Determining the Appropriate Arm's-Length Price for the Intercompany Transfer of Intellectual Property to an Intellectual Property Holding Company

Many multistate corporations—particularly companies that operate in the retail and the services industries—may transfer certain intellectual property to an intellectual property holding company ("IPHC"). The function of the IPHC is to centralize, manage, protect, develop, and commercialize the corporation's intellectual property. After the multistate corporation's intellectual property is centralized in the IPHC, the IPHC enters into a license with the corporation's various operating business units related to the use of the intellectual property. The operating business units typically operate in the various states across the country. The IPHC is the intellectual property licensor and the various operating business units are the intellectual property licensees. Transfer price analysts ("analysts") are often asked to opine on the fair arm's-length price ("ALP") for the use license related to the IPHC-owned intellectual property. These analysts are asked to quantify the ALP royalty rate that an independent licensor would charge to an independent licensee for the use license of the subject intellectual property. In such instances, analysts typically apply generally accepted intangible property transfer pricing methods in order to determine the fair ALP royalty rate for the subject intellectual property intercompany license.

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Introduction

In recent years, many multistate corporations have formed an intellectual property holding company ("IPHC") subsidiary and then transferred legal title to the corporation's intellectual property to that IPHC. The transferred intellectual property is then centralized and organized in the IPHC. The intellectual property is then managed by, protected by, developed by, and commercialized by an intellectual property centralized management function within the IPHC entity.

For purposes of this discussion, the term "intellectual property" includes patents, copyrights, trademarks, and trade secrets. Intellectual property is a subset of the broader category of general commercial intangible property. For simplicity, this discussion will use the terms intellectual property and intangible property interchangeably.

At the time of the initial transfer of the intangible property from the multistate corporation (usually from the parent corporation) to the IPHC, the IPHC will typically pay a fair market value ("FMV")

price for the transferred intangible property. An important consideration in the formation of the IPHC is the determination of that FMV transfer price (or buy-in price) for that initial transfer of the intangible property from the parent company to the IPHC entity.

After the intellectual property transfer, the specialized and centralized management function at the IPHC protects, controls, develops, and commercializes the corporation's intellectual property activities. The intellectual property protection and commercialization activity may include the license of the intellectual property—both inside of and outside of the multistate corporation.

The intellectual property now owned by the IPHC is then licensed for use by the corporation's business units operating in other states.

Such intercompany intellectual property transfers are implemented for corporate strategic planning, intellectual property management, legal protection and risk reduction, and (potentially) state income tax consideration purposes.

For purposes of effecting such an intellectual property centralized management program, the corporation is typically a business enterprise that generates business income in several states. And, the transferred intellectual property is typically used in the generation of that business income in the various states in which the corporation operates.

In a common structure for this intellectual property centralized management activity, the multistate corporation transfers intellectual property such as trademarks, trade names, service marks, service names, trade dress, and domain names to the newly organized IPHC. For simplicity, this discussion will refer to this entire bundle of marketing-related intellectual property as "trademarks and trade names" or simply "trademarks."

In the conduct of its normal business operations, the IPHC licenses the use of the trademarks to the corporation's business units operating in other states.

The operating business units pay a use license fee or royalty payment, sometimes in the form of an intercompany transfer price, to the IPHC. This license royalty payment is for the use of the trademarks and trade names that are now owned by—and managed by—the IPHC.

Obviously, the terms and conditions of the intellectual property license agreement will affect the intercompany economics of the intellectual property centralized management function.

Therefore, another important consideration in the formation of the IPHC is: What is the fair, market-derived arm's-length price ("ALP") for the intercompany license of the intellectual property that is owned and managed by the IPHC?

Such an ALP should consider both the rights and responsibilities of the trademark licensor (the IPHC) and the rights and responsibilities of the trademark licensees (the various operating units).

There are numerous legal, business, risk management, and operational reasons to implement such an intellectual property centralized management program. One incidental benefit to such an IPHC formation may be a reduction in the total state income tax expense of the consolidated corporation. This is because, typically, the IPHC state does not subject intellectual property/license royalty income to state income or state franchise tax.

Typically, the intercompany transfer payments (e.g., the ALP royalty payments for the use license of the IPHC-owned trademarks) represent deductible expenses for determining taxable income in the various states in which the multistate corporation generates business income. But, the intercompany transfer payments (e.g., the ALP royalty payments for the license use of the trademarks to the IPHC) will not represent taxable income for purposes of determining the IPHC state income tax liability.

Accordingly, the parent corporation's consolidated federal income tax expense is typically not affected by such an intellectual property centralized management program. This statement is true because all of the intercompany license royalty payments are between the domestic subsidiaries of the domestic parent corporation.

However, as one potential impact of the intercompany license royalty payments, the corporation's total state income tax expense may be reduced after the formation of the IPHC to centrally manage the intellectual property function.

Of course, the real benefits of the functions of the IPHC are the efficiency and effectiveness of the management of the corporation's intellectual property. The corporation should consider any reduction in consolidated state income taxes as an incidental benefit. Such a reduction in consolidated income taxes should not be the principal consideration in the cost/benefit analysis related to the formation of an IPHC.

This discussion presents several of the transfer pricing, economics, and corporate management aspects regarding the design and implementation of such an intellectual property centralized management program.

Some of the issues that are relevant to the corporation management (and to management's professional advisers) regarding this topic include the following:

1. The identification of which intellectual property to include in the IPHC management program
2. The legal creation of the IPHC licensor
3. The quantification of the FMV price or "buy-in payment" for the initial transfer of the intellectual property to the IPHC
4. The methods of quantifying an arm's-length transfer price to the license the intellectual property
5. The significant economic pros and cons of implementing such an intellectual property centralized management program.

Identification of the Transferred Intellectual Property

Typically, the intangible property transferred from the parent corporation to the IPHC includes one or more of the four intellectual property categories:

1. Trademarks and trade names
2. Patents
3. Copyrights
4. Trade secrets

In addition, the parent corporation may sometimes also transfer related commercial intangible assets to the IPHC. For a commercial intangible asset to exist from a valuation, accounting, or legal perspective, it will typically possess certain attributes.

Some of these attributes include the following:

- It should be subject to specific identification and recognizable description.
- It should be subject to legal existence and protection.
- It should be subject to the right of private ownership, and this private ownership (which may include other property) should be legally transferable.
- There should be some tangible evidence or manifestation of the existence of the intangible asset (e.g., a contract or a license or a registration document).
- It should have been created or have come into existence at an identifiable time or as the result of an identifiable event.
- It should be subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event.

In other words, there should be a specific bundle of legal rights associated with the existence of the commercial intangible assets transferred to the IPHC.

For a transferred intellectual property or an associated commercial intangible asset to have a quantifiable value from an economic perspective, it should possess certain additional attributes.

Some of these additional requisite attributes include the following:

- It should generate some measurable amount of economic benefit to its owner/operator. This economic benefit could be in the form of an income increment or of a cost decrement. This economic benefit may be measured in any of several ways, including net income, net operating income, net cash flow, and the like.
- It should enhance the value of other assets with which it is associated. The other assets may include tangible personal property, real estate, or other identifiable intangible assets.

The appropriate use license ALP is not necessarily a direct function of the transferred intellectual property FMV. However, before the intellectual property license is created, the intellectual property is transferred from the parent corporation to the IPHC. And, that initial transfer of the corporation intangible property to the IPHC is typically made based on an FMV transfer price.

There may be a substantial distinction between the legal existence of an intellectual property and the economic value of that intellectual property. An example of this phenomenon would be the new registration of a legally binding and enforceable patent that, upon creation, immediately and permanently locked in the corporation's vault. If the patent is never used in the production of, or the protection of, income, then it has little economic value—event though it has legal existence.

Generally, analysts categorize any commercial intangible assets transferred with the corporation's intellectual property into several distinct categories. This categorization of commercial intangible assets is used for asset identification and classification purposes and, therefore, it may be relevant for purposes of implementing an intellectual property centralized management function.

Commercial intangible assets in each category are generally similar in nature and function. Also, the commercial intangible assets may be grouped in the same category when similar valuation and transfer price methods apply to that group of assets.

Some of the common categories of commercial intangible assets include the following:

- Technology-related (e.g., engineering drawings)
- Customer-related (e.g., customer lists)
- Contract-related (e.g., favorable supplier contracts)
- Data-processing-related (e.g., computer software)
- Human-capital-related (e.g., a trained and assembled workforce)
- Marketing-related (e.g., customer contracts)
- Location-related (e.g., leasehold interests)
- Goodwill-related (e.g., going-concern value)

Intellectual property is a special subcategory of intangible assets. Intellectual property manifests all of the legal existence and economic value attributes of other intangible assets. However, because of its special legal status, intellectual property enjoys special legal recognition and protection.

Unlike other commercial intangible assets which may be created by the multistate corporation in the normal course of business operations, intellectual property is created by human intellectual and/or inspirational activity. Such activity (although not always planned) is specific and conscious. And, such creativity can be attributed to the activity of identified, specific individuals.

Because of this unique creation process, intellectual property is generally registered under, and protected by, specific federal and state statutes.

Like other intangible assets, intellectual property may also be grouped into categories. The intellectual property in each category is generally similar in nature, feature, method of creation, and legal protection. Likewise, similar valuation, transfer pricing, damages measurement, and other methods of economic analysis would apply to the intellectual property in each category.

One categorization of intellectual property follows:

- Creative (e.g., copyrights)
- Innovative (e.g., patents)

Corporate trademarks and trade names are the most common type of intangible property subject to the above-described intellectual property centralized management program. However, many types of intangible assets and intellectual property may be transferred to an IPHC as part of the intellectual property centralized management program.

As mentioned above, corporations in the retail and services industries have availed themselves of this intellectual property management strategy. This emphasis on intellectual property management may be because of the importance of corporate trademarks and trade names in the retail and services industries.

In addition, this emphasis on intellectual property management is due to the practical necessity to coordinate, protect, manage, control, and commercialize the use of trademarks and trade names in the retail and services industries.

However, corporations in the wholesale, distribution, manufacturing, banking, and other industries may also coordinate, protect, manage, and commercialize the use of their intellectual property, as well. Therefore, the use of an IPHC intellectual property centralized management program is a viable strategic option regarding many types of intellectual property in many industries.

Some of the factors that the multistate corporation management consider with regard to identifying which intellectual property to include in the intellectual property management centralized program are discussed next.

The Intercompany Transfer of Intangible Property

In determining which intangible property to include in the intellectual property centralized management program, the multistate corporation management will typically consider the following factors:

- Which corporation intangible property has legal existence.
- Which corporation intangible property has economic substance.
- Which corporation intangible property can be legally transferred to the IPHC.
- Which corporation intangible property has a practical business reason to be transferred to the IPHC.
- Which corporation intangible property is used in normal business operations in other states.
- Which intangible property can be associated with a license royalty rate or other transfer price, in order to effectively quantify the licenseback component of the intellectual property centralized management program.
- Which intellectual property has a reasonably long-term (and determinable) useful economic life.

- Which intellectual property will not have to be sold, abandoned, or otherwise transferred out of the IPHC in the foreseeable future.

As mentioned above, corporate trademarks and trade names are often included in the IPHC centralized management program. Other intangible property could also meet the selection criteria listed above.

In the case of trademarks and trade names, a number of issues should be considered by the corporation management, including the following:

- Should all trademarks and trade names be transferred?
- Should only the corporation principal trademark be transferred?
- Should all individual brand names, product names, and service marks be transferred?
- Should any future trademarks and trade names developed outside of the IPHC be transferred to the IPHC as they are developed?
- Should the trademarks be transferred in perpetuity? Or should the trademarks be transferred only for a specified limited term?

These corporation management questions cannot be answered in a vacuum. These questions may only be answered after careful consideration of the selection criteria listed above.

And, these questions may only be answered after a thorough consideration of the corporation purpose and objective of the intellectual property centralized management program.

Creation of the IPHC

The formation of the IPHC entity is a legal matter. The corporation management will work with legal counsel before the corporation implements the intellectual property centralized management program. Legal title to the trademarks, trade names, and/or other intangible property should be effectively transferred to the newly created IPHC entity. Management will consult with legal counsel that is familiar with both intellectual property law and the formation of an IPHC.

The new IPHC will have both form and substance. In addition, the IPHC will have a legitimate business purpose related to the centralized management, protection, and commercialization of intangible property.

This centralized management of intangible property will include internal control considerations as well as external control considerations. The internal control elements may include accounting, legal, administrative, financing, and operational control. The external control elements may include the exploration of the possibility of the license, joint venture, and commercialization of the corporation trademarks, trade names, technology, copyrights, and other intellectual property.

The IPHC would be the legal entity to both inbound license and outbound license various intangible property to/from independent, third-party licensees in arm's-length transactions. As with all corporation goals and objectives, the intangible property commercialization (i.e., licensing) initiatives do not have to succeed in order for the intellectual property centralized management program to be successful.

To accomplish the business purposes of the IPHC, it is common for the parent corporation to transfer additional assets (in addition to the intangible property) to the IPHC. The parent corporation may transfer cash balances and certain banking relationships to the IPHC.

Legal, administrative, and marketing employees (all with an intangible property relationship) may be placed on the payroll of the IPHC. These employees are responsible for the management, protection, and control of the corporation' intangible property. These employees may also be responsible for developing and implementing the company's intangible property inbound and outbound licensing and other commercialization activities.

Finally, the parent corporation may also transfer office furniture and fixtures and any other tangible assets that will be used by the IPHC employees.

As with any functional business enterprise, the new IPHC will prepare financial statements. These statements should report the results of operations and the financial position of the IPHC. The results of operations will include any IPHC licensing and investment income less the payroll, rent, utilities, and administrative costs of the IPHC business operations.

Administrative, accounting, or other services provided by the corporate office to the IPHC entity are usually charged to the IPHC entity on an intercompany basis. The IPHC financial position will include any cash and investments, any real estate and tangible personal property, and the intangible property transferred to the IPHC.

Intangible Property Initial "Buy-In" Transfer Price

After the IPHC is created, the parent corporation will typically transfer the intangible property to the IPHC at a fair market value price. Effectively, this fair-market-value-based transfer price represents the IPHC buy-in for the transferred intangible property.

Typically, either the parent corporation or the IPHC will retain an experienced valuation analyst to estimate the fair-market-value-based transfer price for the transferred intangible property. That analyst will apply generally accepted intangible property valuation approaches and methods.

Intangible Property Valuation Approaches and Methods

There are three generally accepted intangible property valuation approaches: the cost approach, the market approach, and the income approach. One or more of these generally accepted approaches is used to estimate the fair-market-value-related buy-in price for the initial transfer of the intangible property to the IPHC.

There are a number of generally accepted valuation methods within each intangible property valuation approach. Each of the methods within an approach is based on common economic principles.

And, there are a number of valuation procedures that are used to apply each intangible property valuation method. The valuation procedures are performed in order for the analyst to select and apply the individual valuation variables that are needed to complete the valuation method.

A detailed description of the generally accepted intangible property valuation approaches and methods is beyond the scope of this discussion. However, Exhibit 1 provides a listing of the generally accepted intangible property valuation approaches and methods.

The analyst should consider all generally accepted valuation approaches and methods in the fair market value valuation of the intangible property that is initially transferred to the IPHC.

Cost Approach Valuation Considerations

Some intangible property lends itself to cost approach valuation analyses. The following considerations should be documented by the analyst as part of the buy-in price fair market value valuation.

All cost approach methods include both (1) a current cost measurement and (2) a depreciation measurement.

The analyst should explain and document the consideration of the following four cost components in the cost approach analysis:

- Direct costs (including direct materials and direct labor)
- Indirect costs (including development-related overhead and administrative expenses)
- Developer's profit (on the sum of the direct costs and the indirect costs)
- Entrepreneurial incentive (that is, the opportunity cost—or the owner/operator's lost income—during the intangible property estimated replacement period)

The analyst should also explain and document the consideration of the following three depreciation components in the cost approach analysis:

- Physical depreciation (not a significant factor in most intangible property valuations)
- Functional/technological obsolescence (where the analyst considers the intangible property estimated useful economic life—or "UEL")
- Economic/external obsolescence (where the analyst considers the intangible asset owner/operator's return on investment—or ROI—related to the intangible property cost approach value indication)

In the valuation of the initial intangible property transfer to the IPHC, the analyst should explain and document the application of the following cost approach valuation formula:

	Current cost measurement
less:	Physical depreciation (if any)
less:	Functional obsolescence
less:	Technological obsolescence (if quantified separately from functional obsolescence)
less:	Economic obsolescence (a component of external obsolescence)
equals:	Intangible property fair market value

In addition, the analyst should consider the following cost approach factors:

- All cost components (including the opportunity cost component) included in the current cost measurement
- The treatment of any excess capital (i.e., related to the intangible property development) costs and any excess operating costs (related to the operation of the intangible property)
- All considerations of (and estimation of) the intangible property UEL
- All considerations of (and estimation of) economic obsolescence that may exist at the intangible property owner/operator entity level

Exhibit 1
Intangible Property
Generally Accepted Valuation Approaches and Methods

Cost Approach Methods
- Reproduction cost new less depreciation ("RPCNLD") method
- Replacement cost new less depreciation ("RCNLD") method
- Trended historical cost less depreciation ("TOCLD") method

Market Approach Methods
- Relief from royalty ("RFR") method
- Comparable uncontrolled transactions ("CUT") method
- Comparable profit margin ("CPM") method

Income Approach Methods
- Differential income (with/without) method
- Incremental income method
- Greenfield method
- Profit split method (or residual profit split method)
- Disaggregated method
- Distributor method
- Residual (excess) income method
- Capitalized excess earnings method ("CEEM")
- Multiperiod excess earnings method ("MEEM")

Market Approach Valuation Considerations

The analyst should be aware that market approach valuation pricing metrics are based on either comparable or guideline:

- licenses of intangible property,
- sales of intangible property, or
- companies that use intangible property.

The initial transfer fair market value valuation should explain and document the analyst's consideration of—and selection/rejection of—the following market approach variables and procedures:

- Any quantitative/qualitative analysis with regard to the ownership and operation of the intangible property
- The guideline license/sale/company selection criteria
- The actual guideline license/sale/company selection (and rejection)
- The verification of the selected guideline transactional data
- The analysis of the selected guideline transactional data
- The selection of the appropriate pricing metrics to use in the subject market approach analysis
- The selection of the specific pricing multiples to apply to the subject intangible property financial or operational fundamentals
- The actual application of the selected pricing multiples to the subject intangible property financial or operational metrics
- The conclusion of the various market approach value indications based on the application of the subject-specific pricing multiples

In the initial transfer fair market value valuation, the analyst should consider and document the following market approach considerations:

- The impact of applying seasoned guideline intangible asset transactional data with regard to a development stage intangible property
- The impact of applying development stage guideline intangible property transactional data with regard to a seasoned intangible property
- The valuation date state of the competition in the owner/operator industry
- The analysis of the guideline company and/or industry average comparable profit margins; the important valuation consideration is whether the intangible property is the only reason for the difference in the operating profit margins between (1) the intangible property owner/operator company and (2) the selected CPM companies

Income Approach Valuation Considerations

Some intangible property lends itself to income approach valuation analyses. The following analyst considerations should be documented in the initial buy-in price fair market value valuation.

The analyst should be aware that, in the intangible property income approach, the common income measurement concepts include the following:

- Incremental (or differential) owner/operator revenue (selling price and/or units sold)
- Decremental owner/operator expense (operating or other)
- Decremental owner/operator investment (capital or other)
- Decremental risk to the owner/operator (resulting in a lower discount rate)
- A split of the owner/operator overall business enterprise income
- Any excess owner/operator overall business enterprise income

Some of the common income measures (related to the transferred intangible property) that may be used in the income approach analysis include the following:

- Earnings before interest, taxes, depreciation, and amortization ("EBITDA")
- Earnings before interest and taxes ("EBIT")
- Net operating income ("NOI") (EBITDA less income taxes)
- Net income
- Net cash flow

The analyst should associate the above-mentioned income concepts and income measures to the transferred intangible property. That is, the income approach valuation should incorporate only the income associated with the ownership of—or the operation of—the transferred intangible property.

That is, the fair market value valuation should explain which of the following methods and procedures were used (and why they were used):

1. Yield capitalization methods, based on a nonconstant expected growth rate in the transferred intangible property income projection
   a. with the income projected over a finite intangible property UEL income projection period (without a terminal value) or
   b. with the income projected over a finite intangible property UEL income projection period with a terminal value
2. Direct capitalization methods, based on a constant expected growth rate in the transferred intangible property income projection
   a. with the intangible-property-related income capitalized over a finite UEL projection period or
   b. with the intangible-property-related income capitalized over a perpetuity UEL projection period

For each of the above-mentioned income approach valuation methods, the estimation of the intangible property UEL is an important part of the fair market value valuation. The estimated UEL affects the income approach analysis and conclusion.

The analyst should explain two components of the UEL estimation. The first component is the term of the UEL—for example, the number of years of remaining useful life in the income projection. The second component is the rate of income decay over the UEL. This factor relates to the slope of the intangible property income decay curve.

That is, will the transferred intangible property income remain constant over the UEL? Will the intangible property income decline over the UEL? Will that future income decrease occur at a constant

rate of change—or at a nonconstant (accelerating) rate of change?

The analyst should decide and document the following income approach considerations in the fair market value valuation analysis:

- How the analysis matched the selected discount/capitalization rate with the selected intangible property income measure
- How the analysis matched the selected discount/capitalization rate with the intangible property level of risk
- How the analyst considered the valuation date state of the competition in the owner/operator industry
- How the analysis considered all subsequent (to the valuation date) capital expenditures, R&D expenses, marketing expenditures, etc., related to the intangible property ownership/operation
- How the fair market value valuation analyzed only the amount of income that is directly related to (or associated with) the intangible property
- How the fair market value valuation present valued the projected income over either:
  - the intangible property average UEL
  - down the intangible property UEL income decay curve

In the fair market value valuation, the analyst should explain and document the decision process with regard to:

1. the selection of the length of the intangible property UEL period and
2. the selection of the shape of the intangible property UEL decay curve.

The Transferred Intangible Property Valuation Synthesis and Conclusion

The analyst should explain (and document) the transferred intangible property valuation synthesis and conclusion process. The synthesis and conclusion is the last procedure in the analyst's process of reaching a fair market value conclusion.

In the valuation synthesis and conclusion, the analyst typically performs a procedure that is often referred to as the valuation reconciliation. In this reconciliation, the analyst reviews all of the intangible property valuation analyses and the various intangible property value indications.

The analyst typically assigns either a quantitative or a qualitative weighting to each value indication. Based on the results of this valuation reconciliation, the analyst selects the final value conclusion for the intangible property transferred to the IPHC.

Intangible Property Transfer Price Considerations

The second component of the intangible property analysis is to determine the fair ALP royalty rate related to the license of the intangible property from the IPHC to the various business operating units. In the intangible property license agreement, the IPHC is the intangible property licensor and the various business operating units are the intangible property licensees.

To estimate an ALP royalty rate for the license of the intangible property from the IPHC to the operating entities, analysts often rely on the intercompany transfer pricing guidance provided in the regulations to Internal Revenue Code Section 482.

Typically, state taxing authorities do not require that the taxpayer corporation adopt an ALP that was calculated by reference to the Section 482 regulations. However, the Section 482 regulations are generally considered to be authoritative guidance, particularly with regard to an intangible property intercompany transfer price that is applied within an income tax context.

Therefore, while analysts do not have to strictly comply with the Section 482 regulations for these intangible property license purposes, analysts typically consider the guidance provided by the Section 482 regulations transfer price methods.

Internal Revenue Code Section 482 typically applies to an intangible property intercompany transfer price analysis that would be performed for federal income tax purposes. Section 482 deals with the allocation of income and deductions among taxpayers.

With regard to intangible property, Section 482 applies to the transfer of intangible property between controlled entities within a common taxpayer corporation. So, Section 482 would apply to the international transfer of intangible property between two (or more) controlled entities.

For example, Section 482 typically applies to a domestic parent corporation taxpayer when a domestic subsidiary (a "controlled entity") develops intangible property and transfers that intangible property to a foreign subsidiary.

After the initial transfer (which would be a taxable event), let's assume that the domestic entity enters into a use license agreement with the foreign entity. That is, the foreign entity allows the domestic entity to use the (now foreign-owned) intangible property in exchange for a license royalty payment. Such a use license payment would represent taxable income in the foreign taxing jurisdiction. And, it would represent a tax deduction in the United States.

The Section 482 regulations provide that all such intercompany transfer prices should be based on the arm's-length standard. Regulation 1.4821(b)(1) relates to any intercompany transfer price: "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. 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 (arm's length result)."

Regulation 1.482-1T(b)(2) explains that there are specified ALP methods related to the intercompany transfers of tangible property and intangible property. Specifically, "Sections 1.482-2 through 1.1482-6 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result."

With regard to each of the allowable transfer price methods, the regulations require that the analyst select and apply the single best method. This procedure is called the "best method rule." Regulation 1.482(c)(1) explains that "the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of the arm's length result."

This so-called best method rule is applicable for intentional intercompany intangible property transfers—that is, transfers that have federal income tax implications. Applying the best method rule, the analyst will select and apply transfer price measurement method—that is, the best method.

With regard to determining an ALP for IPHC intangible property management purposes, the analyst may conclude a transfer price based on a synthesis of various transfer price methods. That is, the application of the so-called best method rule is not required in the analyst's determination of an ALP for the intangible property license between the IPHC and the related-party domestic operating companies.

Regulation 1.482(c)(2) provides the criteria for the analyst's selection of the single best method for measuring the ALP for federal income tax purposes. This regulation indicates that "data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are at arm's length."

The criteria that the analyst should consider to select the best method for purposes of measuring the federal income tax transfer price are the following:

1. Comparability. The analyst considers the comparability between the controlled transaction or taxpayer and the uncontrolled transaction or taxpayer.
2. Data and assumptions. The analyst considers the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions.
3. Confirmation of the results by another method. "If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method" (see Regulation 1.482(c)(2)(iii)).

Regulation 1.482(d) discusses the comparability between (1) the controlled taxpayer or transaction and (2) the uncontrolled taxpayer or transaction:

> [F]or this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). . . . Such factors include the following:
>
> (i) functions,
>
> (ii) contractual terms,
>
> (iii) risks,
>
> (iv) economic conditions, and
>
> (v) property or services.

Regulation 1.482-3 describes the allowable methods for calculating the intercompany transfer price for tangible property. These methods are beyond the scope of this discussion, which focuses entirely on intangible property.

Nonetheless, the analyst should at least be aware of the tangible property intercompany transfer price methods described in the Section 482 regulations:

1. The comparable uncontrolled price method (see Regulation 1.482-3(b))
2. The resale price method (see Regulation 1.482-3(c))
3. The cost plus method (see Regulation 1.482(d))
4. The comparable profits method (see Regulation 1.482-5)
5. The profit split method (see Regulation 1.482-6)
6. Unspecific (other) methods (see Regulation 1.482-3(e))

Regulation 1.482-4 describes the allowable methods for calculating the intercompany transfer price for intangible property. Regulation 1.482-4 is titled "methods to determine taxable income in connection with a transfer of intangible property." Nonetheless, regulation 1.482-4(b) is titled "Definition of intangible."

This regulation defines the term "intangible" as follows:

> For purposes of section 482, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual—
>
> (1) Patents, inventions, formulae, processes, designs, patterns, or know-how;
>
> (2) Copyrights and literary, musical, or artistic compositions;
>
> (3) Trademarks, trade names, or brand names;
>
> (4) Franchises, licenses, or contracts;
>
> (5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and
>
> (6) Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

Regulation 1.482-4(c) describes the comparable uncontrolled transaction ("CUT") method. The CUT method is based on the selection and analysis of the arm's-length sales or licenses of similar intangible property.

As stated in regulation 1.482-4(c)(1):

> [T]he 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.

Regulation 1.482-4(c)(2) describes the comparability and reliability considerations related to the application of the CUT method. As defined in this regulation, reliability looks at whether the uncontrolled transaction involves the transfer of the same intangible property under the same, or substantially the same, circumstances as in the controlled transaction. The regulation also states that the degree of comparability of the controlled transaction and the selected uncontrolled transactions is based on a set of comparability factors.

These comparability factors include the following two categories of factors:

- Category 1: The comparability of the intangible property:
  - Are the CUT intangible property and the taxpayer company intangible property used in connection with similar products or processes within the same general industry or market?
  - Do the CUT intangible property and the taxpayer company intangible property have the same profit potential?
- Category 2: The comparability of the circumstances:

- Are the terms of the transfer (for example, exploitation rights, exclusivity, use restrictions, and geography restrictions) similar?
- Is the stage of development (between the CUT intangible property and the taxpayer company intangible property) similar?
- Are the rights to receive intangible property updates, modifications, and revisions similar?
- Is there a similar degree of uniqueness, including legal protection (between the CUT intangible assets and the taxpayer company intangible property)?
- Is the duration of the license or other agreement similar?
- Are the product liability or other economic risks similar?
- Is the existence of ongoing business relationships (if any) between the transferor and the transferee similar?
- Are the functions performed by the transferor and the transferee similar?

Regulation 1.482-4(a)(1) describes the CUT method by providing illustrative examples of the selection, adjustment, and application of CUT intangible property license agreements and royalty rate data.

Regulation 1.482-5 describes and illustrates the application of the comparable profits method. When used in other (non-Section 482) contexts, this transfer price method is also called the comparable profit margin method.

Whatever title the analyst applies to this method, the transfer price method procedures are the same:

1. The analyst selects uncontrolled companies (in the Section 482 case, uncontrolled taxpayer companies) that can be compared to the taxpayer company. These uncontrolled companies either operate or don't operate (depending on which side of the taxpayer company intercompany transfer is tested) a similar intangible property to the taxpayer's intangible property.
2. The analyst selects the appropriate profit level indicator ("PLI") to use as the intercompany transfer price test metric. The common PLIs are listed in the Section regulations as follows:
   a. Rate of return on the amount of capital employed (that is, a measure of return on investment).
   b. Various profit margin financial ratios, including the ratio of operating profit margin to sales and the ratio of gross profit margin to sales (that is, measures of profit margin). The regulations also allow for other PLIs.
3. The analyst selects the tested party within the taxpayer intangible property transferor. The tested party can be either the transferor of the taxpayer intangible property or the transferee of the taxpayer intangible property. The selection of the tested party is based on which party has the most reliable data and requires the least amount of adjustments.
4. The appropriate intercompany transfer price is the price that brings the tested party's PLI (either a return on investment or a profit margin on sales) in line with the selected uncontrolled companies' PLIs.

When selecting the uncontrolled comparable companies, the analyst should be concerned with the comparability and reliability factors described in the preceding list. In particular, the analyst should consider the functional, risk, and resource comparability of the selected comparable companies compared to the taxpayer company tested party.

Regulation 1.482-6 describes the profit split method for measuring the appropriate intercompany transfer price:

> The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

To allocate the taxpayer company profit under the profit split method (that is, to determine the appropriate profit split percentage), the analyst may use one of two allowable profit allocation methods:

1. the comparable profit split method or
2. the residual profit split method.

The comparable profit split method compares the division (or split) of operating profits among the

controlled taxpayer entities to the division (or split) of operating profits among the selected uncontrolled companies engaged in similar activities under similar circumstances.

It is noteworthy that the comparable profit split method may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparable companies varies significantly from the operating profit earned by the controlled taxpayer entities.

In the residual profit split method, first the analyst identifies and applies a fair rate of return to the taxpayer company's routine (also called "contributory") tangible property and intangible property. The regulation looks at the contribution that these routine (or contributory) assets make to the uncontrolled taxpayer business. Therefore, the regulation uses the term "routine contributions."

Routine contributions are contributions of the same or a similar kind to those made by uncontrolled companies involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services, and intangible property that are owned by uncontrolled companies engaged in similar activities.

The analyst typically performs a functional analysis to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayer entities. Market returns for the routine contributions are determined by reference to the returns achieved by uncontrolled companies engaged in similar activities.

Finally, the unspecified methods (as described in regulation 1.482-4(d) for determining the intangible property intercompany transfer price are any methods not described as allowable methods in the regulations.

Such an unspecified method should meet the comparability and reliability criteria previously described and should be the best method to measure the ALP of the intercompany transfer of the taxpayer intangible property.

The Intangible Property License ALP Synthesis and Conclusion

As mentioned above, for intercompany transfers of intangible property for federal income tax purposes, the intercompany license ALP is always based on the application of the so-called best method rule. For IPHC intangible property management purposes, the intercompany license ALP may be based on a synthesis of two or three of the aforementioned transfer price methods. Depending upon the quantity and quality of available data, the analyst may have to rely on a single transfer price method in the final determination of the intercompany intangible property license ALP.

A common intangible property license royalty formula is one where the transfer price is expressed as a percentage of net sales (e.g., the fair ALP for a retail company trademarks may be 2 percent of net sales).

However, license ALP royalty formulas based on a percent of gross profit or net profit are not uncommon. And, particularly for the technology-related intangible property of a manufacturing company (e.g., engineering drawings or patents), a license ALP royalty formula based upon a number of dollars per units produced (or units sold) is not uncommon.

What is noteworthy is that, for most companies, the intangible property license ALP royalty formula may change over time. Many companies that have implemented intangible property centralized management programs re-evaluate their ALP royalty formula periodically. Some companies re-evaluate the appropriate intangible property license ALP royalty formula on an annual basis.

If economic conditions in the industry change, if the microeconomic dynamics of the subject company change, or if the subject intangible property begins to experience obsolescence (or other forms of economic decay), then the appropriate intangible property license ALP royalty formula may change over time. While the consideration of the generally accepted intercompany transfer price methods remains valid, the periodic applications of these methods may result in different license ALP royalty.

Other Considerations

As with any asset management or other corporate strategy program, there are costs as well as benefits to an IPHC intangible property management program. These costs should be carefully budgeted and thoroughly understood before management decides to implement the intellectual property centralized management program.

The costs of the intangible property management program include possibly significant set-up costs. These costs include the cost of legal advice, the cost of intellectual property fair market value for the IPHC buy-in, the cost to legally create the IPHC corporate entity, and the cost to legally (and physically) transfer tangible property, intangible property, personnel, and operations to the IPHC entity.

> "[T]here may also be some state income tax benefits associated with the intangible property centralized management program."

Also, the corporation management should consider the indirect costs to the organization, including the initial administrative disruption to the parent company associated with the creation and implementation of the intangible property centralized management program.

In addition to the initial start-up costs, there may be continuing administrative costs associated with maintaining the IPHC and the intangible property management program. These costs may include periodic legal advice (to maintain the form and substance of the centralized management program) and periodic transfer price analyses (to re-evaluate the appropriate intercompany license royalty rate).

One additional issue for the corporation considering an intangible property management program is an unexpected change in the value of the transferred intellectual property and the corresponding unexpected change in the intercompany license ALP royalty rate. After the program is implemented and the intellectual property is transferred, the intercompany license ALP royalty rate may change.

Such a royalty rate change may be due to unanticipated intangible property obsolescence or to unanticipated economic changes in the industry or in the operating business units. This is one of the reasons why some corporations re-evaluate their intercompany license royalty rate formula on a periodic basis. Such events could affect the cost/benefit considerations with regard to the intangible property centralized management program.

Before the corporation initiates the intangible property management program, it should carefully evaluate the expected costs and potential benefits of such a program. Competent legal counsel should be consulted during this evaluation phase.

Also, a preliminary fair market value estimate of the intangible property to be transferred may be prepared. This preliminary estimate of the initial ("buy-in" transfer price and IPHC intercompany license transfer price should be adequate for planning, evaluation, and decision making purposes.

Of course, a more rigorous fair market value valuation and intercompany license ALP royalty rate may be required in the actual implementation of the IPHC and the intangible property centralized management program.

Summary and Conclusion

As with any strategic planning considerations, there are numerous pros and cons to the implementation of an IPHC and the associated intangible property centralized management program.

In terms of the pros, the corporation may enjoy increased internal control and external control over its intellectual property. The IPHC may implement a legal and commercial structure to investigate inbound and outbound licensing opportunities—or other intellectual property commercialization. And, as an incidental consideration, there may also be some state income tax benefits associated with the intangible property centralized management program.

In terms of the cons, the corporation may experience intangible property centralized management program implementation costs. Such costs may include the costs of an initial cost/benefit analysis, legal counsel fees, intangible property valuation and transfer price analysis fees, and the temporary organization disequilibrium associated with implementing the IPHC and associated transfers.

There may also be recurring costs associated with the periodic legal fees and intercompany license transfer price analysis fees. In particular, such fees may materialize if state taxing jurisdictions challenge the intercompany license ALP royalty formula.

Lastly, there is the risk that the value—and the associated license ALP royalty—of the transferred intangible property may change over time. And, this risk is not always within the control of company management.

Multistate corporations in many industries could experience administrative, management, and commercialization benefits associated with an IPHC intangible property centralized management program. This observation is particularly true for multistate corporations that rely heavily on intellectual property (such as trademarks, trade names, computer software, patents, proprietary technology, chemical formulae, etc.) in their normal business operations.

Before an IPHC intangible property centralized management program is implemented, the corporation should obtain advice of intellectual property counsel. And, before such an IPHC intangible property centralized management program is implemented, the corporation should obtain the advice of an intellectual property valuation analyst and a transfer pricing analyst.