Valuation Strategies

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TRANSFER PRICING CONSIDERATIONS

GUIDELINE COMPANIES

REAL OPTION ANALYSIS

mastering INTELLECTUAL TRANSFER PRICE

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Section 482 provides guidelines for what can be a complex determination of the transfer prices charged in multinational asset transfers.

PROPERTY ANALYSIS

When a multinational corporation develops and owns intellectual property that is used by its controlled foreign subsidiaries, a reasonable intercompany transfer price should be established as a charge for the use of the intellectual property. The intercompany transfer price must reflect an arm's-length price that unrelated parties would agree to for the use of similar intellectual property. Although the IRS provides guidance on the procedures to estimate the intellectual property intercompany transfer price in this situation, an analyst encounters unique circumstances in each individual case. This discussion addresses issues an analyst may encounter when applying the procedural guidance provided by Section 482 and the corresponding regulations with regard to the calculation of a fair, arm's-length royalty rate for the intercompany transfer of intellectual property between a multinational parent company and its controlled foreign subsidiaries.

Background

The purpose of Section 482 is to ensure that taxpayers clearly reflect the income attributable to controlled party transactions. The standard to be applied in every case is that of a third-party taxpayer dealing at arm's-length with an uncontrolled (and unrelated) taxpayer. A controlled transaction meets the arm's-length standard if the results of the controlled transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.

An intercompany transfer price is the price that one entity charges a related party for the use of (1) tangible assets, (2) intangible assets, or (3) services. The scope of this discussion is limited to the royalty rate (i.e., transfer price in terms of percent of revenue) that one unrelated party intangible property (IP) owner would charge an unrelated party IP operator for the use of the subject IP.

The estimation of a fair, arm's-length transfer price is important when two or more national taxing jurisdictions are involved. Strategic management decisions will almost certainly have income tax implications when a multinational corporation with subsidiaries in multiple taxing jurisdictions is involved. When an IP transfer involves a highly profitable corporation, potential earnings manipulation issues related to transfer prices are of great interest to both domestic and foreign taxing authorities.

Congress enacted Section 482 to address the concern that a domestic taxpayer could shelter income to avoid taxes by transferring assets to a foreign affiliate. Likewise, there is concern that a foreign taxpayer could avoid domestic taxes by not allocating sufficient income to the U.S. taxpayer for the use of assets.

Section 482 addresses these concerns by laying out general rules for the transfer prices charged in multinational asset transfers. The goal of the Section 482 regulations is to determine an arm's-length transfer price that two unrelated parties would have negotiated. This transfer price is then applied to the subject intercompany transaction. According to Reg. 1.482-1(b)(1),"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...."

To determine the arm's-length intercompany transfer price related to IP, the Section 482 regulations lists three specified methods and one unspecified method. The specified methods are:

1. The comparable uncontrolled transaction (CUT) method.
2. The comparable profits method (CPM).
3. The profit split method.

The unspecified method is any method not specified in the regulations. The unspecified method "should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it."[1]

Although all of the methods listed in the regulations should be considered by the analyst, the regulations require that the "best method" be used to determine the arm's-length pricing for each asset in an intercompany transaction. In determining the best method, the analyst should consider:

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

This article addresses issues that valuation analysts may encounter in the application of the CUT method and the CPM.

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Issue #1— Comparability of CUTs

According to Reg. 1.482-4(c), "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." The CUT method is one of the most widely used methods for Section 482 engagements. This is because the CUT method (1) is specifically listed in Section 482 and (2) is based on actual transactions of comparable IP.

The primary procedures in the CUT method are as follows:

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

Section 482 Guidance. Selecting CUTs is one of the most challenging and important procedures in the CUT method. This procedure (1) helps determine if the CUT method is the best method in a Section 482 analysis and (2) drives the subject IP-specific royalty rate concluded from this method.

The Section 482 regulations list factors that may be considered when selecting CUTs. According to Reg. 1.482-1(d)(1), these factors include:

1. Functions.
2. Contractual terms.
3. Risks.
4. Economic conditions.
5. Property or services.

Within the first factor, the functional analysis, Reg. 1.482-1(d)(3)(i) instructs the valuation analyst to consider:

- Research and development.
- Product design and engineering.
- Manufacturing, production, and process engineering.
- Product fabrication, extraction, and assembly.
- Purchasing and materials management.
- Marketing and distribution functions, including inventory management, warranty administration, and advertising activities.
- Transportation and warehousing.
- Managerial, legal, accounting and finance, credit and collection, training and personnel management services.

Within the second factor, contractual terms, Reg. 1.482-1(d)(3)(i) indicates that the valuation analyst should consider these items:

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

Finally, according to Reg. 1.482-4(d)(2), "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."

Each of the factors listed above provides useful guidance regarding the selection of CUTs in the CUT method. The factors presented are both well-reasoned and thorough. Valuation analysts, however, sometimes need to address questions such as the following when selecting CUTs as part of the CUT method:

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

An illustrative example helps clarify these three issues. Although the names and data from the engagement have been altered, the example is based on an actual engagement the authors recently completed.

Example. The subject company, MNC, is a U.S.-based company that manufactures widgets used in the manufacture and remodeling of both residential and commercial buildings. The subject IP is the "Wonderful Widget" trademark. The subject transaction is a licensee agreement between MNC and certain foreign subsidiaries that grants the foreign subsidiaries the right to use the Wonderful Widget trademark in an exclusive territory. The royalty rate paid by the foreign subsidiaries is calculated as a percent of the Wonderful Widget product sales.

To select CUTs for the CUT method, the following databases were searched by keyword and by industry classification:

- RoyaltySource Royalty Rate database.[2]
- ktMINE Royalty Rates and Records database.[3]

In total, these searches yielded over 100 potential CUTs. To further refine the sample of selected license agreements/transactions, the authors focused on two basic comparability factors: (1) the product and (2) the comparable license contract terms. According to Robert Reilly:

> The general standards of comparability govern the selection of a CUT. However the regulations note that two comparability factors are particularly relevant to the use of the CUT method. First, the proposed comparable intangible asset should be the same as, or comparable to, the subject intangible asset. Second, comparability will depend on the contractual terms of the transfer and the economic conditions under which the transfer takes place.[4]

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

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

This list includes some overlap (but not a complete overlap) with the list of comparability factors previously presented. In this case study example, the authors concluded that the factors in the bulleted list were the most important factors at this stage in the CUT search.

After considering these preliminary factors, the list of potential CUTs was reduced from over 100 transactions to 12 transactions. Next, the following additional factors were analyzed to further refine the CUTs selection:

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

The application of these additional screening criteria reduced the number of selected comparable licensing transactions from 12 transactions to four transactions. For each of these four licensing transactions, the authors reviewed the SEC documents filed by the licensor or licensee to obtain more detailed information concerning the licensing transaction.

The authors determined that any other differences remaining between the four selected CUTs and the subject IP could be accounted for when the subject IP royalty rate was selected. That is, rather than exclude a selected CUT based on differences between the CUT and the subject transaction, these differences were accounted for when the subject royalty rate was selected.

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

- All of the CUTs were still effective as of the valuation date.
- All of the CUTs involved companies that manufactured durable goods. None of the CUTs involved a widget manufacturer.
- Comp #1 was primarily a service company. Although it was primarily a service company, Comp #1 manufactured home remodeling products sold under the licensed trademark. Comp #2, Comp #3, and Comp #4 were all primarily manufacturing companies.

1 Reg. 1.482-3(e)(1).

2 The RoyaltySource Royalty Rate database is comprised of royalty rate information from arm's-length licensing transactions that have occurred over the past 25 years. The licensing transaction data are gathered by AUS Consultants.

3 The ktMINE Royalty Rates and Records database consists of over 30,000 royalty rate transactions.

4 Reilly, "Intercompany Transfer Price Analysis in Business Valuations," 8 Val. Strat. 10 (September/October 2004).

- The Comp #1 and Comp #2 license agreements contained a minimum royalty payment. The Comp #1 agreement required annual contributions to the licensor company for advertising, and there was insufficient detail regarding the other two CUTs to determine if the licensee agreed to make payments to the licensor in addition to the agreed-on royalties. All else being equal, these net sales guarantees generally allow for a lower net sales royalty rate.
- 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.
- Several of the CUTs provide for licensee exclusivity in multi-country territories. All else being equal, the exclusivity of a larger territory allows for a higher net sales royalty rate.
- The operating profit margin of the licensee during the year of the CUT was negative for Comp #1 and Comp #2. Comp #3 and Comp #4 reported a 2010 operating profit margin of 4.1% and 8.4%, respectively. A higher profit margin implies a higher net sales royalty rate, all other factors being equal.
- The CUTs net sales royalty rates ranged from 0.75% to 5%. The Comp #4 CUT had a 0.75% net sales royalty rate; the Comp #1 CUT and Comp #2 CUT each had a 3% net sales royalty rate; and the Comp #3 CUT had a 5% net sales royalty rate.
- The Comp #4 CUT royalty rate (0.75%) may have been negotiated down since the royalty rate was based on total product sales, and not only the product sales affected by the licensed trademark. However, the royalty rate on this transaction may have been negotiated up since the licensee was granted worldwide exclusivity.
- The Comp #1 CUT royalty rate (3%) and Comp #2 CUT royalty rate (3%) may have been negotiated down since they included compensation in addition to the royalty rate.
- The Comp #3 CUT net sales royalty rate of 5% was for world exclusivity. This royalty rate may have been less than 5% if the licensee territory was smaller.

It is evident from the above list that the selected CUTs were not perfectly comparable to the subject IP. For example, there were differences between the license territory, exclusivity, and the calculation of the royalty payment.

Differences will always exist between the CUTs and the subject transaction. In every license agreement, the licensed IP is unique (hence, the transaction), the licensor is unique, and the licensee is unique. However, these differences do not necessarily preclude the use of the CUT method. In the case study example presented in this discussion, the authors concluded that despite the differences between the selected CUTs and the subject transaction, the CUT method was still appropriate.

Issue #2— Consideration of Multiple Regions

Valuation analysts are frequently retained by large multinational corporations to perform intercompany transfer price analyses related to the license of IP between entities that are both related to the subject multinational corporation. In these engagements, typically one entity (the licensee/parent company) licenses IP to multiple related entities in different regions (the licensors/foreign subsidiaries).

To continue with the case study example that was previously discussed, assume that MNC licenses the Wonderful Widget trademark to its foreign subsidiaries located in (1) Mexico, (2) the United Kingdom, and (3) Poland. Further assume that (1) the valuation analyst has determined that the best method is the CUT method, and (2) none of the selected CUT licensees operate in the same region that the foreign subsidiaries operate in.

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

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

Section 482 Guidance. When adjusting for differences between controlled transactions and the selected uncontrolled transactions, Reg. 1.482-3(b)(2)(ii) explains that the relevant factors to consider 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, and transport terms).
3. Level of the market (i.e., wholesale or retail).
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.
8. Alternatives that are realistically available to the buyer and seller.

The Section 482 factors listed in the CUT selection discussion also apply to adjusting for differences between controlled and uncontrolled transactions.

In our example, several of the factors discussed above were considered in the CUT search (i.e., these factors were not considered in the royalty rate selection). For example, transactions that were deemed too old were excluded. The regulations suggest that this fac-

tor may instead be considered in the royalty rate selection procedure.

The valuation analyst has discretion regarding how to select CUTs and how to select a transfer price (e.g., a royalty rate) for the subject transaction based on the guideline CUT data. The specific facts and circumstances surrounding the subject transaction and the CUTs must be considered in every valuation assignment.

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

- The economy of the foreign subsidiaries was analyzed. For instance, were there unique political risks, or was the credit rating of each foreign subsidiary region similar?
- The homebuilding and remodeling industry in the foreign subsidiaries region was analyzed. For instance, was the homebuilding market stronger or weaker in one region compared to the others?
- The historical and projected financial statements of the foreign subsidiaries were analyzed. For instance, was one region especially profitable compared to other regions; if so, why?
- The differences between the Wonderful Widget trademark use in each foreign subsidiary region was analyzed. For instance, how long had the trademark been used in each region, and how was the trademark perceived by customers in each region?
- Other unique factors deemed relevant were considered. For instance, what was the existence and nature of related transactions, and the market share of the trademarked products in each region?
- The factors analyzed as part of the CUT search were also considered.

In this example, the biggest difference between the regions was that in the Mexico region the trademark was widely used, it was widely recognized by consumers, and the Mexico subsidiary was the most profitable of the three subsidiaries. Conversely, the Wonderful Widget trademark was one of several construction and remodeling related trademarks that were used in the United Kingdom (U.K.) and Poland. The U.K. and Poland subsidiaries were only marginally profitable.

Based on these considerations, a royalty rate selected for the Mexico subsidiary was greater than the royalty rate selected for the U.K. and Poland subsidiaries. The same royalty was selected for both the U.K. subsidiary and the Poland subsidiary.

Issue #3—
Issues in Applying the CPM

As described in the introduction, Section 482 allows the use of three specified methods and one unspecified method for calculating the arm's-length intercompany transfer price. The methods are:

- The CUT method—addressed earlier in this discussion.
- The profit split method—which allocates the relative value of each controlled party's contribution to that of the combined operating profit.
- The CPM—which uses comparable company profitability measures to determine an arm's-length royalty rate charge to apply to the subject transaction.
- The unspecified method—any method not specified in Section 482 that follows the principle that uncontrolled taxpayers would evaluate the terms of a transaction by considering realistic alternatives.

In certain cases, the analyst may not be able to apply all of the methods effectively. For example, the analyst may determine that there is insufficient data to apply the CUT method. When the subject intangible asset 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 IP. This method may not produce meaningful results in these situations:

1. Information is insufficient to accurately allocate profit margin to specific IP.
2. The combined company operates in an industry where profit margins are generally low in absolute terms.

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

Even when the CUT method and the profit split method do not produce meaningful results, the analyst may still rely on the CPM. Unlike the CUT method, the CPM does not require the analysis of comparable IP sale or license transactions. The CPM focuses on comparable public companies, with data that is generally publicly available. Additionally, the CPM relies on publicly traded companies that operate in the same or a similar industry as the subject company. Relying on the CPM 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 section addresses steps the analyst takes in the application of the CPM. Additionally, this section addresses real life issues and solutions that an analyst may encounter in the application of the CPM in a Section 482 engagement.

Section 482 Guidance. Reg. 1.482-5(a) describes the CPM:

> 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.

There are four procedures to the application of the CPM for estimating an IP intercompany transfer price royalty rate:

1. Select one of the companies in the IP transfer transaction (i.e., the "tested party").
2. Identify an uncontrolled company or group of companies that 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.

5 Capital IQ contains data on approximately 58,000 public companies, as well as nearly 2 million private companies.

6 Mergent contains data on approximately 25,000 active and inactive U.S. companies. The database also covers 95% of foreign public companies.

4. Calculate the IP intercompany transfer price or royalty rate that produces this level of operating profit.

According to Reg. 1.482-5(2)(i), "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."

Furthermore, Reg. 1.482-5(b) states 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."

Example. The facts are the same as in the example above, except that both the CUT method and the profit split method were rejected for various reasons. Because these methods were not applicable, the CPM is considered to determine the subject IP royalty rate.

Selecting the tested party. As explained above, the subject transaction is a licensee agreement between MNC and certain foreign subsidiaries. MNC grants the foreign subsidiaries the right to use the Wonderful Widget trademark in an exclusive territory. The royalty rate transfer price paid by the foreign subsidiaries is calculated based on a percent of the Wonderful Widget product sales.

In applying the CPM, the foreign subsidiaries were selected as the tested parties. The foreign subsidiaries engage in activities that are less complex and of a narrower scope than MNC. Additionally, the analysts were tasked with calculating an arm's-length IP royalty rate for multiple foreign subsidiaries of MNC. Selecting each of the foreign subsidiaries as the tested parties allows the analysts to complete this task.

Adjusting the tested party. Expanding the example's facts and circumstances, assume that one of the foreign subsidiaries of MNC was Eurosub. Eurosub owned a foreign subsidiary with significant operational deficiencies (Greecesub of Europe). Further assume that Greecesub of Europe had structural and operational deficiencies that negatively affected the profitability of Eurosub, independent of the use of the subject IP; and did not enjoy the same brand recognition as the majority of Eurosub, and therefore did not reflect the profit potential relating to the subject IP.

Although Greecesub of Europe accounted for less than 20% of the Eurosub operations, it had a material impact on the Eurosub profitability. Therefore, the Greecesub of Europe financial results from Eurosub are eliminated. Prior to making this adjustment, (1) both the financial data of Greecesub of Europe and Eurosub were normalized and (2) the results of Greecesub of Europe were eliminated from the results of Eurosub line by line. This financial statement adjustment resulted in a more specific and accurate representation of the profitability relating to the Eurosub use of the subject IP.

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

In searching for comparable publicly traded companies for use as uncontrolled comparable companies, the authors searched the following databases:

- Capital IQ Database.[5]
- Mergent Online Database.[6]

These databases were searched based on the following factors:

- The industry in which the company operates.
- The geographic location of the company.
- The annual revenue of the company.
- 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 Reg. 1.482-1(d) also apply to the selection of comparable uncontrolled companies. Therefore, among other factors, the authors considered (1) the risks the company is exposed to, (2) the economic conditions in which the company operates, and (3) the services that the com-

EXHIBIT 1
Controlled and Uncontrolled Company Operating Profit Margins

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

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%

[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.

pany provides. Based on consideration of these and other criteria, five comparable publicly traded companies were selected.

Each of the selected comparable companies (1) had significant operations in the same geographic area as the tested party, (2) operated in the construction and homebuilding and remodeling industry, and (3) operated at a reasonable profit level for the industry in the most recent fiscal year. Additionally, each of the selected comparable companies had sufficiently comparable financial data going back five years.

Selecting the appropriate profit level indicator. In this step of the analysis, a profit level indicator (PLI) from the uncontrolled companies is selected to apply to the tested parties. In the application of the CPM, a PLI measures profits in terms of either (1) resources employed or (2) costs incurred. According to Reg. 1.482-5(4)(i), common CPM profit level indicators are:

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

The choice of PLI to rely on varies based on the company being considered. If the subject company 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 determine which PLI to rely on.

Although the foreign subsidiaries of MNC manufacture Wonderful Widgets, requiring the use of significant assets, the operating profit to sales ratio was determined to be an appropriate PLI to use. This selection was based on (1) the information available for the controlled and uncontrolled companies, (2) the complexity of balance sheet adjustments that must be made to ensure ROCE comparability between the controlled and uncontrolled companies, and (3)

the fact that the royalty rate paid by the foreign subsidiaries to MNC is calculated as a percent of the Wonderful Widget product sales. For this example, assume that the two tested parties are Eurosub and Polandsub (both foreign operating subsidiaries of MNC that enjoy the benefit of the subject IP).

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

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

The economic environments in which Eurosub and Polandsub operate did have some differences. These differences are addressed in the following section.

According to Reg. 1.482-5(b)(4), "the profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables." Because the tested parties (i.e., Eurosub and Polandsub) operate in the cyclical construction and remodeling industry, a five-year average operating profit margin was relied on as the PLI (as opposed to the latest 12-month operating profit margin, three-year average operating profit margin, or some other time period).

Estimating the IP intercompany royalty rate. After calculating the five-year average operating profit margin for the five uncontrolled companies, an interquartile range was calculated. Exhibit 1 presents the operating profit margins of the uncontrolled companies, the uncontrolled company interquartile range, and the operating profit margin of the tested parties. The operating profit margins of both tested parties were greater than the upper limit of the interquartile range.

However, the Eurosub operating profit margin (after adjustment for an underperforming and incomparable subsidiary) was greater than the Polandsub operating profit margin. After it was determined that both of the tested parties warranted a royalty rate charge for the right to use the subject IP, the tested parties were compared further to the uncontrolled companies.

Of the five uncontrolled companies, it was determined that the political, economic, and overall risk environment that Eurosub operates in most closely matched the environment that Uncontrolled Company D and Uncontrolled Company E operate in. The countries in which Uncontrolled Company D and Uncontrolled Company E conduct the majority of operations were more similar to the Eurosub market area in terms of (1) projected GDP growth, (2) housing prices, (3) population growth, and (4) government bond ratings than the other uncontrolled company market areas.

Alternatively, it was determined that the political, economic, and overall risk environment that Polandsub operates in most closely matched the environment that Uncontrolled Company B and Uncontrolled Company C operate in. The countries in which Uncontrolled Company B and Uncontrolled Company C conduct the majority of operations were more similar to the Polandsub market area, based on the factors listed in the previous paragraph, than the other uncontrolled company market areas.

The operating profit margin of Eurosub was compared 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 subject IP. The Polandsub operating profit margin was compared to the median operating profit margin of Uncontrolled Company B and Uncontrolled Company C to determine a royalty rate appropriate for the Polandsub use of the subject IP.

As presented in Exhibit 2, the fair arm's-length royalty rates were then selected based on the difference between the operating profit margins of the tested parties and a normal level of industry profitability for companies that do not enjoy the right to use the subject IP (i.e., the most comparable uncontrolled companies). The royalty rates estimated for Eurosub and Polandsub were within a close range of each other. Additionally, Eurosub and Polandsub used the subject IP to a similar degree and benefited from a similar level of brand recognition relating to the subject IP. A reasonable royalty rate for both Eurosub and Polandsub was selected at 1.5%.

Conclusion

When valuation analysts are asked to estimate the fair, arm's-length price of intercompany transfers of intangible property, they often seek guidance from the Section 482 regulations. Section 482 provides guidelines that lay out general rules for the transfer prices charged in multinational asset transfers.

Of course, no two transfer price analyses are alike, and the examples provided in the regulations almost certainly differ from the subject taxpayer transaction. In the examples described in this article, 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 was only sufficient data to apply the CPM.

The focus of this article was on these three issues because based on the authors' experience, these issues are common in intercompany transfer pricing analyses. Furthermore, the proper handling of these issues requires analyst judgment beyond what can be interpreted from Section 482.

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

The guidance in Section 482, the regulations, and this discussion cannot address every issue that a valuation analyst faces in a transfer pricing assignment. A credible and persuasive analysis results from carefully studying the Section 482 regulations and, more importantly, making sound judgments in the application of the Section 482 guidance to the subject analysis. ●