Practical Guidance in an Intangible Property Transfer Price Analysis

When a multinational corporation develops and owns intangible property that is transferred to a controlled foreign subsidiary, the transferee should pay an arm's-length price ("ALP") for the transferred intangible property. Likewise, when the intercompany use of intangible property is licensed between a controlled foreign entity and a domestic taxpayer, the licensee should pay a fair ALP royalty to the licensor for the use of that intangible property. In addition, when a controlled participant enters into an intercompany cost sharing arrangement, the participant should buy in to the contributed intangible property at an ALP. The purpose of such a 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 the ALP that unrelated parties would agree to for the transfer or use of similar intangible property. For domestic taxpayers, the Treasury Regulations provide guidance on the methods to estimate the ALP in such situations. However, the transfer pricing analyst ("analyst") is likely to encounter special circumstances in each intercompany transfer engagement. This discussion addresses issues that the analyst may encounter when applying the procedural guidance provided by the Regulations to Internal Revenue Code Section 482. These Regulations encompass the determination of an ALP for the intercompany transfer of tangible property, intangible property, and services.

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Introduction

This discussion describes common issues that a transfer pricing analyst ("analyst") may encounter when complying with the Regulations related to Internal Revenue Code Section 482. In particular, this discussion relates to the multinational company transfer of intangible property and/or the contribution of intangible property with respect to an intercompany cost sharing arrangement ("CSA").

The purpose of Section 482 is to ensure that a domestic taxpayer clearly reflects the income attributable to controlled party transactions. According to Regulation 1.482-1, the standard to be applied in every intercompany transfer is that of a third-party taxpayer dealing at arm's length with an uncontrolled (and unrelated) taxpayer.

According to Regulation 1.482-1, 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 transfer of—or the use of—the following:

1. Tangible property
2. Intangible property
3. Services

Regulation 1.482-3 provides guidance related to the methods that may be used to determine an ALP regarding the transfer of tangible property. Regulations 1.482-4, -5, and -6 provide guidance related to the methods that may be used to determine an ALP regarding the transfer of intangible property. And, Regulation 1.482-9 provides guidance related to the methods that may be used to determine an ALP related to the transfer of services.

In addition, Regulation 1.482-7 provides guidance related to the implementation of a CSA.

The intangible property transfer can be between a parent corporation and a subsidiary. Or, the intangible property transfer can be between two affiliated (brother/sister) controlled corporations.

Likewise, the U.S. domestic company could own the intangible property and the controlled foreign company could use the intellectual property (i.e., a hypothetical outbound license). Or, the controlled foreign company could own the intangible property and the domestic company could use it (i.e., a hypothetical inbound license).

This discussion focuses on the determination of a fair, arm's-length price ("ALP") royalty rate (i.e., transfer price expressed in terms of a percent of revenue). This ALP royalty rate should be the price that one unrelated party intangible property owner would charge an unrelated party intangible property operator to enter into a use license for the intangible property.

The Arm's-Length Price Standard

In this discussion, let's assume that the intangible property owner is the hypothetical licensor in the arm's-length license transaction. And, let's assume that the intangible property 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 is transferred between a controlled participant located in one country and a controlled participant located in a different country.

When the intangible property transfer involves a multinational taxpayer corporation, the determination of taxable income related to transfer price is of great interest to both the domestic taxing authority and the foreign taxing authority.

The U.S. Congress promulgated Section 482 to address the concern that a domestic taxpayer could allocate income (and avoid income taxes) by transferring property (tangible property or intangible property) to a foreign affiliate.

Likewise, the Internal Revenue Service (the "Service") may be concerned that a foreign taxpayer may underreport domestic income by not allocating sufficient income to the related U.S. taxpayer for the use of the domestic tangible property or intangible property.

The Section 482 Regulations address these concerns by providing methods for delivering the transfer price charged in the multinational transfer of tangible property, intangible property, or services.

The goal of the Section 482 Regulations is to determine the 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 intercompany 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 Regulations Intangible Property Transfer Price Methods

To determine the ALP related to certain intercompany transfers of intangible property, the Section 482 Regulations list three specified methods and one unspecified method.

The specified methods are as follows:

1. The comparable uncontrolled transaction ("CUT") method, provided in Regulation 1.482-4
2. The comparable profits method, provided in Regulation 1.482-5
3. The profit split method, provided in Regulation 1.482-6

An unspecified method is any transfer price method not specified in the Section 482 Regulations. The unspecified methods are discussed in Regulation 1.482-4. An 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 the Section 482 Regulations should be considered by the analyst in the estimation of the ALP.

However, Regulation 1.482-1 requires that the "best method" be used to determine the arm's-length price for each property (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 some of the issues that may arise, and the potential solutions to those issues, when the analyst performs a transfer price analysis with regard to the intercompany transfer of intangible property.

To address these issues, first this discussion presents guidance from the Regulations.

Second, this discussion presents a simplified example that is based on an illustrative intercompany transfer price analysis engagement.

The general transfer price issues presented here relate to an actual intercompany transfer price analysis engagement. However, the specific information concerning the illustrative example has been altered for both presentation simplification and client confidentiality purposes.

The CUT Method and the Comparable Profits Method

This discussion focuses on the CUT method and the comparable profits method. This discussion addresses issues that analysts may encounter in the application of the CUT method, including the comparability of CUTs and considerations when applying the same CUTs to multiple countries.

This discussion also addresses issues that an analyst may encounter in the application of the comparable profits method, including the following:

1. Selecting the appropriate tested parties
2. Adjusting the tested parties to more accurately represent the impact of the transferred intangible property
3. Selecting appropriate uncontrolled comparable companies
4. Selecting an appropriate profit level indicator
5. Making adjustments to calculate an intangible property intercompany transfer royalty rate

Issue Number 1—Comparability of the 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 common intangible property transfer price measurement method. This is because the CUT method:

1. is specifically listed in the Section 482 Regulations and
2. is based on actual sale or license transactions involving comparable intangible property.

The primary procedures that the analyst may 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 intangible property CUTs 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 intangible property comparable uncontrolled transfer transactions

The following discussion presents (1) Section 482 Regulations guidance related to the selection of

CUTs and (2) practical considerations for the analyst related to the CUT selection process.

These practical considerations may help the analyst to determine:

1. which CUTs are comparable and should be included in the CUT method analysis and
2. if the CUT method is the best method to use in a particular transfer price analysis.

Guidance from the Section 482 Regulations

Selecting CUTs is a challenging but important procedure in the application of the CUT method. This CUT selection procedure should accomplish the following objectives:

1. Help to determine if the CUT method is the best method in the subject intangible property transfer price analysis
2. Affect the subject intangible-property-specific royalty rate concluded from this method

The Section 482 Regulations list factors that should 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 inform the analyst to consider the following factors:

> (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 inform the analyst to consider the following factors:

> (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]

Analyst Practical Guidance—An Illustrative Example

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

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

These three procedural issues are summarized as follows:

1. How does the 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 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 intangible property have to be in order for the CUT method to produce a meaningful transfer price conclusion?

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

In this illustrative example, let's call the subject taxpayer Multinational Corporation ("MNC"). Let's assume that MNC is a U.S.-based multinational company. MNC 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 trademark is owned by the U.S. parent corporation. The trademark is used by controlled subsidiaries in various foreign countries.

The subject transaction is an intangible property use license agreement entered into between (1) the domestic MNC and (2) certain of its foreign subsidiaries. The license agreement grants the foreign subsidiaries the right to use the Wonderful Widget trademark in an exclusive territory.

The intercompany license royalty rate paid by each foreign subsidiary to the U.S. parent corporation will be 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 intellectual property license agreement automated databases:

1. The RoyaltySource Royalty Rate database[8]
2. The ktMINE Royalty Rates and Records database[9]

The analyst searched each database source, by keyword and by Standard Industrial Classification ("SIC") code, that is, standard industrial classification.

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

1. The potential CUT licensed product(s)
2. The potential CUT license contract terms

According to an article published in the journal *Valuation Strategies*:

> 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]

The Primary CUT Selection/Rejection Criteria

In order to focus the CUT search on the transferred intangible property and on 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 criteria:

1. The licensed intangible property was significantly different than the intangible property involved in the subject intercompany 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 (i.e., not to a product trademark)
5. The date of the license transaction was too old compared to the date of the Wonderful Widget trademark license

6. The potential CUT license transaction documentation lacked sufficient information

It is noteworthy that this list of CUT selection/rejection criteria 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 potential CUT selection/rejection process.

After considering these preliminary factors, the analyst reduced the list of potential CUT trademark license agreements from over 100 licenses to a more manageable number of 12 potential CUTs.

Additional CUT Selection/Rejection Criteria

Next, the analyst considered each of the following additional criteria to further refine the CUT selection/rejection process:

1. Products sold (e.g., concrete blocks, heavy machinery, etc.)
2. Product distribution (e.g., wholesale or retail)
3. License term (e.g., license start date, license 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 percent of 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 selection/rejection screening criteria reduced the number of potential CUT license transactions from 12 licenses to 4 licenses.

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

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

That is, rather than exclude a potential CUT license based on differences between the potential CUT and the subject intangible property, the analyst would account for these differences in the selection of the intangible-property-specific royalty rate.

The Selected CUT Licenses

Based on a review of the publicly available documents concerning the selected comparable trademark licenses, the analyst developed the following observations about the selected CUTs:

1. All of the selected CUT licenses were still effective as of the transfer price estimation date.
2. All of the selected CUT licenses involved companies that manufactured durable goods. None of the CUTs involved a widget manufacturer.
3. CUT license company #1 (here called “comp #1) was primarily a service company. Although the company 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 license agreement

required annual contributions to the licensor company for advertising. Also, there was insufficient detail regarding the other two CUT licenses 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 selected CUT licenses 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 last year 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 license 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 license 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 on the product sales affected by the licensed trademark.

   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 license royalty rate (3 percent) and comp #2 CUT license royalty rate (3 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 license 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 CUT licenses are not perfectly comparable to the subject intangible property. 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 CUT licenses and the subject taxpayer intangible property transfer transaction. This is because, in every license agreement, the licensed intangible property 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 our illustrative example, the analyst concluded that (in spite of the differences between the selected CUT licenses and the subject taxpayer transaction), the CUT method was still appropriate.

The above discussion provided a practical example that illustrated the following:

1. The selection and rejection of CUT licenses
2. The factors that may be prioritized over other factors in the CUT selection process
3. Whether or not differences between the selected CUT licenses and the subject taxpayer transaction preclude the use of the CUT method

Issue Number 2—Consideration of Multiple Regions

The analyst may be retained by a multinational corporation to perform intercompany transfer price analyses related to the license of intangible property between entities that are both related to the multinational corporation.

In these engagements, one entity (e.g., the parent company licensor) typically licenses the intangible property to multiple related entities in different regions (e.g., the foreign subsidiary licensees).

To continue with the above illustrative example, let's assume that MNC licenses the Wonderful Widget trademark to its foreign subsidiaries located in the following countries:

1. Mexico
2. The United Kingdom
3. Poland

Let's further assume that (1) the analyst has determined that the transfer price measurement 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 analyst should account for differences between (1) the regions of the selected CUT licenses and (2) the regions of the foreign subsidiaries.

With regard to a multiple region analysis, the analyst may consider questions such as the following:

1. Should the same CUT licenses 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 suggests several practical answers to these analyst questions, using the above illustrative example.

Professional Guidance from the Section 482 Regulations

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.

The Section 482 Regulations provides guidance as to what factors may be considered when adjusting for differences between (1) controlled transactions and (2) the selected uncontrolled transactions.

These comparability adjustment factors listed in the regulations include the following:

> (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 Regulation factors listed in the CUT selection discussion also apply to adjusting for differences between (1) the subject controlled transaction and (2) the uncontrolled transactions.

Analyst Practical Guidance—An Illustrative Example

In our continuing illustrative example, the analyst considered several of the factors discussed above in the CUT search process. That is, the analyst considered these factors in the royalty rate selection process. For example, the analyst excluded license transactions that were considered too stale.

The Section 482 Regulations suggest that data available as of the transaction date should be considered in the royalty rate selection procedure.

The analyst may apply 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 taxpayer transaction and the selected CUTs should be considered in every transfer price analysis.

Royalty Rate Selection Procedures

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

1. The analyst assessed the local economy in 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 countries of the foreign subsidiaries (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 the 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 factors that were relevant (e.g., what was the existence and the nature of related transactions, and

what was the market share of the trademarked products in each region?).

6. The analyst also considered the factors that were previously analyzed as part of the CUT license search process.

Trademark Royalty Rate

In our illustrative 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 foreign 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 for the Poland subsidiary.

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

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

Issue Number 3—Issues in Applying the Comparable Profits Method

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

The intangible property transfer price methods are the following:

1. The CUT method—which was 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 comparable profits method—which uses comparable company profitability measures to determine an arm's-length royalty rate to apply to the subject transaction
4. The unspecified method—any method not specified in the Section 482 Regulations 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 a transfer price method. 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.

Considerations in the Application of the Comparable Profits Method

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

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

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

Relying on the comparable profits 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 may use in the application of the comparable profits method. Additionally, this discussion addresses practical issues and solutions that the analyst may encounter in the application of the comparable profits method in a transfer price analysis.

Professional Guidance from the Section 482 Regulations

The Section 482 Regulations describe the comparable profits 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]

Comparable Profits Method Application Procedures

There are four general categories of procedures involved in the application of the comparable profits 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 intercompany transfer price or royalty rate that produces this level of operating profit.

The Section 482 Regulations provide the 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]

Analyst Practical Guidance—An Illustrative Example

In this illustrative example, let's consider the same taxpayer company (i.e., MNC and its subsidiaries) and the same 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.

In this example, the analyst considered the comparable profits method to estimate the transfer price intangible property transfer price.

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

In the application of the comparable profits 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 illustrative example facts and circumstances. And, let's assume that one of the foreign subsidiaries of MNC was Eurosub.

Further, let's assume that Eurosub owns a foreign subsidiary with significant operational deficiencies (let's call this subsidiary 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 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, Greecesub had a material impact on the Eurosub profitability.

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

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

1. The analyst normalized the financial data of both 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 normalization adjustment resulted in a more accurate representation of the profitability relating to the Eurosub use of the taxpayer intangible property.

Selecting a Group of Uncontrolled Companies

This selection procedure is one of the more difficult procedures in the application of the comparable profits method. However, the selection process may yield more results than a search for CUT license pricing data.

In the search for comparable publicly traded companies for use as uncontrolled comparable companies, the analyst searched the following databases:

1. the Capital IQ database[15]
2. the Mergent Online database[16]

The analyst searched these capital market 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 five selected comparable publicly traded 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 publicly traded 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 comparable profits method, a PLI measures profits in terms of either resources employed or costs incurred.

According to the Section 482 Regulations,[17] common comparable profits 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 (the so-called 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 to consider 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 normalization adjustments that should be made to ensure ROCE comparability between the controlled and uncontrolled companies
3. The fact that the intercompany license royalty rate paid by the foreign subsidiaries to MNC is calculated based on a percent of the Wonderful Widget product sales

For this illustrative 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 respective economic environments in which Eurosub and Polandsub operate did have some differences, which are addressed below.

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]

The tested parties (i.e., Eurosub and Polandsub) operate in the cyclical construction and remodeling industry. Therefore, 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 following financial data:

Exhibit 1
Controlled Company and Uncontrolled Companies 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	0.1%
1st Quartile	2.5%
Median	2.9%
3rd Quartile	3.7%
High	4.1%
Eurosub	5.3%
Polandsub	4.3%

1. The operating profit margins of the uncontrolled companies
2. The uncontrolled company interquartile range
3. 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 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

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 than the other uncontrolled company market areas. This conclusion was based on the factors listed previously.

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—in order 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 analyst then selected the fair ALP royalty rates 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 to 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 an ALP license royalty rate for both Eurosub and Polandsub of 1.5 percent.

Comparable Profits Method Summary

This illustrative example presented one example of the application of the comparable profits method in a intercompany transfer price analysis. Because each application of the comparable profits method will have unique circumstances, and unique issues to overcome, this discussion addressed some of the practical issues that the analyst may encounter.

These comparable profits 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 the 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.

Summary and Conclusion

When an analyst is asked to estimate the fair, arm's-length price for the intercompany transfer of taxpayer intangible property, that analyst will consider the professional guidance provided in the Section 482 Regulations.

As stated in the introduction, the Section 482 Regulations guidance provide general rules to calculate the ALP transfer prices related to the intercompany transfer of tangible property, intangible property, and services transfers.

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

In the illustrative 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 available to apply the comparable profits method.

This discussion addressed these practical issues by:

1. referencing the Section 482 Regulations guidance and
2. providing an illustrative example that was based on an actual multinational taxpayer company fact set.

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

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

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

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

The guidance in the Section 482 Regulations—and in this discussion—cannot address every issue that the analyst will encounter in a transfer price analysis. A credible and persuasive transfer price analysis will be the result of the analyst carefully studying the Section 482 Regulations. And, more importantly, a credible and persuasive transfer price analysis will result from the analyst making sound judgments in the application of the Section 482 Regulations guidance to the subject analysis.

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	2.9%
Company D and Company E Median	3.9%
Company B and Company C Median	2.7%
Eurosub	5.3%
Polandsub	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.

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 nearly all publicly traded companies, as well as on nearly 2 million private companies.
16. Mergent Online contains data on 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).