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**Questions**

If you have any questions please submit them in the “Questions” box.
INTANGIBLE ASSETS IN TRANSFER PRICING
IDENTIFICATION, OWNERSHIP, AND VALUATION

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JULY 8, 2014
AGENDA

• CASES ON TRANSFERS OF INTANGIBLE ASSETS

• POSITIONS TAKEN ABROAD

• MIGRATION OF INTANGIBLES

• FACTORS TO CONSIDER FOR YOUR TRANSFER PRICING

• Q&A
SECTION 1.482-4 METHODOLOGIES ET AL.

• Comparable Uncontrolled Transaction
  – Royalty for the use of the same intangible assets
    • Are terms comparable?
  – Similar intangible assets
    • Profit potential consideration
  – Georgia-Pacific factors

• Profitability of Licensee
  – Comparable Profits Method to determine routine return of licensee in order to estimate residual profits
  – Residual Profit Split: share of residual profits captured by licensee
  – Goldschreiber 25% rule of thumb
    • Never accepted under section 1.482
    • Rejected in Uniloc decision as junk science
    • Critiques from economists on its usefulness
CASES ON TRANSFERS OF INTANGIBLE ASSETS

• Intercompany Licensing: Arm’s Length Royalty Rate
  – Ciba-Geigy
  – Bausch & Lomb
  – Sherwin-Williams
  – Guidant
  – Medtronic
  – Eaton
  – Caterpillar

• Migration of Intangible Assets: Sale at Fair Market Value
  – Nestle (acquisition of Carnation)
  – DHL
  – Veritas
  – Amazon
Licensees in Ireland and Puerto

Cumulative 2001-2 sales = $3162 million with royalties = $261 million or 8.25% of sales

Becker CPM report

- Assumes US parent owns all valuable intangible assets
- Determines routine return as 12% markup over labor and overhead costs
- Estimated routine return is $1 billion less than actual operating profits
- Implies an increase in the royalty rate to around 40% of sales

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CURRENT LITIGATIONS

- IRS positions
  - Ceteris report in Medtronics also based on CPM
  - Hatch report in Eaton also based on CPM

- Taxpayer positions
  - External CUT analyzes suggest much lower royalty rates
  - Licensee bears risks and may own some of the valuable intangibles

BAUSCH & LOMB

- Highly profitable Irish licensee after paying 5% royalty rate
- Court rejected taxpayer’s defense based on external CUT approach
- IRS proposed a royalty rate in excess of 50% based on CPM
- Court settled on a 20% royalty rate based on its own analysis of licensee profitability
• Swiss affiliate licensed intangible assets to U.S. affiliate for royalties = 10% of sales
  – U.S. affiliate retained significant profits after royalty
  – IRS asserted royalty rate should be only 6% of sales

• Two potential CUTs
  – IRS focused on license to 3rd party entities in Eastern Europe
  – Taxpayer noted 3rd parties in U.S. offered royalty rate over 10%

• Profits based analyzes
  – IRS put forth Goldshcreiber’s rule of thumb but the Court noted that royalties were less than 25% of consolidated profits
  – IRS also emphasized capital nature of U.S. operations but the Court noted that royalties were less than 100% of residual profits
SHERWIN-WILLIAMS V. STATE OF NEW YORK

• Standard Delaware Intangible Holdings Company case
  – DIHC owned the trademark but did not do the advertising
  – Consolidated operating profits = 10% of sales
  – Royalty = 3% of sales

• Taxpayer’s position based on CPM analysis
  – Routine return = 5% of sales
  – Residual profits = 5% of sales so a 3% royalty rate appears conservative

• Testimony of state’s expert witness
  – Licensee owns the valuable product and process intangibles
  – Licensee also deserves a portion of residual profits to account for the extra risks it incurs by using other entity’s intangible assets
  – By a residual profits split approach that accounts for both of these facts, licensee deserves most of the residual profits
CATERPILLAR CONTROVERSIES

• *Caterpillar Inc. v. Comr.*, T.C., No. 10790-13
  – During the early 1990’s, the Belgian and French affiliates were occurring losses as was the entire Caterpillar group
  – The IRS economist insisted that the Belgian and French licensees continue to pay royalties (the licensee as risk taking view)
  – Tax authorities in Belgium and France insisted on relief from royalties

• Current Caterpillar controversy
  – From 2011 to 2013, foreign operations generated 15% operating profits before royalties on over $40 billion per year in sales
  – Royalties for the use of U.S. owned technology = 6% of sales
  – Routine returns to foreign operations = 6% of sales
  – Does Swiss affiliate as risk taker and alleged owner of marketing intangibles deserve the remainder?
  – Senate committee asserted U.S. parent deserved 100% of residual profits based on an extreme view of the facts and circumstances
• Foreign Tax Authorities Arguments Against CPM
  – Foreign affiliates created marketing intangibles by virtue of its local marketing activities
    • Position taken by IRS in *GlaxoSmithKline Holdings (Americas)* litigation
  – Foreign affiliate either inherited or created local intangibles
  – Risks incurred by related party licensee
  – Royalties suggested by CPM substantially above royalties observed in third party agreements

• Specific Positions Taken by Chinese & Indian Tax Authorities
  – Location savings
  – Other location specific advantages
  – Role played by local marketing expenses
MIGRATION OF INTANGIBLES

• U.S. tax law
  – If a U.S. affiliate sells intangible assets to a foreign affiliate, section 367(d) requires compensation at fair market value
  – Cost Sharing involves the sale of the foreign rights to pre-existing IP

• Economics of sale of intangibles
  – Present value of future return to transferred intangible assets
  – What is a reasonable royalty rate?
  – What is the economic useful life of the transferred intangible asset?
  – Projected sales over this economic useful life
  – Appropriate discount rate
NESTLE: VALUE OF CARNATION INTANGIBLES

• Background
  – Nestle US purchased Carnation for $3 billion
  – Value of tangible assets = $2.55 billion
  – Nestle asserted value of intangible assets at time of purchase = $450 million consisting of $340 million in trademarks and $110 million in other intangible assets

• Debate over Value of Trademarks
  – Robert Reilly justified $340 million using a discounted cash flow model that assumed a 4% royalty rate
  – IRS argued for a much lower blended royalty rate by a detailed hybrid of CPM for brands with low values and external CUT for brands with high value
  – While Tax Court accepted this IRS analysis, the Appeals Court overturned the IRS win
DHL VALUATION OF TRADEMARKS

• Background
  – Bain & Co. placed a $20 million value on transfers of IP from US to Asian affiliate
  – Their approach assumed US owned all IP but reached a low value by assuming an absurdly high cost of capital

• IRS Position
  – Value of IP must be consistent with the fact that the enterprise market value exceeded the value of tangible assets by $300 million
  – Valuation supported by various discounted cash flow models

• Tax Court and Appeals Decisions
  – Tax Court noted that the foreign affiliate owned its own process intangibles
  – Criticized the IRS position for ignoring this fact and noted that the trademark value was subset of total intangible asset valuation
  – Appeals Court suggested part of the trademark value was created by foreign affiliate’s activities
• Veritas sold certain foreign rights in 1999 for $166 million

• IRS asserted value = $1675 million based on Hatch analysis
  – Economic useful life – perpetuity
  – Assumed high expected future growth rates
  – Royalties equal to all residual profits
  – Discount rate = 13.7% based on an application of Capital Asset Pricing Model (CAPM)

• Veritas defended its low value with testimony from William Baumol
  – Buy-in limited to the technology value
  – Economic useful life = 4 years for the technology
  – Reasonable royalty = 20% of sales for the first year and declining after that
  – Discount rate = 20.5% also based on an application of CAPM
    • Higher estimated beta coefficient
    • Higher assumed premium for bearing market portfolio risk
AMAZON

• European rights to certain technology sold to Amazon Europe Holding Technology on 1/1/2005 for $217 million
  – Deloitte report based on aggregate residual value
  – Projections of income from 2005 to 2011
  – Assumed a 7 year economic useful life with decaying IP value

• IRS Position that the value should be $3.6 billion
  – Daniel Frisch and William Morgan DCF model
  – Also used an aggregate residual value approach with the same projections of income from 2005 to 2011
  – Assumed perpetual life with no IP value decay
  – Assumed sales would grow at a 3.8% per annum rate after 2011
  – Assumed discount rate = 18%
FACTORS TO CONSIDER FOR YOUR TRANSFER PRICING

• Factual
  – Careful delineation of what are your valuable intangible assets
  – Understanding of how they contribute to your overall profitability
  – Clear articulation of ownership of various intangible assets
  – Risks incurred by your related party licensees

• Methodology
  – Can you identify internal comparable third-party transactions?
  – Documentation of drivers of related party licensee’s profits
    • Actual profitability as well as variability of profits
    • Estimation of routine return versus residual return
    • How much of the residual return should accrue to the licensee to account for any intangible assets it owns and as compensation for additional risks?
    • How does royalty rate implied by Residual Profit Split Method compare to 3rd party royalty rates in your sector?
Q&A
THANK YOU FOR ATTENDING!

Contact us with questions:
vanessa.toussaint@thomsonreuters.com