

INTER TAX

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Exclusive Patents and Trademarks and Subsequent Uneasy Transaction Comparability: Some Transfer Pricing Implications

Prof. Roberto Moro Visconti*

Intangible assets are intrinsically difficult to evaluate and compare; due to their immaterial nature, they are frequently negotiated within multinational groups and thus become sensitive to transfer pricing issues. OECD guidelines address the complex problem of trying to adapt standard transfer pricing methods to specific circumstances. Arm's length comparisons are particularly problematic for exclusive and specific patents and trademarks and also as a consequence of the intrinsic confidentiality that concerns their transactions.

I TRADE AND MARKETING INTANGIBLE TRANSACTIONS IN OECD TRANSFER PRICING GUIDELINES

Intangible assets, such as patents or trademarks, are particularly difficult to evaluate¹ due to their intrinsic 'immaterial' nature, and many different – complementary – appraisal methods are traditionally used within the business community; valuation issues are even more complicated for non-tradable or not deposited intangibles, such as know-how, trade secrets, goodwill, and so forth, characterized by limited, if any, marketability, higher information asymmetries and less defined legal boundaries.

These difficulties in market evaluation are even more evident if we consider that, from an accounting point of view, according to IAS 38, there is no active market for intangibles, and it is consequently difficult to assess their fair value.

Tax regulators are conscious of the problem, and in OECD Transfer Pricing Guidelines (TPG) for Multinational Enterprises and Tax Administrations² (revised version of 22 July 2010), there is a specific chapter (VI) with a meaningful title: 'Special Considerations for Intangible Property'. Even for what

concerns intangibles, the target of TPG is to minimize controversies and maximize tax certainty, avoiding double or less-than-single taxation. The tax treatment of intangibles in the context of transfer pricing (TP) has become a major international tax concern. Possible cross-border relocation, with income shifting policies looking for milder taxation, may cause tax base erosion in countries where the intangible originates.

According to section 6.1: 'particular attention to intangible property transactions is appropriate because the transactions are often difficult to evaluate for tax purposes'. And also: 'intangibles are one of the most challenging topics in the transfer pricing area, both from a theoretical perspective and because of the number and size of the disputes that arise in relation to their recognition and valuation'.³ Ad hoc meetings⁴ and specific papers⁵ about the intangible issue confirm the importance of the problem.

Among the many difficulties, there is a sort of philosophical and rhetoric question that may often have deep practical implications: patents and trademarks are highly valuable when they are exclusive and specific, but in such a case, it is ontologically difficult – if not impossible – to make external comparisons; a high value, with its potential tax base, may so prove extremely difficult to appraise using arm's length methods,⁶ which

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¹ See A. Oestreicher, 'Valuation Issues in Transfer Pricing of Intangibles: Comments on the Scoping of an OECD Project', *Intertax* (2011): 1–7; M. Markham, *The Transfer Pricing of Intangibles* (The Hague: Kluwer Law International, 2005).

² <www.oecd.org/ctp/tp/guidelines>.

³ <www.oecd.org/department/0,3355,en_2649_45675105_1_1_1_1_1,00.html>.

⁴ OECD meets with business commentators on the valuation of intangibles for transfer pricing purposes in <www.oecd.org/document/52/0,3746,en_2649_45675105_47445940_1_1_1_1,00.html>.

⁵ C. Silberstein, 'Transfer Pricing Aspects of Intangibles: The OECD Project', *Transfer Pricing International Journal* (2011): 8.

⁶ See J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (The Hague: Kluwer Law International, 2010).

are – in their different forms – the cornerstone of TP comparisons.

Another cornerstone – described in Chapter 3, section A.4 of TPG – is represented by ‘comparable uncontrolled transactions’, intrinsically referable to arm’s length principles (what an independent enterprise would have done in comparable circumstances, referring to standard and ‘open market’ prices); further problems may arise with intangible assets, since they are commonly negotiated within international groups,⁷ being so relevant for TP issues but not useful for uncontrolled – arm’s length – comparisons. But famous and celebrated trademarks or patents are typically owned by big companies within an international group, and so any comparison with smaller and uncontrolled negotiations becomes intrinsically difficult and often meaningless. Treating related companies as if they were unrelated does not properly consider the peculiar Coasian nexus of contracts of multinationals, which tend to internalize costs and to exploit economies of scale and experience.

Even the TPG definitions (in section 6.8) duly reflect these peculiar characteristics:

- a patent gives an exclusive right to its owner to use a given invention; patents are basically concerned with the production of goods (which may be sold or used in connection with the provision of services);
- a trademark is a unique name, symbol or picture that the owner or licensee may use to identify special products or services.

How can ‘exclusivity’ or ‘uniqueness’ be fit for ‘comparable uncontrolled transactions’ if its semantic meaning seems the opposite?

Some preliminary classification of the main intangibles is useful before going deeper in the analysis of the aforementioned tax evaluation paradox. TPG distinguish between commercial and marketing intangibles:

- commercial intangibles include patents, know-how, designs, and models that are used for the production of a good or the provision of a service;⁸
- marketing intangibles⁹ are a special type of commercial intangible with a somewhat different nature, include trademarks and trade names that aid in the commercial

exploitation of a product or service, customer lists, distribution channels, and unique names, symbols, or pictures that have an important promotional value for the product concerned.¹⁰

Patents and trademarks have similar aspects, but also remarkable differences, even beyond their technological or marketing area of natural reference; patents expire normally within twenty years – and their value normally peaks in the first years – whereas trademarks may continue indefinitely. But key patents, with their ‘killing’ applications, may have an undisputed, albeit ephemeral value, originating highly rewarding monopolistic rents.¹¹ Patents are more difficult to compare because they are intrinsically ‘unique’ (if an invention is not unique, it cannot be patented); relevant patentability requirements include novelty and non-obviousness. Trademarks are not necessarily ‘unique’: ‘trademarks may confer a valuable market status on the goods or services to which they are attached, whether or not those goods or services are otherwise unique’ (TPG, section 6.8). For trademarks, comparability is normally less difficult than for patents.

The distinction between different intangibles, however, has to consider their intrinsically versatile nature,¹² according to which they may be easily moved and frequently combined, looking for precious synergies (e.g., a branded product whose quality is enhanced by various patents) and creating the potential for fruitful tax planning. When a combination of intangibles is sold or licensed in a package-deal-‘bundled’ transaction,¹³ often ‘embedded’ in some material assets, specificity sours and then the fiscal detection of their value may become even more difficult, trespassing to arbitrariness.

Characteristics of intangibles are also difficult to isolate and may overlap: ‘in some cases patents, because of their outstanding quality, may also have a very strong marketing effect similar to that of a pure trademark’.¹⁴

2 FACTORS INFLUENCING THE TAX VALUE OF TRADE AND MARKETING INTANGIBLES

According to section 6.4 of TPG, the value of marketing intangibles depends upon many factors, including:

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⁷ For a definition of associated enterprises, see Art. 9 of OECD model tax convention on income and capital.

⁸ Section 6.3.

⁹ See M. Levey et al., ‘The Quest of Marketing Intangibles’, *Intertax* (2006): 2.

¹⁰ Section 6.4.

¹¹ ‘Patents may create a monopoly in certain products or services whereas trademarks alone do not, because competitors may be able to sell the same or similar products so long as they use different distinctive signs’, TPG, s. 6.8.

¹² This is due to their intangibility, with consequent little if any problems of transportation, storing, etc.

¹³ See s. 6.18.

¹⁴ TPG, s. 6.9.

- the reputation and credibility of the trade name or the trademark fostered by the quality of the goods and services provided under the name or the mark in the past;
- the degree of quality control and ongoing research and development, distribution and availability of the goods or services being marketed;
- the extent and success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services (in particular advertising and marketing expenditures incurred in order to develop a network of supporting relationships with distributors, agents, or other facilitating agencies);
- the value of the market to which the marketing intangibles will provide access; and
- the nature of any right created in the intangible under the law.

Section 6.24 specifies that:

- when marketing intangibles are involved, the analysis of comparability should consider the value added by the trademark, taking into account consumer acceptability, geographical significance, market shares, sales volume, and other relevant factors;
- when trade intangibles are involved, the analysis of comparability should moreover consider the value attributable to such intangibles (patent protected or otherwise exclusive intangibles) and the importance of the ongoing research and development functions.

To the extent that value may be estimated with replacement cost methods (how much would the potential buyer spend to reconstruct the intangible from scratch instead of buying it?) frequently used within the financial community, key differences between patents and trademarks should again be underlined (TPG, section 6.9):

- Patents are usually the result of risky and costly research and development¹⁵ and the developer will try to recover its costs (and earn a return) through the sale of products covered by the patent, licensing others to use the invention (often a product or process), or through the outright sale of the patent.
- The legal creation of a new trademark (or one newly introduced to a given market) is usually not an expensive matter.¹⁶ In contrast, it will very often be an expensive business to make it valuable and to ensure that the value is maintained (or increased). Intensive and costly advertising campaigns and other marketing

activities will ordinarily be necessary, as will expenditure on the control of the quality of the trademarked product. The value and any changes will depend to an extent on how effectively the trademark is promoted in the markets in which it is used.

The very fact that costs are incurred mainly before patentability for inventions or typically mostly after registration of trademarks – to keep value alive with proper advertising – may well have important transactional differences, both in economic and in subsequent fiscal terms:

- patents are ripe for sale or licensing even immediately after registration, considering also their finite useful life, with typically soon peaking and then declining values;¹⁷
- trademarks need time and long-term investments to become valuable, this being a result of the perceived quality of branded products.

Considering the timely value chain of patents and trademarks, their differences – aforementioned in broad terms to be adapted to specific cases – are likely to be challenged and incorporated within either sale or licensing contracts, according also to the tasks to be performed by the buyer or licensee. ‘Value will also depend on the reputation of the owner for quality in production and rendering of services and on how well this reputation is maintained. In certain cases, the value for the licensor may increase as the result of efforts and expenditure by the licensee’ (TPG, section 6.9).

3 A PROBLEMATIC APPLICATION OF THE ARM’S LENGTH PRINCIPLE

As outlined by section 6.13, ‘the arm’s length principle appears to be difficult to apply to controlled transactions involving intangible property because such property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of the transaction’.

Actually, as it has been shown above, trademarks and patents do always have – not ‘may’ have – an ontological ‘special’ character.

A further problem, properly described in section 6.14, is concerned with the circumstance that ‘arm’s length pricing for intangible property must take into account for the purposes of comparability the perspective of both the transferor of the property and the transferee’. There is a sort of double arm’s length, referring to the transferor but

Notes

¹⁵ Examples of contract research activities are currently found at paras 2.55, 7.41 and 9.26 of TPG.

¹⁶ A trademark may be sold, licensed, or otherwise transferred by one person to another.

¹⁷ Terminal value of an expiring patent is not necessarily zero, if it can still be used as a distinctive, albeit no more protected, invention, during and after its phase out.

also to the transferee, which finds a final synthesis in the agreed transactional price:

From the perspective of the transferor, the arm's length principle would examine the pricing at which a comparable independent enterprise would be willing to transfer the property. From the perspective of the transferee, a comparable independent enterprise may or may not be prepared to pay such a price, depending on the value and usefulness of the intangible property to the transferee in its business. In such a case, the usefulness of the property should be taken into account when determining comparability.

A further characteristic is concerned with 'usefulness of the property', considered from both sides; this theoretic concept may better be understood and investigated considering not only the functional analysis of both the potential seller and the potential buyer (answering questions such as, where is the intangible best located and how does it synergistically interact with other assets¹⁸ in order to create value and a consequent positive taxable base?) but also the forecast of the future 'usefulness' of the intangible for sale; the price, being represented by the market equilibrium between supply and demand, is a function of estimated future usefulness of the intangible, typically expressed in economic terms by extra-revenues or extra-cash flows.

Usefulness of property depends also on the traditional dichotomy between exchange-value and use-value known from the times of Aristotle and then Adam Smith and Carl Marx: a potential seller of the intangible is stimulated when the exchange-value exceeds the use-value, while the opposite happens for the potential buyer. Even in this case, economic marginality – expressed by expected revenues exceeding expected costs – matters.

As noted in section 6.20, 'in applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between the controlled and uncontrolled transactions should be considered'.

Possible factors include:

- the expected benefits from the intangible property (possibly determined through a net present value (NPV) calculation);
- any limitations on the geographic area in which rights may be exercised;

- export restrictions on goods produced by virtue of any rights transferred;
- the exclusive or non-exclusive character of any rights transferred;
- the capital investment (to construct new plants or to buy special machines), the start-up expenses and the development work required in the market;
- the possibility of sub-licensing;
- the licensee's distribution network;
- whether the licensee has the right to participate in further developments of the property by the licensor.

Calculation of expected benefits with NPV is given by the following formula, considering NPV accruing to equity holders (the ultimate taxpayers):

$$NPV_{\text{equity}} = \sum_{t=1}^n \frac{CFN_t}{(1 + K_e)^t} - CF_0$$

wherein:

CFN = net cash flow; t = time; K_e = cost of equity; CF_0 = initial investment.

Proper calculation of NPV should include even the other factors, incorporating in the net cash flow's geographic limitations, restrictions, exclusivity, and so forth. One well-known critical problem with NPV calculation is represented by the intrinsic difficulty to properly estimate cash flows, especially in the presence of unforeseeable events or flexibility options, particularly frequent with patents.¹⁹

As Silberstein points out: 'There is currently no international consensus on the circumstances where financial valuation approaches and in particular the discounted cash flow (DCF) may be appropriate for applying the arm's length principle', and again: 'one of the main difficulties regarding the application of these methods is that they are based on inherently uncertain projections';²⁰ if tax audits take place some years later,²¹ projections become history, but differences from reality, in any sense, may well be huge.

Particular attention has to be paid if the purchase cost of the patent or trademark is capitalized, also for tax purposes, according to the legislation of each country.

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¹⁸ With economies of scale and experience that are due to naturally expand the tax base.

¹⁹ A patent is like a real option, because it allows its owner to choose between exclusively commercializing the patented invention sometime during the patent term or foregoing commercialization altogether. See C.A. Cotropia, 'Describing Patents as Real Options', *Journal of Corporation Law* (2009): 34–1127. Available at SSRN, <<http://ssrn.com/abstract=1359445>>.

²⁰ See TPG, Ch. VI, C.4 Arm's length pricing when valuation is highly uncertain at the time of the transaction.

²¹ This problem is considered in s. 6.35.

According to section 6.21, ‘when the intangible property involved is a patent, the analysis of comparability should also take into account the nature of the patent (e.g., product or process patent) and the degree and duration of protection’. TPG explicit that ‘not only the duration of the legal protection but also the length of the period during which patents are likely to maintain their economic value is important’. An estimate of the real useful life of the patent is always problematic due also to the difficulty to foresee competitive inventions or the evolution of the market, even beyond the expiry of the protection.

Many intangibles can be considered only within a portfolio, for instance, in the case of complementary patents or associated trademarks (e.g., of the car manufacturer and model), using factor analysis: ‘for example, where a patented invention covers only one component of a device, it could be inappropriate to calculate the royalty for the invention by reference to the selling price for the complete product’.²²

4 LICENSE OR SALE?

Intangible transactions may temporary or permanently transfer the property or the right to use the patent or trademark, being alternatively classified under a license or sale agreement, which should consider both the legal (formal) and the economic (substantial) ownership.

Even if many comparability problems are similar in both circumstances, some major differences arise and may be fiscally significant:

- (temporary) licenses are more common within the group, where information asymmetries are minimized and synergies shared, and on an international basis, so as to bypass geographical exclusivity problems – and so making arm’s length comparisons applicable but more difficult to estimate;
- definitive sales may conversely occur even outside (international) groups, especially when a small and independent company who owns a promising patent (or, less frequently, a still appealing but declining brand) is aware of the intrinsic and potential value of its intangible but lacks the economic and financial soundness to properly exploit it, especially abroad;
- licensing (outside the group, so making TP issues irrelevant) may typically be riskier than selling for the owner of the intangible, since in many cases the royalty rate depends on unknown characteristics of the licensee (‘when the royalty is based on the licensee’s output or

sales, the rate may vary according to the turnover of the licensee²³);

- risk is asymmetrically transferred from the seller/licensor to the buyer/licensee, both in its dimension and timing, with a potentially not negligible impact on the tax base and its repartition in different fiscal years (the longer the period, the higher the possibility of smoothing incomes); albeit this parameter is difficult to estimate, it should be carefully investigated, together with its economic and fiscal impact; risk transmission is definitive in sales (unless there are earn-out or other conditional clauses), being otherwise shared and diluted across time in license agreements.

A combination between licenses and sales is always possible, especially when a license contract contains a put and call option, according to which, after a certain time span and at a stated price, the intangible may be purchased by the licensee or sold by the licensor. This option has a deferred fiscal impact, which may be uneasy to assess and challenge, especially if the option structure is complex and depends on different contingent states of the world.

Legal ownership of the intangible is not exclusively linked to its exploitation, not only because of possible licensing but also as a consequence of the versatility of the intangible, which can be exploited with partnership agreements, risk sharing, common investments, and so forth, within an articulated international value chain, where it may prove difficult to estimate the value of each segment and its consequent tax base. Section D (Marketing activities undertaken by enterprises not owning trademarks or trade names) of Chapter 6 of TPG is dedicated to this slippery issue: ‘difficult transfer pricing problems can arise when marketing activities are undertaken by enterprises that do not own the trademarks or tradenames that they are promoting (...)’ (section 6.36).

Cost contribution arrangements are dealt with in Chapter VIII of TPG.

5 TRYING TO COORDINATE TRANSFER PRICING METHODS WITH FAIR MARKET VALUATIONS OF PATENTS AND TRADEMARKS

The link between standard market evaluation models for intangibles and TP methods is important because they are in practice likely to interact much more than expected. Whereas financial/market models are potentially used in

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²² Section 6.22.

²³ Section 6.16.

any transaction, even irrespectively of tax purposes, TP methods matter only within international intra-group negotiations; but since negotiations relevant for TP have to follow an arm's length comparison with uncontrolled transactions, the latter takes place outside any TP application perimeter and so is typically driven by financial/market models, not necessarily consistent with tax objectives.

In other words, transactions relevant for TP have to be compared to uncontrolled transactions, which are outside this (narrower) fiscal framework; a comparative analysis of fiscal and financial/market models so seems relevant, albeit uneasy to carry on. Accepted market good practices may conveniently be modelled in a new version of TP guidelines for intangibles.

Market valuations of intangibles, such as patents or trademarks, specifically address the peculiar appraisal problem²⁴ with ad hoc empirical or analytical methods; empirical methods are based on allegedly comparable market prices (hopefully referring to ... 'uncontrolled' transactions), and value is estimated upon guideline transactions of comparable assets, whereas analytical methods have a sounder scientific background and a longer appraisal tradition, mainly referring to financial and/or economic flows estimates, deriving from exploitation of the intangible.

The main financial/market methods used for patent or trademark fair pricing are the following:

- (1) cost-based methods, with an estimate of the costs to reproduce or replace the intangible from scratch, assuming that there is some relationship between cost and value; this method ignores both maintenance and the opportunity cost of time (reproducing an intangible may take years, while purchase is immediately beneficial) and are not very useful for income generating assets, such as performing patents or trademarks, as stated also by TPG;²⁵
- (2) income methods, based on the estimate of past and future economic benefits, assessing the ability of the intangible to produce income, with licensing (royalties) or sale of the intangible; they may include:
 - capitalization of historic profits deriving from the exploitation of the intangible;
 - DCFs to estimate NPV, duly incorporating risk factors in the discount rate;

- gross profit differential methods; they look at the difference in sales price between a branded (or patented) product versus a generic one; the profit differential is then forecasted and discounted;
- excess or premium profit methods; similar to the gross profit, it is determined by capitalizing the additional profits generated by the business over and above those generated by similar businesses that do not have access to the intangible asset. Excess profits can be calculated by reference to a margin differential;
- relief from royalty method: based on the assumption that the owner of intangible is 'relieved' from paying a royalty to obtain its use, the method considers the hypothetical royalty that a potential user would be willing to pay, and discounts its projection;

- (3) market-based methods, evaluating an intangible asset by comparing it with the sales of comparable/similar assets (considering their nature, using functional analysis, and so forth). Information asymmetries often conceal the real (mostly secret) nature of the allegedly comparable transaction. A market-based variety may refer to the evaluation of the incremental equity, with indicators of the market surplus, given for instance by the Tobin's Q,²⁶ the ratio between the market value and replacement value of the same asset; a market value exceeding the replacement value may be a numerical consequence of valuable intangibles.

As seen above, cost-based methods are not particularly fit for patents and in particular trademarks (whose accrued past costs may be negligible, in front of possible larger future advertising investments to promote the brand), whereas market-based methods, so ... happily close to the Comparable Uncontrolled Price method – the first option within TPG TP choices – seem attractive but difficult to use. Analytical databases,²⁷ used also by tax authorities, make comparisons easier to find and provide international examples of both royalty rates and of contractual clauses; their usefulness is however often biased by differences that are frequently large enough to make the comparison meaningless (appealing but ... appalling), especially if serious preliminary functional analysis is conducted.

The purpose of the evaluation may change according to the context and the foreseen scenario and may be targeted at the following different values:

Notes

²⁴ See A. Amram, 'The Challenge of Valuing Patents and Early-Stage Technologies', *Journal of Applied Corporate Finance* (2005): 17–68; J.A. Cohen, *Intangible Assets. Valuation and Economic Benefit* (New Jersey: John Wiley & Sons, Inc., 2005); J.F. Duffy, *A Minimum Optimal Patent Term* (Berkeley Center for Law and Technology, Paper 4, 2005); J. Hand et al., *Intangible Assets: Values, Measures, and Risks* (Boston: Oxford University Press, 2003); G. Parchomovsky & R.P. Wagner, *Patent Portfolios* (University of Pennsylvania Law School, Scholarship at Penn Law, Paper 51, 2004); R.F. Reilly & R.P. Schweihs, *Valuing Intangible Assets* (New York: McGraw-Hill, 1999).

²⁵ 'The actual fair market value of intangible property is frequently not measurable in relation to the costs involved in developing and maintaining the property', s. 6.27.

²⁶ J. Tobin, 'A General Equilibrium Approach to Monetary Theory', *Journal of Money Credit and Banking* (1969): 1–15.

²⁷ See for instance <www.royaltysource.com>, <www.ktmine.com>, <www.royaltyconnection.com>, <www.royaltystat.com>.

- Fair Market Value: The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.²⁸
- Investment Value: The value of the intangible would be worth in consideration of the specific buyer's intended use (and so with use-value higher than exchange-value).
- Intrinsic Value: The value that an investor considers, on the basis of an evaluation of available facts, to be the 'true' or 'real' value that will become the market value when other investors reach the same conclusion.²⁹
- Liquidation Value: The company may pass from a going concern to a break-up context, this being a particularly conservative scenario for intangibles, especially if not autonomously tradable.

Whereas fair market value is fully consistent with TP arm's length principles, other scenarios may seem less impartial, especially if we consider the investment value to be strategically biased and typically not 'uncontrolled'.

Chapter VI of the TPG confirms to a large extent that all five TPG recognized methods may, in theory, apply to transactions involving intangibles, depending on the facts and circumstances of the case. At the same time, it also repeatedly points to the difficulties that arise in their application, due in particular to comparability issues where valuable unique intangibles are involved.³⁰

An analysis of the main TP methods, described in Chapter II of TPG, goes far beyond the scope of this paper; some preliminary link between TP methods and financial/market techniques may however be investigated.

The comparable uncontrolled price (CUP) method compares the price charged in a TP-sensitive controlled transaction to the price of a comparable uncontrolled transaction in comparable circumstances;³¹ this methodology, consistent with market-based transactions, faces severe limitations within the intangible market,

where external comparability, for many aforementioned reasons, is often strongly biased or unfeasible.

According to section 6.23, 'in establishing arm's length pricing in the case of a sale or license of intangible property, it is possible to use the CUP method where the same owner has transferred or licensed comparable intangible property under comparable circumstances to independent enterprises'. In practice, this may be considered a wishful thinking exercise – nice but unlikely.³²

According to the resale price method (RPM), goods are regularly offered by a seller or purchased by a retailer to/from unrelated parties at a standard 'list' price less a fixed discount. Testing is by comparison of the discount percentages.³³ According to section 6.23, 'If the associated enterprise sub-licenses the property to independent parties, it may also be possible to use some form of the RPM to analyse the terms of the controlled transaction'. And according to section 6.24, 'in the sale of goods incorporating intangible property, it may also be possible to use the CUP or RPM following the principles in Chapter II'.³⁴

The transactional profit split method is an alternative to one-sided methods and first identifies the 'combined' profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those combined profits between the associated enterprises (so recognizing also the value added by licensees) on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.³⁵ According to section 6.26, 'in cases involving highly valuable intangible property (...) the profit split method may be relevant although there may be practical problems in its application', especially in the presence of non-routine functions.³⁶

Other TP methods (cost plus; transactional net margin) are not considered suitable for valuable intangibles. TPG flexible approach bypasses the hierarchical 'best method rule', proposing a set of alternative methods.

Notes

²⁸ The International Glossary of Business Valuation Standards.

²⁹ S.P. Pratt, *Business Valuation Body of Knowledge: Exam Review and Professional Reference* (New York: Wiley & Sons, 2003), 75.

³⁰ Silberstein, *supra*, 4.

³¹ TPG, s. 2.13.

³² Consider also TPG s. 6.28 ('Intangible property may have a special character complicating the search for comparables and in some cases making value difficult to determine at the time of a controlled transaction involving the property').

³³ See also TPG 2.14-2.31, 26.

³⁴ 'When marketing intangibles (e.g., a trademark) are involved, the analysis of comparability should consider the value added by the trademark, taking into account consumer acceptability, geographical significance, market shares, sales volume, and other relevant factors. When trade intangibles are involved, the analysis of comparability should moreover consider the value attributable to such intangibles (patent protected or otherwise exclusive intangibles) and the importance of the ongoing R&D functions'.

³⁵ TPG, s. 2.108.

³⁶ 'Because of the difficulty in obtaining uncontrolled profit split information, including information needed for consistent accounting treatment, it is likely that the comparable profit split method will seldom be a viable approach'. Income Tax Reg. s. 1.482-6(c)(2), quoted in <<http://pmstax.com/intl/bull9902.shtml>>.

6 THE DIFFICULTY TO IDENTIFY A FAIR VALUE FOR PATENTS AND TRADEMARKS ACCORDING TO IAS 38

IAS 38 (section 12) defines an intangible asset as *an identifiable non-monetary asset without physical substance*. The definition requires an intangible asset to be identifiable to distinguish it from *goodwill*. An asset is identifiable if it either:

- (a) is separable, that is, is capable of being separated or divided from the entity and sold transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
- (b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Intangible assets may be carried at a re-valued amount (based on fair value) less any subsequent amortization and impairment losses only if fair value can be determined by reference to an active market [section 75]. Such active markets³⁷ are expected to be uncommon for intangible assets [section 78].

The classification of the main financial/market evaluation methods³⁸ is consistent with international accounting principles; according to IFRS 13:62, three widely used valuation techniques are:

- market approach – uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g., a business);
- cost approach – reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost);
- income approach – converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts.

In some cases, a single valuation technique will be appropriate, whereas in others, multiple valuation techniques will be appropriate [IFRS 13:63].

Recognition of self-generated intangibles is forbidden and capitalization of incurred costs typically not admitted or strongly restricted; the prudential exclusion of home-grown intangibles from the balance sheet increases information asymmetries, hampering comparability.

7 CONCLUDING REMARKS

Both multinationals and tax regulators have converging interest in reducing litigation about TP issues, especially if they regard non-routine assets such as super/exclusive intangibles, within increasingly specific industries. Real economic substance of economic transactions is increasingly important and consequently prices do not have to be arbitrary, capricious or unreasonable; pricing calculations have to be adequately supported, compliant, acceptable, reliable and verifiable.

The most controversial issue is that intangibles, especially if exclusive, are difficult to compare, and also because arm's length uncontrolled transactions are both hardly similar and difficult to find out: sale circumstances may seldom be identified as 'substantially the same', and comparisons are often ambiguous and fictitious. Identification of proper comparables is also hindered by the intrinsically slippery perimeter of overlapping commodity sectors.

This difficult comparison is particularly true with technology-related patents, which are typically case specific and whose transactions are mostly 'company confidential' and so not of public domain, due to a natural reluctance to inform competitors.

For brands or trademarks, the context is different, since there is normally an intrinsic value in divulging their sale or license, even if particulars are typically not disclosed.

Further efforts are needed in order to improve the quality and comparability of data bases, rulings, and advance price agreements, disentangling the intangibles' value chain and softening their natural information asymmetries.

Notes

³⁷ According to IFRS 13, Appendix A, an 'active market' is 'a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis'.

³⁸ See para. 5.