selection of a CUT. However the regulations note that two comparability factors are particularly relevant to the use of the CUT method. First, the proposed comparable intangible asset should be the same as, or comparable to, the subject intangible asset. Second, comparability will depend on the contractual terms of the transfer and the economic conditions under which the transfer takes place.¹⁰

CUT Selection Criteria

In order to focus our search on the IP and the contract terms—and to exclude transactions otherwise considered unsuitable for use in the CUT method—the analyst excluded license agreements/transactions that met one or more of the following factors:

1. The licensed intangible property was significantly different than the intangible property involved in the subject transaction
2. The licensee did not manufacture products
3. The license transactions were between related parties
4. The license agreement pertained to a franchise, technology, or software
5. The date of the license transaction was deemed too old
6. The license transaction lacked sufficient information

It is noteworthy that this list includes some overlap (but not a complete overlap) with the list of comparability factors presented in the prior section of this discussion.

In this case study example, the analyst concluded that the factors in the prior bulleted list were

the most important factors at this stage in the CUT search process.

After considering these preliminary factors, the analyst reduced the list of potential CUT transactions from over 100 transactions to a more manageable 12 transactions.

Additional CUT Factors

Next, the analyst considered each of the following additional factors to further refine the CUT:

1. Products sold (e.g., concrete blocks, heavy machinery, etc.)
2. Product distribution (e.g., wholesale or retail)
3. License term (e.g., transaction start date, end date, and renewal options)
4. Exclusivity (e.g., exclusive or nonexclusive)
5. Territoriality (e.g., North America or world)
6. Royalty rate terms (e.g., percent of total sales or trademarked product sales)
7. Other payments (e.g., reimbursement of advertising expenses)
8. Profit potential from trademarked products (e.g., operating profit margin from sales of trademarked products)

The consideration of these additional screening criteria reduced the number of selected comparable license transactions from twelve transactions to four transactions.

For each of these four license transactions, the analyst reviewed the SEC documents filed by the licensor and/or licensee. The analyst reviewed the license agreement in order to obtain more detailed information concerning the licensing transaction.

The analyst concluded that the methodology could account for any other differences that remained between the four selected CUTs and the subject IP during the final selection of the IP-specific IP royalty rate.

That is, rather than exclude a selected CUT based on differences between the CUT and the subject transaction, the analyst accounted for these differences in the selection of the IP-specific royalty rate.

The Selected CUTs

Based on a review of the publicly available documents concerning the comparable license transactions, the analyst made the following observations about the selected CUTs:

1. All of the CUT licenses were still effective as of the transfer price estimation date.
2. All of the CUTs involved companies that manufactured durable goods. None of the CUTs involved a widget manufacturer.
3. CUT license company #1 (called “comp #1”) was primarily a service company. Although it was primarily a service company, comp #1 manufactured home remodeling products sold under the licensed trademark. Comp #2, comp #3, and comp #4 all were primarily manufacturing companies.
4. The comp #1 and comp #2 license agreements contained a minimum royalty payment. The comp #1 agreement required annual contributions to the licensor company for advertising. Also, there was insufficient detail regarding the other two CUTs to determine if the licensee agreed to make payments to the licensor in addition to the agreed upon royalties. All else being equal, these net sales guarantees generally allow for a lower net sales royalty rate.
5. The royalty rate specified in the comp #4 license agreement was based on a percent of the licensee’s total sales (and not only the sales related to the licensed products). All else being equal, this formula allows for a lower net sales royalty rate.
6. Several of the CUTs provide for licensee exclusivity in multi-country territories. All else being equal, the exclusivity of a larger territory allows for a higher net sales royalty rate.
7. The operating profit margin of the licensee during the year of the CUT was negative for comp #1 and comp #2. Comp #3 and comp #4 reported a 2010 operating profit margin of 4.1 percent and 8.4 percent, respectively. A higher profit margin implies a higher net sales royalty rate, all other factors being equal.
8. The CUT net sales royalty rates ranged from 0.75 percent to 5.0 percent. The comp #4 CUT had a 0.75 percent net sales royalty rate; the comp #1 CUT and comp #2 CUT each had a 3 percent net sales royalty rate; and the comp #3 CUT had a 5 percent net sales royalty rate.
9. The comp #4 CUT royalty rate (0.75 percent) may have been negotiated downward. This is because the royalty rate was based on total product sales and not only the product sales affected by the licensed trade-

mark. However, the royalty rate on this transaction may have also been negotiated upward. This is because the licensee was granted worldwide exclusivity.

10. The comp #1 CUT royalty rate (3.0 percent) and comp #2 CUT royalty rate (3.0 percent) may have been negotiated downward. This is because these licenses include other compensation in addition to the royalty rate.
11. The comp #3 CUT net sales royalty rate of 5 percent was for world exclusivity. This royalty rate may have been less than 5 percent if the licensee territory was smaller.

The analyst concluded that the selected CUTs are not perfectly comparable to the subject IP. For example, there are differences between the license territory, exclusivity, and the calculation of the royalty payment.

Comparability Considerations

There will always be differences between the CUTs and the subject taxpayer transaction. This is because, in every license agreement, the licensed IP is unique (hence, the transaction), the licensor is unique, and the licensee is unique.

However, such differences do not preclude the use of the CUT method. In the case study example presented in this discussion, the analyst concluded that (in spite of the differences between the selected CUTs and the subject transaction), the CUT method was still appropriate.

This section provided a real-world example that illustrated (1) the selection of CUTs, (2) the factors that may be prioritized over other factors in the CUT selection process, and (3) whether or not differences between the selected CUTs and the subject transaction preclude the use of the CUT method.

ISSUE NUMBER 2— CONSIDERATION OF MULTIPLE REGIONS

The valuation analyst may be retained by large multinational corporations to perform intercompany transfer price analyses related to the license of IP between entities that are both related to the subject multinational corporation.

In these engagements, typically one entity (e.g., the licensor/parent company) licenses the IP to

multiple related entities in different regions (e.g., the licensees/foreign subsidiaries).

To continue with the above case study example, let's assume that MNC licenses the Wonderful Widget trademark to its foreign subsidiaries located in (1) Mexico, (2) the United Kingdom, and (3) Poland.

Let's further assume that (1) the valuation analyst has determined that the best method is the CUT method and (2) none of the selected CUT licensees operate in the same region that the foreign subsidiaries operate in.

In situations such as these, the valuation analyst should account for differences between the regions of the selected CUTs and the regions of the foreign subsidiaries.

The valuation analyst may answer questions such as the following:

1. Should the same CUTs be used for each region?
2. Should the selected royalty rate be the same for each region?
3. If the royalty rate is different for each region, how should the royalty rate differ between regions?

This discussion provides practical answers to these questions, using the case study example.

Section 482 Guidance

As discussed in the prior section, the Section 482 regulations list many different factors that may be considered when selecting a CUT for the application of the CUT method.

Section 482 provides guidance as to what factors may be considered when adjusting for differences between controlled transactions and the selected uncontrolled transactions.

These comparability adjustment factors include:

- (1) Quality of the product; (2) Contractual terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms); (3) Level of the market (i.e., wholesale, retail, etc.); (4) Geographic market in which the transaction takes place; (5) Date of the transaction; (6) Intangible property associated with the sale; (7) Foreign currency risks; and (8) Alternatives realistically available to the buyer and seller.¹¹

The Section 482 factors listed in the CUT selection discussion also apply to adjusting for differences

between (1) the subject controlled transaction and (2) the uncontrolled transactions.

Practical Advice—An Illustrative Example

In the illustrative example, the analyst considered several of the factors discussed above in the CUT search. That is, the analyst did not consider these factors in the royalty rate selection process. For example, the analyst excluded transactions that were considered too old.

The Section 482 regulations suggest that the transaction date may instead be considered in the royalty rate selection procedure.

The valuation analyst has discretion regarding (1) how to select the CUTs and (2) how to select a transfer price (e.g., a royalty rate) for the subject transaction based on the guideline CUT data.

The specific facts and circumstances surrounding the subject transaction and the CUTs should be considered in every transfer price analysis.

Royalty Rate Selection Procedures

In this example, the analyst performed the following procedures to select a royalty rate applicable to each region:

1. The analyst assessed the economy of the foreign subsidiaries (e.g., were there unique political risks, or was the credit rating of each foreign subsidiary region similar?).
2. The analyst considered the home building and remodeling industry in the foreign subsidiaries region (e.g., was the home building market stronger or weaker in one region compared to the others?).
3. The analyst considered the historical and projected financial statements of the foreign subsidiaries (e.g., was one region especially profitable compared to other regions, and why?).
4. The analyst considered the differences between the Wonderful Widget trademark use in each foreign subsidiary region (e.g., how long had the trademark been used in each region, and how was the trademark perceived by customers in each region?).
5. The analyst considered other unique factors that were deemed relevant (e.g., the existence and nature of related transactions, and the market share of the trademarked products in each region).
6. The analyst considered the factors that were analyzed as part of the CUT search.

Trademark Royalty Rate

In the case study example, the analyst observed that the biggest difference between the regions was in the Mexico region. In that region, the trademark was widely used, it was widely recognized by consumers, and the Mexico subsidiary was the most profitable of the three subsidiaries.

Conversely, the Wonderful Widget trademark was one of several construction and remodeling-related trademarks that were used in the United Kingdom and in Poland.

Finally, the analyst noted that the U.K. and Poland subsidiaries were only marginally profitable.

Based on these considerations, the analyst selected a royalty rate for the Mexico subsidiary that was greater than the royalty rate selected for the U.K. subsidiary and the Poland subsidiary.

The analyst selected the same royalty for the U.K. subsidiary and the Poland subsidiary.

This discussion provides a real-world example regarding the selection of a transfer price for multiple regions using the same CUT data. And, specifically, this discussion lists several factors that the valuation analyst can consider when applying the same CUTs to multiple regions.

Further Reading

Reilly, Robert F. "Intercompany Transfer Price Analyses in Business Valuations" *Valuation Strategies* (September/October 2004): 11–19, 43.

ISSUE NUMBER 3—ISSUES IN APPLYING THE CPM METHOD

As described in the introduction, Section 482 allows three specified methods and one unspecified method for calculating the arm's-length intercompany transfer price for intangible property.

The intangible property transfer price methods are as follows:

1. The CUT method—which is addressed earlier in this discussion
2. The profit split method—which allocates the relative value of each controlled party's contribution to that of the combined operating profit
3. The CPM method—which uses comparable company profitability measures to determine an arm's-length royalty rate charge to apply to the subject transaction
4. The unspecified method—any method not specified in Section 482 that follows the

principle that uncontrolled taxpayers would evaluate the terms of a transaction by considering realistic alternatives

Best Method Selection Issues

In certain cases, the analyst may not be able to effectively apply all of the transfer price methods. For example, the analyst may determine that there are insufficient data to apply the CUT method.

When the subject intangible property is in a unique industry or involves a company with unique characteristics, the analyst may find it difficult to select comparable intangible property sale or license transactions.

When performing the profit split method, the analyst evaluates the allocation of the combined operating profit attributable to the subject intangible property.

This transfer price method may not produce meaningful results if (1) there is insufficient information to accurately allocate profit margin to specific intangible property or (2) the combined company operates in an industry where profit margins are generally low in absolute terms.

If either of these situations exists, it may be difficult to allocate the operating profit margin to each area of the company contributing to business activity, including the subject intangible property.

Advantages of the CPM Method

Even when the CUT method and the profit split method do not produce meaningful results, the analyst may still rely on the CPM method. Unlike the CUT method, the CPM method does not require the analysis of comparable sale or license transactions.

The CPM method focuses on comparable public companies, with data that are generally publicly available.

Additionally, the CPM method relies on publicly traded companies that operate in the same or a similar industry as the subject company.

Relying on the CPM method may allow the analyst to produce a meaningful arm's-length price for the subject transaction, even when the profit margin of the subject controlled company is minimal.

This discussion addresses the procedures that the analyst will use in the application of the CPM method. Additionally, this discussion addresses real life issues and solutions that the analyst may encounter in the application of the CPM method in a transfer price analysis.

Section 482 Guidance

The Section 482 regulations describe the CPM method. According to the Section 482 regulations:

The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances.¹²

CPM Method Procedures

There are four procedures to the application of the CPM method for estimating an intangible property transfer price royalty rate:

1. Select one of the companies in the intangible property transfer transaction (i.e., the "tested party").
2. Identify an uncontrolled company or group of companies that is/are comparable to the tested party.
3. Match the tested party's operating profits to that of the comparable uncontrolled companies, by applying a profit level indicator from the comparable, uncontrolled companies to the tested party.
4. Calculate the intangible property inter-company transfer price or royalty rate that produces this level of operating profit.

The Section 482 regulations provide guidance that, "the tested party will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments."¹³

The Section 482 regulations further state that, "to the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions."¹⁴

Practical Advice— Illustrative Example

In this illustrative example, let's consider the same taxpayer company (i.e., MNC and subsidiaries) and the same subject intangible property (i.e., the Wonderful Widget trademark).

However, let's now assume that both the CUT method and the profit split method were rejected for various reasons.

Since the analyst determined that these methods were not applicable, the analyst considered the CPM method to estimate the subject IP royalty rate.

Selecting the Tested Party

As explained in a prior section, the subject transaction is a license agreement between MNC and certain foreign subsidiaries. MNC grants the foreign subsidiaries the right to use the Wonderful Widget trademark in an exclusive territory.

The royalty rate transfer price paid by the foreign subsidiaries is calculated based on a percent of the Wonderful Widget product sales.

In the application of the CPM method, the analyst selected the foreign subsidiaries as the tested parties. The foreign subsidiaries engage in activities that are less complex and of a narrower scope than MNC.

Additionally, the analyst calculated an arm's-length intangible property royalty rate for multiple foreign subsidiaries of MNC. Selecting each of the foreign subsidiaries as the tested parties allowed the analyst to complete this task.

Adjusting the Tested Party

Let's expand the case study example facts and circumstances, and let's assume that one of the foreign subsidiaries of MNC was Eurosub.

Further, Eurosub owned a foreign subsidiary with significant operational deficiencies (Greecesub of Europe).

Let's further assume that Greecesub of Europe (1) had structural and operational deficiencies that negatively affected the profitability of Eurosub, independent of the use of the taxpayer intangible property, and (2) did not enjoy the same brand recognition as the majority of Eurosub, and therefore

“... to the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions.”

did not reflect the profit potential relating to the taxpayer intangible property.

Although Greecesub of Europe accounted for less than 20 percent of the Eurosub operations, it had a material impact on the Eurosub profitability.

Therefore, the analyst eliminated the Greecesub of Europe financial results from Eurosub.

Prior to making this adjustment, the analyst performed the following procedures:

1. The analyst normalized both the financial data of Greecesub of Europe and Eurosub.
2. The analyst eliminated the results of Greecesub of Europe from the results of Eurosub on a line-by-line basis.

This financial statement adjustment resulted in a more specific and accurate representation of the profitability relating to the Eurosub use of the taxpayer intangible property.

Selecting a Group of Uncontrolled Companies

This is one of the most difficult procedures in the application of the CPM method. However, the process may yield more results than a search for CUT pricing data.

In the search for comparable publicly traded companies for use as uncontrolled comparable companies, the analyst searched (1) the Capital IQ Database¹⁵ and (2) the Mergent Online Database.¹⁶

The analyst searched these databases based on the following factors:

1. The industry in which the company operates
2. The geographic location of the company
3. The annual revenue of the company
4. Specific keywords common to the tested party

The initial search generated a list of over 40 publicly traded companies. The rules for comparability used in the selection of CUTs outlined in Regulation 1.482-1(d) also apply to the selection of comparable uncontrolled companies.

Therefore, among other factors, the analyst considered the following:

1. The risks the company is exposed to
2. The economic conditions in which the company operates
3. The services that the company provides

Based on consideration of these and other criteria, the analyst selected five comparable publicly traded companies.

Each of the selected comparable companies (1) had significant operations in the same geographic area as the tested party, (2) operated in the construction and home building and remodeling industry, and (3) operated at a reasonable profit level for the industry in the most recent fiscal year.

Additionally, the analyst was able to find sufficiently comparable financial data going back five years for each of the selected comparable companies.

Selecting the Appropriate Profit Level Indicator

In this analysis procedure, the analyst determined a profit level indicator (PLI) from the uncontrolled companies to apply to the tested parties. In the application of the CPM method, a PLI measures profits in terms of either (1) resources employed or (2) costs incurred.

According to the Section 482 regulations,¹⁷ common CPM method profit level indicators are as follows:

1. The rate of return on capital employed (ROCE)
2. The ratio of operating profit to sales
3. The ratio of gross profit to operating expenses (Berry Ratio)

The choice of PLI to rely on varies based on the company being considered. If the subject entity uses significant assets in its operations, it may be appropriate to use ROCE as a metric. Income statement measures such as operating income and costs may be more appropriate for an entity that does not rely on a significant level of assets for operations.

The reliability and applicability of available data with respect to the uncontrolled companies is another factor in determining which PLI to rely on.

Although the foreign subsidiaries of MNC manufacture Wonderful Widgets, the analyst determined that the use of the operating profit to sales ratio was an appropriate PLI to use.

The analyst selected this PLI based on the following factors:

1. The information available for the controlled and uncontrolled companies

2. The complexity of balance sheet adjustments that must be made to ensure ROCE comparability between the controlled and uncontrolled companies
3. The fact that the royalty rate paid by the foreign subsidiaries to MNC is calculated based on a percent of the Wonderful Widget product sales

For this example, let's assume that the two tested parties are Eurosub and Polandsub (both foreign operating subsidiaries of MNC that enjoy the benefit of the taxpayer intangible property).

Estimating the Intangible Property Intercompany Royalty Rate

The analyst relied on the same group of uncontrolled comparable companies for both Eurosub and Polandsub for the following reasons:

1. There were a limited number of sufficiently comparable uncontrolled companies in each of the tested parties' specific market areas.
2. The economic and political environments in which the two subsidiaries operate are comparable.
3. The operations of the two subsidiaries are similar.

The economic environments in which Eurosub and Polandsub operate did have some differences, which are addressed later.

According to the Section 482 regulations, "the profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables."¹⁸ Because the tested parties (i.e., Eurosub and Polandsub) operate in the cyclical construction and remodeling industry, the analyst relied on a five-year average operating profit margin as the PLI (opposed to the latest 12 months operating profit margin, three-year average operating profit margin, or some other time period).

After calculating the five-year average operating profit margin for the five uncontrolled companies, the analyst calculated an interquartile range.

Exhibit 1 presents the operating profit margins of the uncontrolled companies, the uncontrolled company interquartile range, and the operating profit margin of the tested parties. The operating profit margins of both tested parties were greater than the upper limit of the interquartile range.

However, the Eurosub operating profit margin (after adjustment for an underperforming and incomparable subsidiary) was greater than the Polandsub operating profit margin.

First, the analyst determined that both of the tested parties warranted a royalty rate charge for the right to use the taxpayer intangible property. Second, the analyst further compared the tested parties to the uncontrolled companies.

Comparability Considerations

Of the five uncontrolled companies, the analyst determined that the political, economic, and overall risk environment in which Eurosub operates most closely matched the environment in which Uncontrolled Company D and Uncontrolled Company E operate.

The countries in which Uncontrolled Company D and Uncontrolled Company E conduct the majority of operations were more similar to the Eurosub market area than the other uncontrolled company market areas in terms of the following:

1. Projected GDP growth
2. Housing prices
3. Population growth
4. Government bond ratings

Exhibit 1 Controlled and Uncontrolled Company Operating Profit Margins	
Five-Year Average Profitability (Operating Profit to Revenue)	
Uncontrolled Company A	0.1%
Uncontrolled Company B	2.5%
Uncontrolled Company C	2.9%
Uncontrolled Company D	3.7%
Uncontrolled Company E	4.1%
Low Profit Margin	0.1%
1st Quartile Profit Margin	2.5%
Median Profit Margin	2.9%
3rd Quartile Profit Margin	3.7%
High Profit Margin	4.1%
Eurosub	5.3%
Polandsub	4.3%

Alternatively, the analyst determined that the political, economic, and overall risk environment that Polandsub operates in most closely matched the environment that Uncontrolled Company B and Uncontrolled Company C operate in.

The countries in which Uncontrolled Company B and Uncontrolled Company C conduct the majority of operations were more similar to the Polandsub market area, based on the factors listed in the previous paragraph, than the other uncontrolled company market areas.

The analyst compared the operating profit margin of Eurosub to the median operating profit margin of Uncontrolled Company D and Uncontrolled Company E to determine a royalty rate appropriate for the Eurosub use of the taxpayer intangible property.

The analyst compared the Polandsub operating profit margin to the median operating profit margin of Uncontrolled Company B and Uncontrolled Company C to determine a royalty rate appropriate for the Polandsub use of the taxpayer intangible property.

Selecting the Fair Arm's-Length Price Royalty Rates

As presented in Exhibit 2, the fair arm's-length price royalty rates were then selected based on the difference between (1) the operating profit margins of the tested parties and (2) a normal level of industry profitability for companies that do not enjoy the right to use the taxpayer intangible property (i.e., the most comparable uncontrolled companies).

The royalty rates estimated for Eurosub and Polandsub were within a close range of each other.

Additionally, Eurosub and Polandsub used the taxpayer intangible property to a similar degree and benefitted from a similar level of brand recognition relating to the taxpayer intangible property.

Therefore, the analyst selected a reasonable royalty rate for both Eurosub and Polandsub at 1.5 percent.

CPM Method Summary

This illustrative example outlined one example of the application of the CPM method in a inter-company transfer price analysis. Although each application of the CPM method will have unique circumstances, and therefore unique issues to overcome, this discussion addressed some issues that an analyst may encounter.

These CPM method application issues include the following:

1. Adjustments to a tested party that did not originally reflect the profitability of the taxpayer intangible property
2. Selection of appropriate comparable companies from a limited group
3. Selection of a PLI not necessarily typical to the subject company type
4. Adjustments to the PLI in order to capture differences between controlled and uncontrolled companies.

Exhibit 2

Eurosub Operating Profit Margin Spread

Five-Year Average Profitability (Operating Profit to Revenue)	
Uncontrolled Company A	0.1%
Uncontrolled Company B	2.5%
Uncontrolled Company C	2.9%
Uncontrolled Company D	3.7%
Uncontrolled Company E	4.1%
Overall Median Profit Margin	2.9%
Company D and Company E Median	3.9%
Company B and Company C Median	2.7%
Eurosub Profit Margin	5.3%
Polandsub Profit Margin	4.3%
Excess Eurosub Operating Profit [a]	1.4%
Excess Polandsub Operating Profit [b]	1.6%
Notes:	
[a]	Based on the difference between (1) the Eurosub operating profit margin and (2) the Company D and Company E median operating profit margin.
[b]	Based on the difference between (1) the Polandsub operating profit margin and (2) the Company B and Company C median operating profit margin.

SUMMARY AND CONCLUSION

When the valuation analyst is asked to estimate the fair, arm's-length price for the intercompany transfer of taxpayer intangible property, the analyst will often seek guidance from Section 482 and the related regulations.

As stated in the introduction, Section 482 regulations provide guidelines that provide general rules to calculate the intercompany transfer prices to use in multinational tangible property, intangible property, and services transfers.

Of course, no two transfer price analyses are alike. And, the examples provided in the Section 482 regulations will almost certainly differ from the subject taxpayer transaction.

In the examples described above, the discussion focused on situations where the following statements were true:

1. There were imperfect CUTs.
2. The subject trademark was licensed from the parent company to multiple foreign subsidiaries.
3. Of the three specified methods, there were only sufficient data to apply the CPM method.

This discussion addressed these issues by (1) providing Section 482 guidance and (2) providing an illustrative example that was based on a recent transfer price engagement.

This discussion focused on the above-listed three issues for the following reasons:

1. These issues are common in intercompany transfer pricing analyses.
2. The proper handling of these issues requires analyst judgment beyond what can be interpreted from the Section 482 text.

The illustrative examples provide the analyst with practical guidance to resolve three specific problems that he or she may encounter in a transfer price analysis. Moreover, even in situations where an issue is not listed in Section 482 and not described herein, the analyst can use the practical guidance presented in this discussion to help address the particular issue at hand.

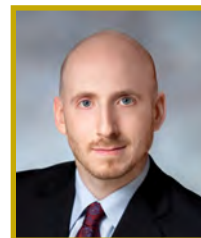
For example, the analyst can apply certain practical guidance described in the "Issue Number 3—Issues in Applying the CPM Method" section to the selection of comparable publicly traded companies in the profit split method.

The guidance in Section 482 and in this discussion cannot address every issue that the analyst will face in a transfer price assignment.

A credible and persuasive analysis will be the result of carefully studying the Section 482 provisions and, more importantly, making sound judgments in the application of the Section 482 guidance to the subject transfer price analysis.

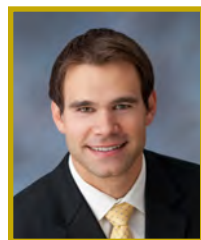
Notes:

1. Treas. Reg. § 1.482-1(b)(1).
2. Treas. Reg. § 1.482-3(e)(1).
3. Treas. Reg. § 1.482-4(c).
4. Treas. Reg. § 1.482-1(d)(1).
5. Treas. Reg. § 1.482-1(d)(3)(i).
6. Treas. Reg. § 1.482-1(d)(3)(i).
7. Treas. Reg. § 1.482-4(d)(2).
8. The RoyaltySource Royalty Rate database is comprised of royalty rate information from arm's-length license transactions that have occurred over the past 25 years. The license transaction data are gathered by AUS Consultants.
9. The ktMINE Royalty Rates and Records database consists of over 30,000 royalty rate transactions.
10. Robert F. Reilly, "Intercompany Transfer Price Analysis in Business Valuations," *Valuation Strategies* (September/October 2004): 17.
11. Treas. Reg. § 1.482-3(b)(2)(ii).
12. Treas. Reg. § 1.482-5(a).
13. Treas. Reg. § 1.482-5(2)(i).
14. Treas. Reg. § 1.482-5(b).
15. Capital IQ contains data on approximately 58,000 public companies, as well as nearly 2 million private companies.
16. Mergent Online contains data on approximately 25,000 active and inactive U.S. companies. The database also covers 95 percent of foreign public companies.
17. Treas. Reg. § 1.482-5(4)(i).
18. Treas. Reg. § 1.482-5(b)(4).



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